

**HEDGE FUNDS:**

**ISSUES FOR TRADE UNIONISTS**

**A UNI Global Union Report**

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## Foreword

We are in the midst of the world's worst financial crisis since the crash of the 1920's. We have out of control financial markets with systems of supervision and regulation which are not up to the task. In many instances not even the top management of the financial institutions were aware of the consequences of their investment policies of the companies they were supposed to be running. Ignorance reigned whilst bonuses and profits soared. The world's political leaders have recognised that today's financial markets are a black hole with a toxic mix of new instruments, methods and dated of regulation. Reality has brought a crash landing for financial markets.

It is important that unions have an understanding of the new financial instruments which have gained so much influence in financial markets. That is why UNI Global Union has produced this introductory report on hedge funds which follows other UNI reports on private equity and pension fund investment in alternative assets.

The activities of hedge funds are now part of a wider global debate on the taxation, regulation and transparency of alternative financial assets. They have vast wealth at their disposal with the aim of winning big for their usually already fabulously rich client base. They can impact market behaviour and the decisions of individual companies. When things go wrong the consequences are dramatic.

UNI affiliates have reported how hedge funds influence the day to day operations of companies. These are known as 'Activist Hedge Funds'. When a hedge fund becomes involved in day to day media and whispering campaigns against companies in search of hyper returns, we find a downward manipulation of working conditions and employment levels. It would appear that the hedge funds objective of promising high returns to its investors makes no place for the broader social consequences of their behaviour. Whilst many businesses have made attempts to have higher standards on CSR, this discussion is largely absent from the hedge fund world. Yet their decisions impact millions of working people everywhere.

UNI Global Union has commissioned this report on hedge funds to assist us to make sense of their implications on our members and highlight points of concern for trade unionists to consider.

**Philip Jennings**

UNI Global Union General Secretary

# Hedge Funds: Issues for Trade Unionists

|  |    |
|--|----|
| Introduction.....  | 3  |
| Background .....   | 3  |
| What are Hedge Funds? .....                              | 4  |
| Attractions of hedge funds .....                         | 7  |
| Types of hedge funds .....                               | 7  |
| Differences with Private Equity funds .....              | 8  |
| Differences with Mutual Funds.....                       | 9  |
| Structure and relationship with Prime Brokers .....      | 10 |
| The growth of hedge funds .....                          | 11 |
| The key players .....                                    | 13 |
| Location of hedge funds.....                             | 14 |
| Investors in hedge funds.....                            | 16 |
| Concerns over Hedge Funds.....                           | 17 |
| Activist hedge funds and the role of fund managers ..... | 17 |
| The impact of retailisation .....                        | 19 |
| Market integrity .....                                   | 19 |
| Systemic collapse or contagion .....                     | 20 |
| Questions and issues for trade unionists.....            | 22 |
| The wider economy .....                                  | 22 |
| Pension Funds.....                                       | 23 |
| Taxation .....   | 23 |
| Union objectives .....                                   | 23 |
| Transparency and corporate governance .....              | 23 |
| Tax regulation .....                                     | 25 |
| Pension funds.....                                       | 25 |
| Workers' rights.....                                     | 26 |
| Union action .....                                       | 27 |
| Research and education .....                             | 27 |
| The law – rights and regulation.....                     | 27 |
| Dialogue, campaigns and moves towards bargaining.....    | 28 |
| References.....  | 30 |

## ***Introduction***

In April 2005, Franz Müntefering, then leader of Germany's SPD, memorably described hedge funds as 'predatory scum that feed on misfortune' who 'fall like a plague of locusts over our companies, devour everything, then fly on to the next one' (Evans-Pritchard, 2005).

This paper draws together information on hedge funds, explaining what they are and identifies both general concerns and issues they raise of particular importance to trade unionists. It is part of the international trade union movement's efforts to bring hedge funds 'out of the shadows'.

## ***Background***

The 'financialisation' of the world economy has been one of the key features of the last three decades. Dore's definition (2007: 116-117) is widely used. He describes it as:

the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketed securities, and particularly of equities, among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles.

This linking together of countries through cross-border financial holdings (IMF, 2007a: 4) was eased by the rise of the capital market from the mid 1980s onwards on the back of the collapse of the Bretton Woods System. Governments across the OECD and beyond lifted exchange controls, lowered access barriers for foreigners in the banking sector and stock exchange membership and permitted trading in new financial instruments (Lutz, 2005: 144; Glyn, 2006: 65).

The authors of a report for the Socialist Group in the European Parliament (PSE, 2007: 31) suggest that capitalism has gone through a series of broad phases or stages, as follows:

- family-owned capitalism
- manager capitalism
- shareholder- value capitalism, and then
- 'fund-driven' capitalism (or financial market capitalism)

According to this model, we have entered this latest stage in the development of capitalism, 'within which the real economy is more and more dominated by the operational principles of the financial markets' (PSE, 2007: 32). The OECD Trade Union Advisory Committee (TUAC) (2007: 3) argues that in just five years, Dore's definition of financialisation has been overtaken by events –

specifically the growth in importance of 'alternative' investment vehicles such as private equity and hedge funds.

## ***What are Hedge Funds?***

As one commentator has noted, 'hedge funds are not new - just notorious' (Bush, 2006). Alfred W. Jones, a former financial journalist, is credited with inventing hedge funds in 1949 (Farrell et al, 2007: 97). But it was not until the 1980s that they came to public prominence with the emergence of figures like George Soros, most famous for when his Quantum Fund bet against the UK pound in 1992 and won.

There is no single definition of a hedge fund<sup>1</sup>. As the newly formed UK Hedge Fund Supervisory Board (HFSB) (2008) explains, the term 'was originally used to describe a type of private investment fund that charges investors a performance fee, uses leverage to magnify returns and short selling to limit market risk'. By this is meant an investment fund that borrows to boost its investment pool and thereby (hopefully) its returns to investors and also invests against the general trend of the market to 'hedge' its bets. Short selling involves making money on a decline in the value of a particular security<sup>2</sup>. However the HFSB also notes that although this description fits most hedge funds it does not fit all. The International Trade Union Confederation (ITUC) (2007: 14) cut through some of the confusion by describing hedge funds as 'investors that try to make a quick buck by speculating in everything possible'.

The European Central Bank (ECB) (2005: 8) agrees that there is no common definition, but observes that the term:

denotes a fund whose managers receive performance-related fees and can freely use various active investment strategies to achieve positive absolute returns, involving any combination of leverage, derivatives, long and short positions in securities or any other assets in a wide range of markets

A typical hedge fund is a limited partnership that invests on behalf of wealthy individuals and institutional investors. The fund generally charges investors 2% of the value of the assets managed each year plus an additional 20% of all positive performance - as against a typical UK unit trust which charges around 1.5% of the value of the assets managed each year (Warwick-Ching, 2006).

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<sup>1</sup> The US Securities and Exchange Commission carries a large number of slightly different definitions on their website. <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm>

<sup>2</sup> A very simplified example of the process of 'short selling' would be if Person A (the hedge fund) is loaned a table by Person B (a broker). Person A sells the table for £100. By the time that Person A has to return the table, the price of tables has gone down to £50 so the replacement cost paid by Person A is half the price at the time of the loan, resulting in a considerable profit. Of course, the example relies on Person A correctly predicting that the price of tables would fall. If they went up to more than £100, then Person A would incur losses and have to provide Person B with a more expensive table.

International Financial Services, London (IFSL, 2007a) argues that hedge funds have certain features which include: their exemption from much investment protection and disclosure regulation because most hedge funds are domiciled offshore or are subject to light touch regulation by onshore regulators; they have extreme flexibility in investment options; they are expected to deliver positive absolute returns whatever happens in the wider market; and fund managers' compensation is linked to performance with managers often investing their own money in the fund. And these fund managers can make extraordinary sums of money. According to the AFL-CIO, in 2006 the top 25 hedge fund managers collected \$14 billion dollars (AFL-CIO, 2007). To the list above should be added the fact that hedge funds generally require a high level of capital contribution – in 2007 in the USA this was increased from US\$1 million to US\$2.5 million, excluding equity in any homes or businesses (ITUC, 2007: 14) - thereby ruling out all but individuals of high net worth (the exceptionally rich).

