Reflections on the Tenth Anniversary of the Financial Crisis: The Collapse and Aftermath (Part One of Two)

By Robin L. Barton, The Hedge Fund Law Report

On September 15, 2008, Lehman Brothers filed for bankruptcy, essentially marking the beginning of the 2008 global financial crisis. The stock market plummeted, unemployment rose, millions of people in the U.S. lost their homes to foreclosure and hedge funds that had invested heavily in subprime mortgage-backed securities collapsed.

In response, Congress passed the Dodd-Frank Act, which, among other things, directed the Federal Reserve to establish risk-based capital requirements and liquidity requirements for large banks; barred banks from maintaining ownership interests and other relationships with hedge funds and private equity funds; and amended the Investment Advisers Act of 1940 (Advisers Act) to change registration, reporting, recordkeeping and disclosure requirements for private funds.

Ten years later, however, is the financial system stronger and more resilient? Have hedge funds changed their structures, practices and compliance programs to better protect themselves and their investors? How have new regulations affected the hedge fund space?

In connection with the tenth anniversary of the financial crisis, The Hedge Fund Law Report asked Lowenstein Sandler partner Benjamin Kozinn, who was vice president and associate general counsel at Goldman Sachs during the crisis, to answer these and other questions on the 2008 crisis and its impact on hedge funds. In this first article in a two-part series, Kozinn explains the causes of the crisis; the role – if any – hedge funds played in it; the regulatory changes in its aftermath; and the new focus on counterparty risk. In the second article, he will discuss the focus on compliance programs and chief compliance officers (CCOs); the present strength of the financial system; changes in hedge fund strategies; the current state of hedge fund regulation; and the future of the hedge fund space.

For additional insight from Kozinn, see our two-part series “Why Fund Managers Should Ensure Personal Trading Policies Address Cryptocurrencies and ICOs” (Jul. 26, 2018); and “Factors Fund Managers Must Consider When Addressing Cryptocurrencies and ICOs in Personal Trading Policies” (Aug. 2, 2018).

The 2008 Crisis

HFLR: It is the tenth anniversary of the 2008 financial crisis. Where were you working then?

Kozinn: I was at Goldman Sachs, working as a lawyer in the prime brokerage business. That was an interesting place to be from 2007-2012.

The week after Lehman filed for bankruptcy, my colleagues and I probably spent 16 hours a day on the phone with hedge funds and other institutional investors of Goldman Sachs, helping them understand why their assets were safe as a regulatory matter due to a rule that nobody outside of our world had heard of: Rule 15c3-3, the so-called “Customer Protection Rule.” It’s a rule under the Securities Exchange Act of 1934 that puts significant handcuffs on how broker-dealers handle customers’ assets, which is why, on a historical basis, many broker-dealer failures have not been major catastrophes.

HFLR: What happened ten years ago?

Kozinn: Ten years ago, we had a systemic breakdown in our financial system, primarily driven by the housing crisis. In hindsight, home prices in certain markets were very artificial as a result of a lack of transparency around mortgage origination. In addition, there was a lack of regulation with respect to the creation and sale of derivative instruments related to those mortgages (along with synthetic versions of those derivative instruments). Finally, at a certain level, there was a lack of fiscal responsibility by individuals.

When there is a crisis, people always want to point a finger at one person or one thing. In reality, however, ten years ago, it was a confluence of things. We had a combination of mortgage brokers at a consumer level behaving badly; individual home buyers going well beyond their means; a banking sector speculating significantly in the market; and
financial professionals structuring products that allowed for the packaging and continuation of the issuance of these bad mortgages.

As the economy started to crack, the floodgates then opened in a seismic way, creating a tsunami of credit problems in the country, both at the corporate and consumer levels.

HFLR: What role, if any, did hedge funds play in the crisis?

Kozinn: At the consumer level, people were getting mortgages on the basis of their stated income and without having to produce any documentation such as W-2s. Financial products that were created to trade on that asset class grew geometrically during that period. Some hedge funds invested in those products to seek profits for their investors but suffered significant financial losses instead. The smart hedge funds saw what was going on in the broader market and were able to bet against those products.