The European Central Bank reports that, unlike many other pooled investment vehicles, hedge funds make extensive use of short selling, leverage and derivatives, but even these attributes are not exclusive to hedge funds. The key difference in the ECB's view (2005: 7) is that 'hedge funds do not have any restrictions on the type of instruments or strategies they can use owing to their unregulated or lightly regulated nature'. The ECB summarises some key hedge fund characteristics (reproduced in Table 1).

**Table 1: Hedge fund characteristics**

|                         |  |
|-------------------------|--|
|                         |  |
| Return objective        | Positive absolute returns under all market conditions. Usually managers also commit their own money, therefore the preservation of capital is important.   |
| Investment strategies   | Position-taking in a wide range of markets. Free to choose various investment techniques and instruments, including short-selling, leverage and derivatives.   |
| Incentive structure     | Typically 1-2% management fee and 15-25% performance fee. Quite often high watermarks apply (i.e. performance fees are paid only if cumulative performance recovers any past shortfalls) and/or a certain hurdle rate must be exceeded before managers receive any incentive allocation. |
| Subscription/Withdrawal | Predefined schedule with quarterly or monthly subscription and redemption. Lock-up periods for up to one year until first redemption. Some hedge funds retain the right to suspend redemptions under exceptional circumstances.  |
| Domicile                | Offshore financial centres with low tax and regulatory regimes, and some other onshore financial centres.  |
| Legal structure         | Private investment partnership that provides pass-through tax treatment or offshore investment corporation. Master-feeder structure may be used for investors with different tax status, where investors choose appropriate onshore or offshore feeder funds pooled into a master fund.  |
| Managers                | May or may not be registered or regulated by financial supervisors. Managers serve as general partners in private partnership agreements.  |
| Investor base           | High net worth individuals and institutional investors. High minimum investment levels. Not widely available to the public. Securities issued take the form of private placements.   |
| Regulation              | Generally minimal or no regulatory oversight due to their offshore residence or “light touch” approach by onshore regulators; exempt from many investor protection and disclosure requirements.  |
| Disclosure              | Voluntary or very limited disclosure requirements in comparison with registered investment funds.  |
|                         |  |

Source: ECB (2005: 7)

## Attractions of hedge funds

The main attraction of hedge funds to investors is the claim that their methods allow them to generate returns for investors against the general run of the market. Hedge funds are seen as providing investors with access to a wider range of portfolio diversification strategies and to new investment opportunities (McVea, 2007: 737). They are also regarded as likely to deliver much better returns with less risk than equities (traditional stocks or shares) (Ferguson and Laster, 2007: 47). However, 'hedge fund indices substantially overstate the returns and understate the risk of hedge funds' (Ferguson and Laster, 2007: 48). There is also a problem in relation to access to reliable data on the performance of hedge funds. Consequently as Christian Noyer (2007: 106), Governor of the Banque de France, points out:

The many theoretical benefits of hedge funds... may fail to materialize in practice. A whole body of research has been devoted to look at hedge funds performance. The results are not all conclusive, in part due to data availability and reliability.

Supporters believe that beyond the advantages claimed for individual investors, there are wider gains from the activities of hedge funds. Ferguson and Laster (2007: 45, 48) maintain that hedge funds 'support the robustness of markets in various ways' by providing attractive investment alternatives and by improving risk-sharing. The funds also assume risks that other market players would not, provide liquidity and help to correct mis-priced assets. It is claimed that by acting as an additional source of liquidity for financial markets, hedge funds offer 'the prospect of accelerated economic growth and improved financial market resilience' (McVea, 2007: 715). Through their willingness to assume risk and lower transaction costs, they assist the process of capital accumulation because raising finance becomes easier and cheaper (McVea, 2007: 715). Former US Federal Reserve chairman, Alan Greenspan supported the growth of hedge funds arguing that their arbitrage activity (taking advantage of price discrepancies in different markets) makes markets more efficient and keeps the financial system fluid and flexible (Plender, 2005).

## Types of hedge funds

Hedge funds can be categorised by their investment strategy (ECB, 2005: 8-10):

- directional
- market neutral
- event driven
- fund of (hedge) funds (FOHFs)

Directional hedge funds attempt to anticipate market movements. To compensate for the high risks and leverage involved, they offer high returns. Macro hedge funds are an example of this type, following a 'top-down' approach, and aiming to profit from major economic trends or events. Other

directional funds include emerging markets which have a regional focus, and utilise a 'bottom up' approach, picking assets in certain markets and looking for inefficiencies in developing markets.

Market neutral hedge funds are also known as arbitrage or relative value funds. These look for arbitrage or relative value opportunities in order to exploit price discrepancies, and they try to avoid exposure to market-wide movements.

Event driven strategies look for profit opportunities in key events in a company's life, e.g. mergers and acquisitions, reorganisations or bankruptcies. Merger arbitrage would normally involve buying shares in the target company and selling shares of the acquiring company. These 'activist' hedge funds are of particular concern to workers and their trade unions.

FOHFs are different to single hedge funds in that (as their name suggests) they are funds that invest in a number of different hedge funds. Therefore they offer greater diversification and less risk. Investors that do not meet the criteria for single hedge funds are able to use this model. In other words, they are open to retail investors, not just the super-rich. They usually have lower charges than single hedge funds and offer monthly or quarterly redemption which suits institutional and retail investors (ECB, 2005: 8). There is also a third layer of funds called F3 or funds of FOHFs. These carry less risk than either FOHFs (F2) or single hedge funds (F1).

Distinctions can be drawn between hedge funds and two other investment vehicles:

- private equity funds
- mutual funds

### **Differences with Private Equity funds**

Although hedge funds are often grouped with private equity funds, they have important differences, in the term, the type of investment, investors' liquidity, capital contributions, management fees and performance-based compensation (see Table 2).

The authors of the PSE paper suggest (2007: 34) that although hedge funds traditionally invested short-term without exercising ownership authority, compared to private equity funds which tended to be more likely to exercise ownership authority, this has begun to change in recent years and the two types of alternative investment funds have become more closely related.

**Table 2: Hedge funds and private equity funds**

|                                       | <b>Hedge funds</b>  | <b>Private Equity funds</b>              |
|---------------------------------------|---|--|
| <i>Term</i>                           | Unlimited   | Usually 10-12 years                      |
| <i>Type of investment</i>             | Fairly liquid   | Illiquid                                 |
| <i>Investors liquidity</i>            | Open-ended fund, periodic withdrawals possible                | Closed-end funds                         |
| <i>Capital contributions</i>          | 100% contribution at subscription date                        | Based on capital commitment              |
| <i>Management Fees</i>                | Based on net asset value                                      | Based on capital commitment              |
| <i>Performance-based compensation</i> | Incentive fee taken annually on realised and unrealised gains | Carried interest on realised investments |

Source: IFSL (2007a)

Despite these differences, private equity and hedge funds are bound together in an ‘intimate relationship’ (ITUC, 2007: 11). Hedge funds often provide the funds (through corporate bonds) that private equity funds use to buy companies. They also invest in the leveraged loan market in their push for high returns and thereby indirectly fuel the private equity buy-outs.

### **Differences with Mutual Funds**

Mutual funds are also collective investment funds. They pool money from (often small) investors in order to create a diversified portfolio of equities, bonds and other securities. Each investor is a shareholder in the fund and participates in the gain or loss of the fund. The shares can be redeemed as required. They differ from hedge funds (although more markedly than private equity funds). A report published by the Socialist Group in the European Parliament (PSE, 2007: 36) suggested five specific distinctions between mutual funds and hedge funds.