I personally believe that the hedge fund community did not have any significant role in creating the financial crisis and was certainly nowhere near as culpable as other players. Hedge funds did continue to feed the machine of derivative products that were being created to fuel the ongoing purchases of mortgages and securitization of mortgages. In the end, however, hedge funds were just the consumers of those products.

The Aftermath

Regulatory Changes

HFLR: What were some of the key regulatory changes made in the wake of the crisis, and how did they affect hedge funds?

Kozinn: Pre-crisis, the hedge fund industry was subject to less regulatory scrutiny by the SEC than it faces today. Most hedge fund managers were not required to be registered with the SEC, although some did register because they believed it was prudent or simply because of investor pressure. In certain cases, funds with very substantial assets under management (AUM) were not under the regulatory eye of the SEC or the CFTC.

The financial crisis largely changed that. New regulations required all investment advisers with a certain level of AUM to register with the SEC as investment advisers, to file certain information about themselves that would be made available to the public and to subject their firms to regular examination by the SEC.

For fund managers, that was the most significant change from the crisis because, outside of general principles of fraud and fiduciary obligations, they were not subject to a detailed set of regulations. Of course, the best managers either were required to be registered, operated as if they were registered or decided to register voluntarily because it gave them more credibility with their investors by showing that they were willing to subject themselves to the oversight of an independent governmental authority.

[See “Does Dodd-Frank Enable Certain Hedge Fund Managers to Elect Between Registration with the SEC and CFTC?” (Oct. 8, 2010).]

Focus on Counterparty Risk; Investor Due Diligence

HFLR: Aside from what they are now required to do by regulation, did hedge funds make internal changes to their policies and procedures in the wake of the crisis?

Kozinn: Yes. After the collapse of Lehman Brothers, there has been intense focus on counterparty risk. Assets were frozen in the Lehman Brothers bankruptcy, and it was unclear whether, when and how people were going to recover those assets. That was very frightening for both hedge funds and their investors, and it had two consequences.

First, hedge fund managers use, as one of their key vendors, a prime broker or brokers. Pre-crisis, larger fund managers generally had one or maybe two or three brokers. Post-crisis, there was a move toward utilizing more than a few prime brokers. Suddenly fund managers had seven, eight or even nine prime brokers.

Fund managers started to realize, however, that it is difficult to manage so many different counterparties, and it may not be a best practice to have a multitude of prime brokers. After all, at a conceptual level, the whole point of having a prime broker is to consolidate trading and other activity in one place. When a manager uses so many prime brokers, the word “prime” no longer has any meaning.

There has also been a realization that, if a fund manager spreads its business around too much, then it isn’t that important to any one service provider, which causes a deterioration in service. Fund managers want their service providers to think they are very important clients.

As a result, over the last three to four years, there has been a return to normalcy, so to speak. Fund managers have begun to
refocus on using a few key prime brokers that they trust, like doing business with and believe are the safest.

Second, counterparties have always conducted due diligence on hedge fund managers. Now, fund managers are focusing very carefully on who has custody of their assets and asking how they are going to keep their investors’ assets safe from another Lehman Brothers-like collapse. This means having a much more in-depth understanding of how assets are financed, where they are held, who is holding them, what is the counterparty’s creditworthiness, which bankruptcy regime is a counterparty subject to and what happens if all else fails.

Fund managers have also begun to consider what they need to do, even while things are calm, to ensure that they can move assets between prime brokers if they are concerned with a broker’s financial stability. On the operational side, that was probably the single biggest impact: fund managers really having to get into the weeds as to how their assets were being financed and where they were being maintained.

[See our three-part series on how fund managers can mitigate prime broker risk: “Preliminary Considerations When Selecting Firms and Brokerage Arrangements” (Dec. 1, 2016); “Structural Considerations of Multi-Prime or Split Custodian-Broker Arrangements” (Dec. 8, 2016); and “Legal Considerations When Negotiating Prime Brokerage Agreements” (Dec. 15, 2016).]

HFLR: It sounds like fund managers started conducting more in-depth due diligence on those counterparties.