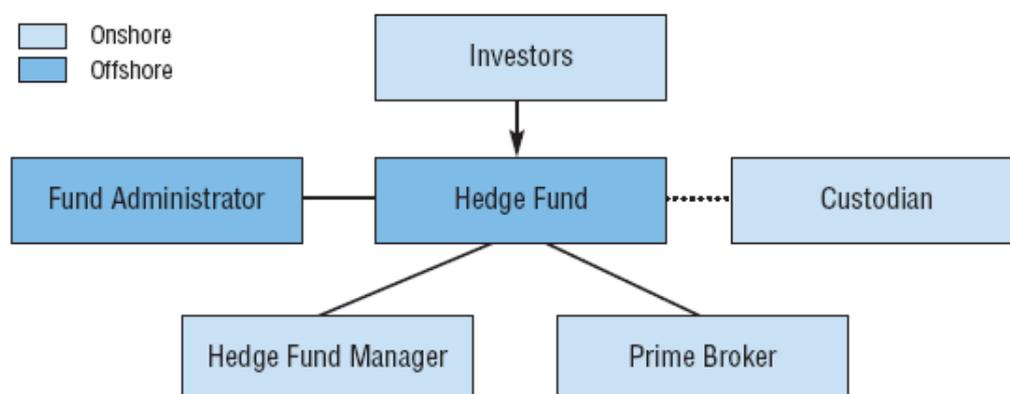
- Mutual funds are highly regulated and restricted in the variety of investment options
- Mutual funds are measured on relative performance against a benchmark such as a market index (like the FTSE 100) or other mutual funds. Hedge funds are expected to deliver absolute return (in other words, they pay out to investors regardless of how markets have generally performed).
- Mutual funds typically remunerate managers based on percent of assets under management. Hedge funds remunerate managers with very high fees that are geared to performance.
- Hedge funds make requirements on much larger minimum investments (average \$1m) than mutual funds. Usually very little of the investment manager’s own money is invested in mutual funds.
- While mutual funds are available to the general public, hedge funds usually face many restrictions in selling their product.

We could add to this list the fact that regulated funds require changes in policy to be subject to investor approval; have an outside board of directors, trustee, auditor or administrator to monitor the fund and its managers; and timely audited accounts.

## Structure and relationship with Prime Brokers

Hedge funds are typically structured as in Figure 1 below. Apart from the largest funds, most hedge funds are relatively small with capital under management of less than US\$ 100 million (ECB, 2005: 20) and have small numbers of staff. Decision making, dealing in financial instruments and risk management may be retained in the hedge fund itself; operational tasks are usually outsourced to external providers (prime brokers – generally investment banks) (PSE, 2007: 36). They usually have limited numbers of (large scale) investors.

**Figure 1: Structure of a typical hedge fund**



Note: Dashed line indicate optional relationships

Source: PSE (2007: 37)

The prime brokers provide a variety of different services, including securities lending, cash lending, trade execution, clearance and settlement, fund administration, custody services, risk management services, capital introduction and credit lines (IFSL, 2007b). Large banks are very keen to provide prime brokerage services to hedge funds because margins in traditional business have been squeezed. Plender (2005) argues that competition 'has led to an erosion of credit standards' and quotes one survey respondent describing prime brokerage as 'the crack cocaine of the financial system'. It is estimated that 25% of investment bank revenues now come from hedge funds (Credit Suisse First Boston, 2005: 11). What Chan et al (2005: 1) describe as the 'symbiotic relationship' between hedge funds and banks means that the latter can be closely affected by the fortunes of the hedge funds.

**Table 3: Largest global prime brokers**

| <b>2006</b>    | <b>Total client assets (%)</b> |
|----------------|--------------------------------|
| Morgan Stanley | 22                             |
| Bear Stearns   | 19                             |
| Goldman Sachs  | 17                             |
| UBS            | 7                              |
| Credit Suisse  | 5                              |
| Citigroup      | 4                              |
| Merrill Lynch  | 3                              |
| Deutsche Bank  | 3                              |
| Lehman         |                                |
| Brothers       | 2                              |
| JP Morgan      | 2                              |

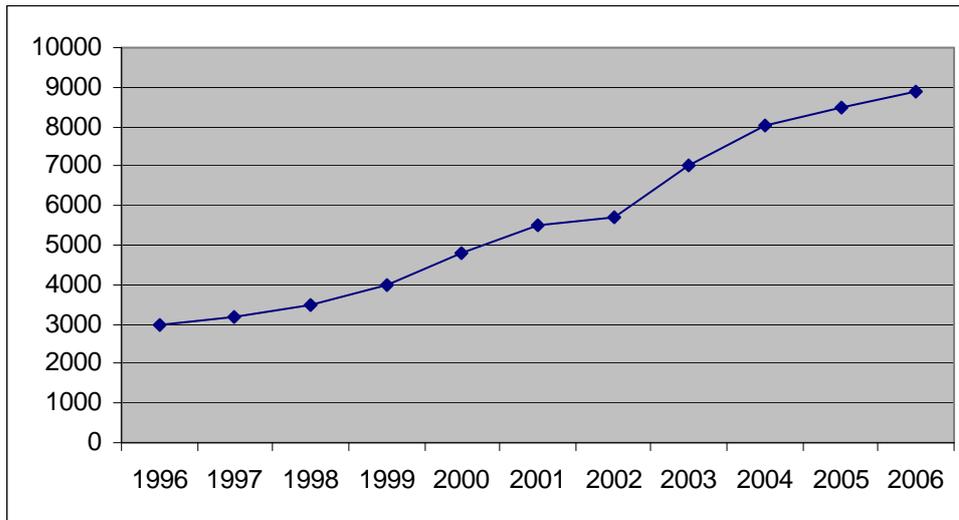
Source: Institutional Investor, cited in IFSL (2007b)

### **The growth of hedge funds**

As McVea (2007: 737) comments, from ‘a fringe activity in the early 1990s, aimed in the main at wealthy investors of high net worth’, hedge funds have grown spectacularly in the last few years until they are now regarded as mainstream with pension funds and other institutional investors eager to invest in them. In 1990 the amount invested globally in hedge funds was around \$50 billion. By 2004 this rose to approximately US\$1 trillion (Malkiel and Saha, 2005: 80). Although this is a spectacular rise, it should be kept in perspective: the global mutual funds industry has US\$ 18 trillion under management (OECD, 2007: 21).

The number of hedge funds has tripled over the last decade and their total assets increased by a factor of eleven (see Figures 2 and 3). The growth in hedge funds (and that of private equity funds as well) has been explained by the existence of a ‘global money glut’ (RENGO, 2007: 1) – the availability of cheap credit as a result of several different factors: the effect of rising oil prices; growing foreign currency reserves among emerging economies; financial institutions and pension funds moving into investment vehicles like hedge funds that used to be the preserve of wealthy individuals.

**Figure 2: Number of Global Hedge Funds, 1996-2006**

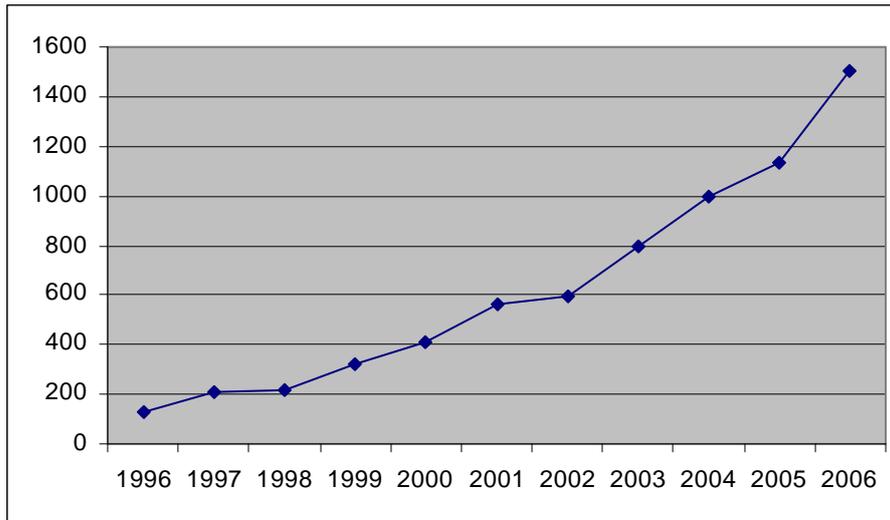


Source: Hennessee Group LLC; IFSL estimates for 2005, cited in IFSL (2007b)

Although hedge funds have grown massively over the last few years, they actually have an even greater market influence than this growth would suggest. First, they considerably amplify their impact because they make extensive use of leverage (debt) and derivatives - described by US investor Warren Buffet as 'financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal' (Berkshire Hathaway, 2003: 15).

It is estimated that the funds have leverage levels of four to five, meaning they can borrow (and invest) four to five times the amount of money raised. Secondly, they turn over their portfolios more often than mainstream investment funds and so account for a greater proportion of trading volumes than assets managed. In the US and UK, hedge fund activity accounts for between 40% and 70% of daily trading in the equity markets (Woolley, 2004). Thirdly, the type of activity is as important as the scale. Their investors look for quick results. This drives aggressive investment strategies with greater risk taking in the hope of higher returns.

**Figure 3: Global Hedge Funds: Total Assets 1996-2006 (US\$ bn)**



Source: Hennessee Group LLC; IFSL estimates for 2005, cited in IFSL (2007b)

## The key players

**Table 4: Largest hedge funds and funds of hedge funds**

| <b>Largest hedge funds (end-2006)</b> | <b>\$bn</b> |
|---------------------------------------|-------------|
| 1. JPMorgan Asset Management          | 34.0        |
| 2. Goldman Sachs Asset Management     | 32.5        |
| 3. Bridgewater Associates             | 30.2        |
| 4. D.E. Shaw Group                    | 26.3        |
| 5. Farallon Capital Management        | 26.2        |
| 6. Renaissance Technologies Corp.     | 24.0        |
| 7. Och-Ziff Capital Management        | 21.0        |
| 8. Cerberus Capital Management        | 19.2        |
| 9. Barclays Global Investors          | 18.9        |
| 10. Man Investments Limited           | 18.8        |

| <b>Largest global fund of hedge funds (end-2005)</b> |      |
|--|------|
| 1. UBS Global Asset Management                       | 45.0 |
| 2. Man Investments                                   | 35.6 |
| 3. Oaktree Capital Management                        | 35.6 |
| 4. Union Bancaire Privee                             | 20.8 |
| 5. HSBC Private Bank                                 | 20.2 |

Source: HedgeFund Intelligence, Institutional Investor, cited in IFSL (2007b)

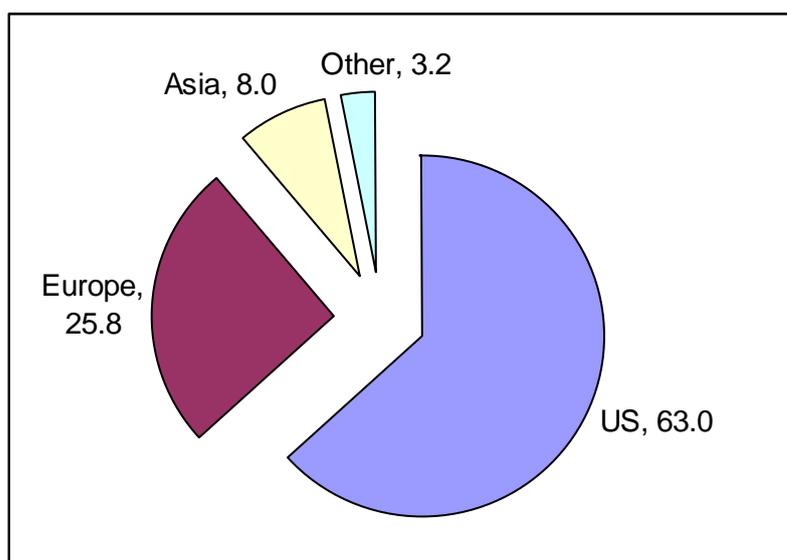
## Location of hedge funds

The hedge fund industry is dominated by American, British and to a lesser extent, French-based managers/partners. New York and London are the two main centres for hedge fund managers. The funds themselves are often based offshore for tax reasons in places like the Cayman Islands, the British Virgin Islands, Bermuda and the Bahamas. Where they are onshore they are subject to extremely light touch regulation.

Although they have had their biggest impact in the US and UK, they are extending their reach around the world, and as noted by the ITUC (2007: 11):

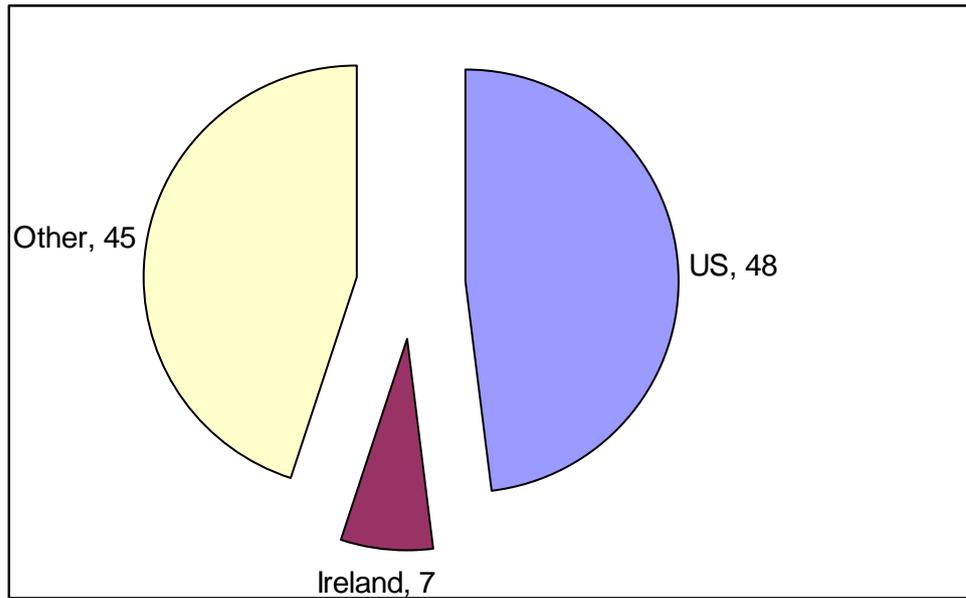
If past phenomena of capitalism are any guide, financialisation will soon be making its mark in the majority of emerging and developing countries, if it is not already there.

**Figure 4: Regional breakdown of global hedge fund assets 2006 (%)**



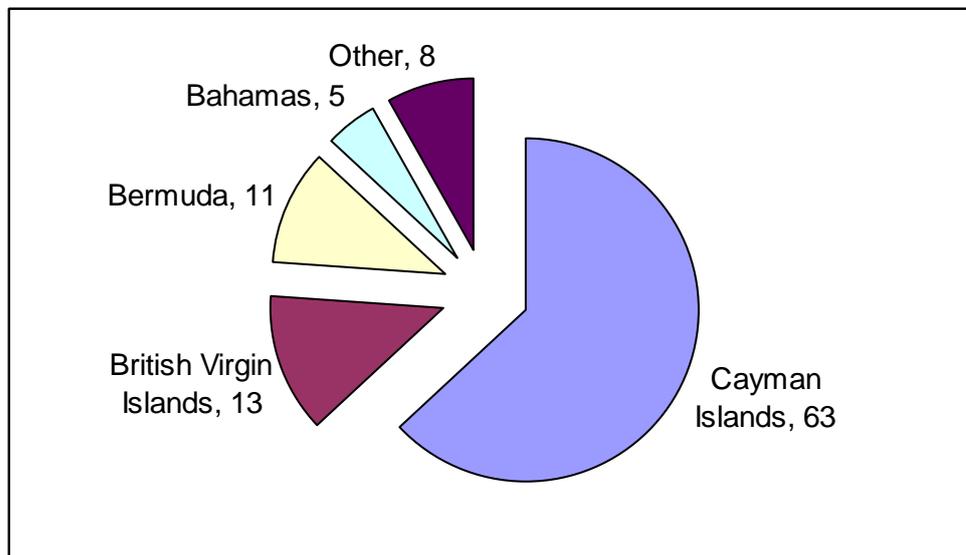
Source: IFSL (2007b) estimates based on various sources