Kozinn: Yes, they did, which dovetails into the next piece of the story: hedge fund investor due diligence. Investors are driving a lot of the changes that have been made to the infrastructure of hedge funds post-crisis. Investors had historically felt like the hedge fund industry was an exclusive club that they really wanted to get into because those funds could produce much better returns than the market and provide downside protection against another crisis. Thus, they did not ask a lot of questions.

After the crisis, however, investors started saying, “We’re trusting you as a manager with a lot of money, so we really need to get under the hood and see how you run your business.” In other words, they are no longer just concerned with a fund’s investing prowess. Investors now also want to know things like:

- What compliance controls does the fund manager have in place?
- Who are the CCO and chief operating officer, and what is their experience?

- What policies, procedures and practices are in place to ensure that the fund is not going to lose investors’ money because of poor compliance infrastructure?

This increased level of scrutiny is more investor-driven than regulatory-driven. Investor due diligence sometimes reveals issues within a fund manager, such as:

- a lack of understanding of how to transfer assets or reconcile trades on a daily basis;
- inadequate expertise regarding calculating net asset value or dealing with difficult-to-value assets; and
- the absence of committees or individuals to internally assess or question the fund's practices, such as whether they are truly achieving "best execution" or how the portfolio managers are marking their assets.


HFLR: Does this increased due diligence apply to both qualified individual investors and institutional investors?

Kozinn: Not really. Most of this was driven by the large fund-of-fund investors, pensions, endowments and family offices that built teams of operational due diligence experts to ask hard questions separate from the investment diligence team. In some cases, the operational team may veto the investment team’s decision to invest with a fund manager because of concerns that the manager’s control functions are not adequate to protect the investor’s assets or that there is an insufficient compliance infrastructure.
In the wake of the 2008 global financial crisis, the landscape of the hedge fund industry has changed. Hedge fund managers now face more regulation; more scrutiny from both regulators and investors; and more compliance burdens. As a result, fund managers have been forced to change their structures, practices and compliance programs.

In connection with the tenth anniversary of the financial crisis, The Hedge Fund Law Report spoke to Lowenstein Sandler partner Benjamin Kozinn about the 2008 crisis and its impact on the hedge fund space. In this second article in our two-part series, he explores the new focus on compliance programs and chief compliance officers (CCOs); the present strength of the financial system; changes in hedge fund strategies; the current state of hedge fund regulation; and the future of the hedge fund space.

The New Focus on Compliance

HFLR: Have the roles of the CCO and the compliance program become more important and scrutinized?

Kozinn: The CCO definitely became much more scrutinized, especially by investors. For a period of time, regulators scrutinized CCOs more closely, too. For several years after the financial crisis, the SEC sought out CCOs and made examples of them by accusing them of failing to perform their functions adequately. That scared a lot of CCOs, who felt that even if they were honestly doing their best, the SEC could still come down on them.

In the last three to four years, however, the noise from the regulators as to CCO liability seems to have subsided. The SEC wants the best and the brightest people in the CCO role at hedge fund managers. Threatening prosecution even just civil prosecution – had a chilling effect on getting the best people into those roles.

The other role that became more important was the chief operating officer (COO), who now has to bear the burden of dealing with investors’ due diligence requests and ensuring that the fund manager is adequately meeting the demands that investors are placing on it. In many instances, this means higher costs to run the business than historically has been the case.

Pre-crisis, hedge funds were often run really leanly. For example, many hedge funds had maybe ten people in the office, along with a COO who was only there to help run the non-investment side of the business, such as human resources, payroll and accounting.

HFLR: And now?

Kozinn: That role has changed dramatically in the sense that that person has to understand regulation and how it impacts the business. Whether he or she is the chief financial officer, COO or a combination, he or she is ultimately responsible for ensuring that the regulatory reporting is being done in a timely and accurate fashion, usually in conjunction with the CCO, if there is one, or the general counsel (GC). That person must also ensure that disclosures to investors – both at the outset of investment and as an ongoing matter – are fair, are accurate and do not omit anything material. Plus, there is more scrutiny on marketing materials and advertising than there ever was.