**Figure 5: Onshore global hedge funds by domicile (% share, January 2006)**



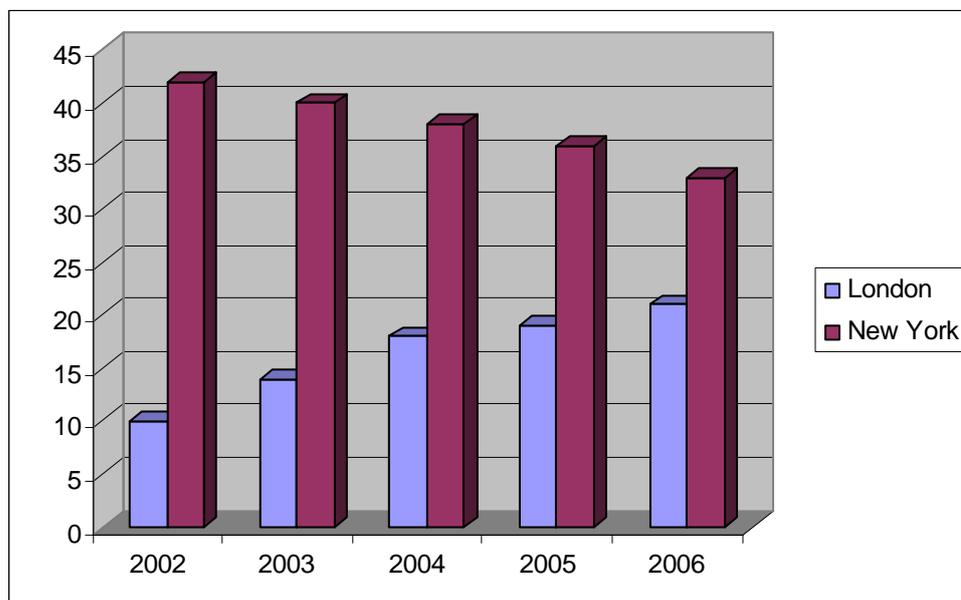
Sources: Alternative Asset Center, , cited in IFSL (2007b)

**Figure 6: Offshore global hedge funds by domicile (% share, January 2006)**



Sources: Alternative Asset Center, , cited in IFSL (2007b)

**Figure 7: Share of global hedge fund industry, London vs. New York (% share of global hedge fund assets by location of manager)**

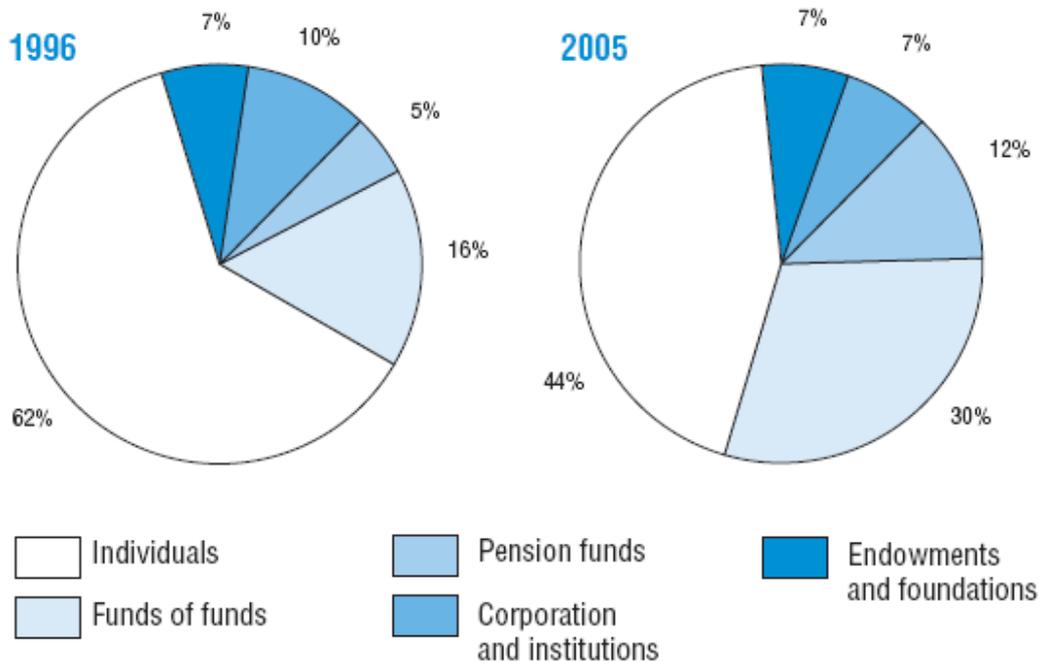


Source: IFSL (2007b) estimates based on various sources

## **Investors in hedge funds**

In 2005 wealthy individuals provided 44% of total hedge fund assets (down from 62% in 1996). Institutional investors such as pension funds, insurance companies, endowments and foundations account for 26% of hedge fund assets (up from 22%) and funds-of-hedge funds – which also attract both institutional investors and individuals – contribute 30% (up from 16%). This trend away from high net worth individuals represents a form of ‘retailisation’ of investment with ‘ordinary’ investors becoming involved in hedge funds through either funds of hedge funds or other institutional investors. The other changed element is that working people are increasingly (and unwittingly) involved through the actions of their pension funds investing in hedge funds.

**Figure 8: Global hedge funds by sources of capital**



Source: Hennessee Group LLC, IFSL estimates, cited in PSE (2007: 41)

### **Concerns over Hedge Funds**

There is a general concern about hedge funds (that is equally applicable to private equity funds) that their activities clash with the wider social interest because they 'are simply about extracting rather than creating value in the companies' in which they invest (PSE, 2007: 33). It is argued that these essentially 'speculative models' (ITUC, 2007: 5) are so focussed on short term gains that they undermine the long term viability and competitiveness of individual companies and wider economies. There are also a series of more specific concerns that are raised:

- Activist hedge funds and the role of fund managers
- The impact of retailisation
- Market integrity
- Systemic risk

### **Activist hedge funds and the role of fund managers**

The OECD (2007: 18) defines 'Activist hedge funds' as 'investment vehicles that seek, often through the exercise of voting power or the threat of it, to influence publicly held companies to take actions that the hedge fund believes will increase the company's value'. Not all hedge funds are 'activist' funds. It is estimated (OECD, 2007: 6) that there are probably only between 100-120 with funds under management of approximately US\$50 billion. This sum rises to

around US\$200 billion if all funds pursuing event-driven strategies are included. But even this figure is dwarfed by US\$18 trillion under management in the mutual funds industry (ibid).

They use a range of different strategies, usually based on gaining a relatively small but significant voting stake in a particular company. They either use, or threaten to use their voting rights (sometimes also running public campaigns for change). They use derivatives or other techniques like share lending to maximise their vote at little cost and pull in support from other investors, like private equity funds or more traditional institutional investors (OECD, 2007). Hence they generate the 'cloud of locusts' around a company. All of this is used to make demands such as share buybacks, increases in dividends, change of CEO or board membership, preventing a merger or supporting a takeover, the disposal of 'non-core' businesses..

This activist strategy is driven by the hedge fund managers who receive large performance fees. The effect of such high fees is that it not only attracts individuals from traditional bank and funds (ECB, 2005: 24) - and in the process arguably making it more difficult for remaining staff to cope with rapid change (ECB, 2005: 24) – but also is likely to have significant effects on the behaviour of hedge fund managers.

Folkman et al (2006: 7) argue that hedge fund managers (among a variety of fee earning capital market actors) are 'the marine corps of the intermediary groups who live by deals and novelty'. These people have 'a stake in an economy of permanent restructuring which is a practical project where deals (be it acquisition or demerger, new issues or buybacks, securitisation or rebundling risks) are the source of fees' (Folkman et al, 2006: 10). The problem arises that while constant restructuring and change may be good for earning hedge fund managers' fees, it may not be good for either individual companies or the wider economy.

The OECD (2007: 60) notes that activist funds are frequently charged with pressurising 'companies to make concessions that result only in short term gains by the shareholders at the expense of crucial long-term investments that would also benefit other stakeholders'. The OECD argues that this is difficult to verify but concedes that activist fund behaviour can lead to poor corporate governance practices and lists as possibilities: distortion of shareholder rights, insider trading, market abuse, the overlooking of stakeholder interests, and inadequate exercise of fiduciary duties by board members.

There are a number of examples of the impact of activist strategies in UNI-organised sectors. The Children's Investment Fund (TCI), a UK-based activist hedge fund has intervened in two significant companies (ABN Amro and J-Power) in a way that was widely perceived as hostile.

In March 2007, as the largest shareholder in J-Power (Japan's main electricity wholesaler), TCI wrote to the company to request it to table a proposal at the General Shareholders' Meeting to more than treble its dividend. TCI had just under 10% of J-Power shares. J-Power responded by stating: "Our dividend

policy is basically to pay stable dividends because our business is long-term." (Nakamoto, 2007). The battle has been raging for over a year and J-Power recently turned down five proposals from TCI - including a restriction on acquisitions and cross-shareholdings, the appointment of three outside directors and a share buy back of up to Y70bn of its own shares. It did make one concession and offered a modest dividend increase (Nakamoto, 2008).

The intervention at J-Power began after an earlier and similar campaign to force change by TCI at ABN Amro, the Dutch bank. With just over 1 per cent of the bank's shareholding, TCI wrote to the chairman of ABN's supervisory board with the aim of pushing the bank into selling some of its subsidiaries and preventing any further acquisitions. Within a short period of time, ABN Amro had been taken over by a consortium which subsequently broke up the bank.

### **The impact of retailisation**

As the balance among hedge fund investors has shifted in the recent past away from high net worth individuals towards more institutional investors and funds of hedge funds, it has 'lowered significantly the entry ticket for an indirect exposure to hedge funds' (Noyer, 2007: 107). This 'retailisation' or increased involvement of retail or 'ordinary' investors in hedge funds – however indirectly – and the growing participation of pension funds has increased calls for regulation.

### **Market integrity**

Market integrity refers to market abuse and insider trading. Noyer (2007: 107) claims that although this is not specific to hedge funds, such risks can more easily develop within hedge funds because insider information may not be adequately managed and conflicts of interest may arise if a hedge fund is active across markets and is tempted to use information from one in the other. Noyer (ibid) gives the example of hedge funds engaged in private equity that may use information to trade on credit markets. Further, because hedge funds dominate some markets, like structured credit, they might be able to manipulate prices.

According to the UK Financial Services Authority (FSA, 2005: 53) some hedge funds are 'testing the limits of acceptable practice' in a number of areas, including insider trading and market manipulation. The FSA (2005: 53) reported that fund managers of larger funds might be tempted 'to use their size, or start market rumours, to deliberately move the market in order to benefit from advantageous prices'. There is also the danger that 'given their payment of significant commissions and close relations with counterparties, [hedge funds] create incentives for others to commit market abuse' (FSA, 2005: 55).

The ECB (2005: 43) notes that a number of international organisations have reported 'suspicions that hedge funds had compromised market integrity by allegedly engaging in manipulation, collusion or other possibly unfair trading practices', but points out that this is difficult to prove.

## **Systemic collapse or contagion**

The most important concern in relation to hedge funds is the risk of systemic collapse or contagion throughout the financial system. There are worries that the collapse of a hedge fund (or several funds) will expose the fault lines in the financial system 'causing a shock in one sector to trigger a loss of confidence, which in turn spills over to other sectors of the financial system and, possibly, to other financial systems' (McVea, 2007: 720). Because of their increasing embrace of hedge funds, a crisis might spill over to pension funds and banks.

The catastrophic collapse of the hedge fund, Long-Term Capital Management (LTCM) in 1998 shocked the financial world. Just the year before, US economist and Nobel Prize winner, Merton Miller recorded that:

It was deliciously intense and exciting to have been a part of creating LTCM... [It] characterises the theme of the productive interaction of finance theory and finance practice (cited in Glyn, 2006: 50).

This 'productive interaction of finance theory and finance practice' actually revealed 'that the banking system can be jeopardised by the ill-judged risk-taking of a single hedge fund' (Plender, 2005). In July 1998, LTCM held assets of US\$125 billion: it borrowed most of the funding on the back of US\$4.1 billion of its own capital. Its 50,000 derivatives contracts had a notional sum involved in excess of US\$1 trillion (Glyn, 2006: 71). Its gamble that the yields on particular bonds were out of synch with short term interest rates ran aground on the rocks of the Russian government's debt default. Glyn (2006: 71) says that a compounding factor was the 'herding behaviour' of market players in that 'other financial institutions had set out to copy the particular deals which had been proving very lucrative for LTCM'. Incidentally, the European Central Bank recently described this 'herding' or 'crowding' among hedge funds, as 'another major risk for financial stability' (ECB, 2006: 12) that 'could lead to highly correlated exits across large parts of the hedge fund industry' (ECB, 2006: 135).

One of the strengths of hedge funds is supposed to be their ability to disperse risk to those best equipped to carry it. However, as Plender (2005) remarks:

the near-collapse of the Long-Term Capital Management hedge fund suggested that risk was being transferred to where it was least visible and least supervised, rather than where it sensibly belonged.

And Glyn (2006: 72) argues that the LTCM episode revealed the 'the potential fragility of the financial system at its most sophisticated end'. The LTCM collapse was a decade ago and the markets have changed markedly in those

ten years. The ECB claims that risk management practices have improved (2005: 37) and that several initiatives have been launched to address some of the concerns raised by hedge funds (2005: 49). Moreover three additional factors supposedly mitigate the potential problem: banks now use more sophisticated techniques to manage their exposures to hedge funds; as more players enter the market, positions are much less concentrated than before; and, hedge funds now take on lower levels of leverage (ECB, 2005: 56). These sorts of changes encourage supporters of hedge funds to insist that they are now 'unlikely' to pose systemic risks (Ferguson and Laster, 2007: 45)

Not all are so sanguine. Glyn (2006: 72) comments that problems 'seem endemic given the search for ever more exotic ways of beating the market' and McVea (2007: 723) notes that while there have been measures taken to attempt to deal with stresses within the hedge fund sector 'much of this work amounts to nothing more than papering over the cracks'.

The continued use of complex financial products, together with the use of high levels of debt to boost returns makes market contagion more likely. The OECD (Wright et al, 2007: 38) notes that the 'packaging of debt into financial instruments such as Collateralized Debt Obligations (CDOs) and Collateralized Loan Obligations (CLOs) is causing concerns as to whether it is known who actually owns the large amount of leveraged loans now being issued'. The fact that hedge funds use leverage (debt) to buy these complex financial products (like CDOs) means that off balance sheet risks can still return to banks, as they have in the present crisis.

There are also new areas for potential problems (for example, the increased role of funds of hedge funds) which may have actually increased systemic risk. As the FSA (2005: 22) concedes:

A newer contagion risk relates to the additional debt leverage of some funds of funds. The failure of one hedge fund may lead a fund of funds to breach its banking covenants, prompting it to withdraw capital from underlying funds, potentially causing them to fail. Enhanced liquidity sometimes granted by hedge funds to fund of funds investors may allow such a situation to develop rapidly. If these failures caused other leveraged fund of funds to breach their banking covenants then a domino effect could ensue, leading to a number of funds – and funds of funds – failing at around the same time.

The IMF made a similar point in its April 2007 Global Financial Stability Report and suggested that while hedge funds generally have a constructive influence on market efficiency and stability (IMF, 2007b: 57), they could 'act as transmitters or amplifiers of shocks initiated elsewhere' (IMF, 2007b: 58).