So, the overall demand on that side of the business has increased significantly and has become, in some respects, just as important as a good return. In the end, of course, a good track record and performance will rule the day. A good track record coupled with a weak infrastructure (such as compliance, accounting and operations), however, may cause people to question the stability of the firm and the track record. If there...
Kozinn: That is an interesting question. It is hard to know whether the crisis itself or post-crisis returns have caused more pushback on fees from investors. We are currently in one of the longest bull runs in the broader stock market. Some investors have been questioning hedge fund fees for funds whose returns are not exceeding or keeping up with the broader markets, but in fact, many hedge fund strategies are intentionally designed to not correlate with the market on a one-for-one basis. This means that, although they may not match every point when the S&P rises, they don't match every point when the S&P falls – and they may even make money in a down market. If a hedge fund is not outperforming the broader markets, an investor selecting a hedge fund may be under pressure to explain why they are paying 2 and 20 fees. This is obviously a short-sighted (and often misinformed) view, but many investors – particularly state plan investors – face political pressure.

Fund managers must balance the increasing demands on infrastructure and the cost of getting the right people in compliance, accounting and operations positions against a fee structure that aligns the investor and manager more closely. If you pull all the revenue away from the managers, it becomes really challenging for them to get the best people and the best systems in place to run their businesses in a way that is compliant and in sync with the investors’ expectations on the business side.

[See “The Death of Alpha: A True Challenge or a Poor Manager’s Excuse? DMS Summit Discusses Alpha Generation, ‘2 and 20’ Fees, AI and Impact Investing” (Apr. 12, 2018).]

The Present State of the Financial System

HFLR: In your opinion, is the financial system stronger now? Is it more resilient?

Kozinn: Absolutely. We have a lot more capital in the system. We generally have smart regulation, even if some of it may have gone too far. Hopefully, we will see some fine tuning of the regulation. Overall, however, I definitely think we are in a much safer environment.

[See “SEC Chair Outlines Approach to Dodd-Frank Rulemaking and Expectations for Fund Gatekeepers” (Feb. 15, 2018).]
The Future of the Hedge Fund Industry

HFLR: Can you play oracle and opine on what we might expect in the next five years in the hedge fund industry?

Kozinn: The next recession will reinvigorate the hedge fund industry. People are going to realize that this bull run will end at some point. As a result, people will need something other than full exposure to long positions in their portfolios to protect themselves.

There will be a renaissance for hedge funds in the next crisis. The big funds will likely continue to get bigger and offer more products that are customized and tailored to investor demands. The proliferation of index products will also likely continue.
We will probably see more use of artificial intelligence in the next five years now that fund managers are starting to use computers not just for high-speed trading, but also for creating machine-learning strategies that are able to trade in a way that involves less human intervention. We may see more managers using computing power and data to teach machines how to look at information and make trading recommendations. To do that, however, requires a massive amount of computing power.

[See “How to Prepare for the Technological Revolution’s Transformation of the Hedge Fund Industry” (Apr. 5, 2018).]

In addition, new portfolio managers may be able to step out of the shadows of their former bosses with new ideas and different ways of thinking about investing. There may be opportunities in the marketplace that a smart, young, talented manager may see and understand that an old timer may not.

Thus, we may see a resurgence in the search for new talent and new portfolio managers, although some people may want to stay with the tried and true. This industry has always had young energy and an entrepreneurial spirit. New talent have always wanted to try their own hands at running their own shops, and I don’t see that ever ending. There have always been investors who want to find the newest talent and not just rely on people who have gotten comfortable in their jobs.

HFLR: Sometimes you need somebody who is going to think about things from a different angle or perspective.

Kozinn: Right. That is why fund managers and investors look for hires who are smart and willing to challenge the old guard on how to invest. They want people who have a contrarian view of things or the ability to analyze securities in a way that others don’t see. They also want individuals who may be open to new kinds of investments, such as cryptocurrency.

[See “HFLR Cryptocurrency Webinar Examines Regulatory Developments, ICOs, Cryptocurrency Sweep, Custody and Other Compliances Issues” (May 3, 2018).]