So there is disagreement about whether such a collapse could happen again and what would be the consequences if it did. Chan and colleagues (2005: 97) say that the data required to make a conclusive assessment of the systemic risks posed by hedge funds is simply not available and 'is unlikely to

become available in the near future'. However they cautiously warn (Chan et al 2005: 6):

Our tentative inferences suggest that the hedge-fund industry may be heading into a challenging period of lower expected returns, and that systemic risk has been increasing steadily over the recent past

### ***Questions and issues for trade unionists***

While the hedge fund sector was a small, fringe activity akin to an over-sized roulette wheel for the super wealthy, interest among most trade unionists (apart from those working for companies bought and sold by the funds) was fairly minimal. Today, that is no longer true. Hedge funds have grown enormously and are extremely influential in the markets. They increasingly have an impact (or a potential impact) on workers' lives whether or not they work for a firm targeted by the funds. There are several reasons for trade unionists to take a greater interest in the activities of hedge funds:

- Their growing influence on the wider economy
- The increased involvement of pension funds
- The impact on the tax take

### **The wider economy**

Paul Woolley (2004), an investment manager who is not a hedge fund enthusiast, notes that 'unstable markets provide hedge funds with their ideal conditions'. Woolley goes on to say that unstable markets also lead to inefficient allocation of capital, impede economic growth and can cause turmoil in financial sectors'. He might have added that economic instability may offer opportunities for hedge fund managers but it offers nothing but misery and the threat of poverty to working families. Hedge funds' aggressive short-termism is a threat to economic stability and as the European Trade Union Confederation (ETUC) (2007) has said, unions have been warning for some time 'about the risks of hedge fund operations and how no-one can be sure about who is responsible for what, or what the true liabilities are in today's casino economy'. The dangers became all too clear with the advent of the sub-prime crisis in the United States and the ease with which it spread to other countries (eventually forcing a reluctant UK government to nationalise the Northern Rock bank).

At a company level, hedge fund strategies of 'value capture' often mean that jobs are cut, plant relocated, wages and conditions attacked in order to drive down costs and extract value. And as ETUC general secretary, John Monks (2006) pointed out:

The potential damage from hedge funds is not limited to actual takeovers; the pressure to avoid hostile takeovers forces incumbent management to take actions that bolster the firm's share price in the short run (including

postponing investment, making workers redundant) with damaging effects on the longer term performance of the company.

## **Pension Funds**

Pension funds are taking a greater and greater degree of involvement in hedge funds. This should be a cause of concern for those whose future livelihoods rest on these pension provisions. Pension fund investment in hedge funds essentially transfers risk to workers. Not only are they risky endeavours however, they are also ethically suspect given that many hedge funds look for short term gains at the expense of workers, so pension fund investments in such behaviour sees one group of workers seeking benefit at the expense of a different group. This alone should be enough to make pension funds think twice about such investment. However, there is a third element in this and that is the fact that hedge funds often take an 'activist investor' approach aiming to gain a seat on the board of the company in which they invest, setting company policies and effectively taking the pension fund away from the approach of making neutral investments.

## **Taxation**

Hedge funds (and private equity funds) make extensive use of favourable tax regimes, often domiciled offshore for tax purposes. When private equity funds take over a company through a leveraged buy-out, the company concerned often reduces its tax obligation through 'optimising the tax deductibility' of the debt used to acquire the asset. Ordinary tax payers therefore have to make up the difference and effectively provide a tax subsidy to funds and to the very well paid fund managers. Hedge funds are now beginning to adopt similar practices (PricewaterhouseCoopers, 2007). Erosion of a country's tax base means cuts in public services or increases in tax for everybody else. Hedge fund managers have their 'earnings' treated as capital gains and pay much lower rates of tax than those paying income tax, which is effectively another tax subsidy.

## ***Union objectives***

Unions have well-worked out policy objectives in these key areas of interest in relation to hedge funds:

- Transparency and corporate governance
- Tax regulation
- Pension funds
- Workers' rights

## **Transparency and corporate governance**

Hedge funds are both opaque and either virtually unregulated or lightly regulated. The lack of transparency and the asymmetric nature of information

available is potentially a source of instability in the financial system. The authors of the PSE report (2007: 19) suggest that hedge funds' structure and opacity is not accidental:

Unnecessary and costly, complex holding structures are created – and effectively make it impossible to lift the corporate veil to the detriment of all parties with an interest in the firm – regulators, tax authorities, trade unions and others.

In a recent speech in London, Charlie McCreevy, the European Commissioner for Internal Market and Services, contemptuously dismissed those calling for greater regulation of private equity and hedge funds as 'an army of pro-regulation junkies and lobbyists' (McCreevy, 2008). Instead he pointed to the review of private equity and hedge fund investment currently being undertaken by the European Parliament and the voluntary code of conduct drawn up by the UK hedge fund industry. McCreevy neglected to mention that had it not been for the 'army of pro-regulation junkies' there would be no European Parliament review nor a voluntary code of conduct – however inadequate.

Despite the political capture by the hedge fund sector of senior Brussels bureaucrats, the issues of regulation and corporate governance will not go away and, in fact, are likely to become ever more pressing as the hedge fund sector grows. As McVea (2007: 739) comments, it is 'an industry which has assumed for far too long that it is a law unto itself' and the case for greater regulatory scrutiny is as irresistible as the call for maintaining the status quo is irresponsible. (McVea, 2007: 723)

This may not be recognised by McCreevy, but he might be surprised to find that among what he would call 'the pro-regulation junkies' are the International Monetary Fund and the European Central Bank. In April 2007, the IMF (2007b: 60) remarked that although suggestions to require disclosure from funds had been met with strong resistance:

From a financial stability perspective, efforts to develop standardized leverage and liquidity measures for hedge fund disclosure (to investors and counterparties) could be useful.

The Global Unions (2007) have pointed to the fact that 'current national corporate governance frameworks focus on publicly traded companies and have far weaker requirements for unlisted companies' and that measures need to be taken to defend the long term interests of companies regardless of whether or not hedge funds invest in the firm.

Transparency and corporate governance are linked. A level playing field should be established between 'alternative' funds like hedge funds and traditional collective investment vehicles. This should cover transparency and reporting on performance, risk management and fee structure. The investment policies of hedge funds should be subject to rules 'aimed at both financial market stability and long-term asset value creation' (Global Unions, 2007).

The unions have led the demands for greater transparency in both private equity and hedge funds. Some progress has been made, for example in the UK, hedge funds now have a voluntary code of conduct. This is not enough but it is a beginning. At international level the Global Union Federations (GUFs) and ITUC continue to push a trade union agenda within the general demand for greater openness.

## **Tax regulation**

Tax regulation, particularly in the key centres of hedge fund activity (Europe and the US), needs to be reconfigured to cover hedge funds so that tax systems are not biased toward short-term investor behaviour. Denmark has increased tax rates on short term investments to discourage 'quick flips' (Monks, 2008). The expansion of hedge funds should not be allowed to jeopardise government revenues from corporate taxes. It is necessary to distinguish between the taxation of the hedge funds, the fund managers and the companies owned by the funds.

Unions in Europe could begin by leading a campaign for a uniform, progressive capital gains tax rate applicable in all member states. The rate would need to be high for short-term arbitrage deals, in order to discourage short-term buying and selling of firms on the market for corporate control. Tax should be paid in the country where the object of the transaction is located (PSE, 2007: 26).

## **Pension funds**

As the International Trade Union Confederation (2007: 9) urges, pension fund trustees

must moreover consider investments in private equity and hedge funds very carefully. Due consideration should be given to the real profitability record of such investments, the risks associated with them, the many externalities they generate, and the direct or indirect impact they may have on the workplaces of the owners of the pension plans of tomorrow.

Japanese trade union federation, RENGO (2007: 8), wants to see pension funds practicing 'socially responsible investment (SRI) so that funds contributed by workers and trade unions do not have an adverse impact on jobs and workers' conditions because of the activities of investment funds.'

The Dutch union federation, FNV, urges an extremely cautious approach to hedge funds, and says that they carry a large risk for pension funds with regard to the assessment of a good social policy. FNV (2007: 8) says that those hedge funds that seek a seat on company boards 'place the executive boards of pension funds in an impossible position' because any pension fund that invests in such a hedge fund becomes indirectly responsible for the company's policy - a role that pension funds, as investors, should avoid.

## **Workers' rights**

Hedge funds should accept that workers' rights to collective bargaining, information, consultation and representation within the firm are key mechanisms by which the long-term interests of companies in which the funds have an interest can be secured and promoted. When hedge funds consider an investment they should not only engage in a dialogue with the company's management but also with the relevant trade unions and works councils (FNV, 2007: 9) and agree to uphold workers' rights in advance of taking important stakes.

Specifically, this should mean – as a minimum - a commitment to abide by the core labour standards of the ILO, in particular Conventions 87, 98 and 135, the ILO Tripartite Declaration on Multinationals, and the OECD Guidelines. Union representatives should have timely access to information before, during and after hedge funds have taken over a company. They should be made aware of the source of the investment, the ultimate owners and party to future business plans for their company.

Investment by hedge funds can obscure who exactly is the employer within a particular company or rather where the real power lies. Once hedge funds have a key stake in the company, the management may no longer really be in charge and effective control may lie with the hedge fund. For the purposes of negotiation or consultation however, hedge funds usually shy away from their responsibility, claiming to be 'just another investor'. As John Monks (2006) noted, 'the fund managers who control these companies, in effect, do not see themselves as employers' – they are not legally defined as employers and have none of the obligations of employers.

As hedge funds begin to act more like private equity funds in taking controlling stakes or even buying up entire companies, unions in Europe might consider testing the application to these funds of European legislation on work and social dialogue, for example, the European Works Councils Directive. Unions could also push for amendments to the European Acquired Rights Directive (which safeguards acquired rights of employees transferred in the course of a transfer of an undertaking) so that it covers takeovers through share transfers. If amended and transposed into Member States' legislation it would oblige employers to inform and consult employee representatives before the transfer, would impose rules protecting employees against transfer-connected dismissals or changes to employment terms and conditions if the variation is by reason of the transfer.

In the absence of such an amendment within the EU and outside the EU anyway, unions need to negotiate with existing employers succession clauses for takeovers which ensure continuity of employment; pay and conditions; union recognition and security of pension. They also need to press national governments for legislation to secure such rights to succession clauses. GUFs and the ITUC need to engage with hedge funds directly to gain commitments to guarantee rights, jobs, pay, pensions and conditions of workers in any future takeovers.

## **Union action**

In the face of the expansion of activity by alternative investment vehicles like hedge funds, unions around the world have moved into action at both national and international level. Union activity has focussed around three areas:

- Research and education
- Dialogue, campaigns and moves towards bargaining
- The law – rights and regulation

### **Research and education**

This paper forms part of UNI's continuing research activity around alternative investment vehicles. Earlier work has included reports on sovereign wealth funds and pension funds. Other affiliates, national centres, the ITUC and other GUFs have also commissioned and published research in this area. This growing body of union literature is being used by affiliates to train officers and activists dealing with the impact of hedge funds and the other alternative investment vehicles (for example, AFL-CIO, 2007; FNV, 2007; GMB, 2007; ITUC, 2007; IUF, 2007; RENGO, 2007; SEIU, 2008; TUC, 2003, 2007). At an international level, UNI is coordinating the activity of affiliates through a working group and beyond UNI, close co-operation is taking place between national unions and GUFs both bilaterally (such as the UNI-IMF-IUF joint workshop on private equity in Nyon, in November 2007) and through TUAC and the ITUC.

Further research is planned on the situation in France, the Nordic countries and the Netherlands, on taxation and on a case study of the Norwegian sovereign wealth fund. As a result of discussions that began at the World Economic Forum in Davos, the General Secretary was part of an advisory board researching the 'Globalisation of Alternative Investments'. The first report was *The Global Economic Impact of Private Equity Report 2008* but further research will take place in the near future and the General Secretary will also be involved in this. UNI also committed to participate in a case study on KKR, coordinated by American affiliate SEIU. Affiliates were surveyed about KKR in their countries as part of the research, and SEIU released a report on KKR activity in February 2008 (*Winners and Losers: Fallout from KKR's Race for Profit*).

### **The law – rights and regulation**

Unions are engaging at various levels to push for greater regulation and transparency of alternative investment vehicles. At international level, TUAC (2008: 2) made representations to the OECD and is pressing for greater openness and for the OECD to give 'more weight to constituencies that are impacted by investment funds, than to investment funds themselves'. TUAC describes this as an 'end-user approach'.

In particular countries, unions have used both existing law to defend members and pressed for new legislation to strengthen regulation. In Denmark, Dansk Metal successfully challenged private equity conglomerate Nordic Telephone Company in a court case to force minor shareholders to sell their shares in order to delist the public company. The private equity owned company TDC lost the case, appealed the decision and lost again. Dansk Metal worked with minor shareholders, who were in large part a pension fund to win the case and maintain TDC's public status.

In the Netherlands, FNV-KIEM supported members at a Dutch publishing company PCM when it was taken over by private equity firm APAX partners who stripped it of funds and exited the market. The union took PCM to the Dutch courts to challenge its operational strategy and set a favourable precedent that will aid unions to challenge similar practice in the future.

In the USA, the SEIU have been active in challenging private equity and sovereign wealth fund alliances, and were involved in the introduction of 'The Responsible Private Equity Investment Act of 2008' in the California legislature in February this year. The Bill aimed to stop California's Public Employees' Retirement System (CalPERS) and State Teachers' Retirement System (CalSTRS) from making new investments or renewing investments in private equity firms in which sovereign wealth fund of a country with poor human rights record has an ownership stake.

In the UK, workers have some limited protection of pay and conditions when their employer is taken over by another employer. This is as a result of the UK interpretation of the EU Acquired Rights Directive. However, this protection does not extend to those workers in a situation where there is a transfer of shares that gives a new controlling interest. Consequently, the British unions backed a Private Member's Bill, the Private Equity (Transfer of Undertakings and Protection of Employment) bill, which aimed to extend existing, limited protection of workers' conditions to takeovers involving a share transfer.

Unfortunately, neither the attempt in the UK Parliament nor in California was successful. Nevertheless, both allowed the unions to raise issues of workers' rights to a broader audience and force the alternative investment lobby on to the defensive.

## **Dialogue, campaigns and moves towards bargaining**

UNI was represented by the General Secretary at the World Economic Forum held in Davos in January 2008. His involvement has helped to establish UNI and the other GUFs as legitimate representatives of the workforce in companies with alternative investment capital.

UNI held meetings with national private equity councils: the British Private Equity and Venture Capital Association (BVCA), Association Française des Investisseurs en Capital (AFIC) in France and the US Private Equity Council (PEC). The General Secretary met with these groups to advocate the UNI global principles on private equity. Further meetings are in hand to take the

discussion forward – in the case of the US Private Equity Council, to discuss a set of labour principles proposed by the council. This approach could be extended to the hedge fund bodies like the UK-based Alternative Investment Management Association and the US-based Managed Funds Association. This could be used as a precursor for direct contact with the key hedge funds themselves.

US affiliates have led the way on seeing the importance of pension funds on which the unions are represented, but others are following suit. The British TUC has issued guidance (TUC, 2007) to union pension fund trustees on private equity, but much of it applies to hedge funds as well.

UNI is supporting the global day of action on KKR in July 2008, to be organised by the SEIU. UNI and affiliates will also examine the possibility of establishing a European works council for KKR. Following the activity around the ‘Super Returns’ conference, UNI has written to the conference organisers, with a request that the unions attend and speak at the 2009 event.

UNI urges affiliates to negotiate ‘succession clauses’ with existing employers so that in the case of a take over – particularly in areas outside the EU and not covered by the Acquired Rights Directive – continuity of employment, conditions of work and union recognition are safeguarded.

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