

# Lessons from Hedge Fund Registration

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## Abstract

Regulation of the investment industry is an on-going matter of concern in the United States and Europe. Hedge funds, which operate largely outside of regulatory definition and oversight, have attracted considerable capital in the past decade. With this capital has come increased scrutiny. In February, 2006, hedge funds over a certain size with less than a two-year lockup period were required by the U.S. Securities and Exchange Commission to register as investment advisers and file the required Form ADV. Motivated by a desire to provide investors with data that could be used to avoid operational risk, the requirement was highly controversial and was struck down by the Federal courts in July 2006. Hedge funds argued that registration is burdensome and does not provide material information for investors. We examine this hypothesis by examining every ADV form filed in February. By correlating the responses to fund characteristics we can begin to quantify a measure of operational risk distinct from market risk. We find that operational risk is indeed related to the extent to which funds can obtain leverage and to the ownership structures of these funds. This suggests that well informed investors may already have access to this information. However, this information has no bearing on the return flow relation, suggesting either that investors lack this information, or that they have the information and choose not to act on it. This finding casts an interesting light on investor disclosure requirements in a more general setting.

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## **I. Introduction**

One of the most important challenges to U.S. financial market regulators in recent years has been the question of hedge funds. As the scale and influence of hedge funds in the global financial marketplace has grown over the past decade, and fiduciary U.S. institutions such as pensions funds and endowments have turned to them for enhanced returns, regulators have increasingly sought to define and control these investment vehicles.<sup>2</sup> In the on-going dialogue over the pros and cons of hedge fund activity, the U.S. Securities and Exchange Commission (SEC) in particular has tried to walk a fine line between allowing the invisible hand of the market establish the level and type of disclosure demanded of investment managers, while at the same time seeking to require a minimum framework of transparency. The debate over hedge fund registration and disclosure requirements highlights the critical role of regulators in financial markets. The U.S. hedge fund industry originally developed as a result of regulatory exemptions for investment managers who served a limited number of sophisticated clients. A recent attempt to bring them within the purview of SEC regulation affords an opportunity to test whether mandated disclosure –at least for one sector of the investment industry -- has value as a public good or instead is simply costly and redundant. The results of our analysis thus provide a framework for the cost-benefit analysis of regulation. Most of the discussion about regulatory oversight of hedge funds to date has focused on whether or not they should be required to reveal their holdings or at least, their exposure to market factors. In this paper we do not address this issue. Instead we focus on the role of the regulator in requiring disclosure related to issues of operational risk.

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<sup>2</sup> According to Lipper TASS Inc. hedge fund assets under management have doubled over the last five years to over \$1 trillion in December 2005.

On October 26, 2004, the SEC adopted a new rule and rule amendments under the Investment Advisers Act of 1940 that would require hedge fund managers to register as investment advisers by February 1, 2006. The SEC issued the new rule and amendments on December 2, 2004. Prior to the new requirements, only a small number of mostly large hedge fund managers were required to be registered as investment advisers with the SEC. To comply with the new requirements, hedge fund managers were required to file Form ADV with the SEC and to comply with a variety of additional regulatory requirements. Form ADV is a regulatory filing that is required of all types of fund managers, including hedge fund managers, mutual fund managers, and separate account managers, who come within the definition of "investment adviser" in the Investment Advisers Act. On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the rule changes that had required many newly-registered hedge fund managers to register as investment advisers under the Investment Advisers Act. Many fewer hedge fund managers are now required to be registered as investment advisers than before the rule changes were vacated.

As a result, the February 2006 ADV filings by a large number of hedge fund managers present a rare opportunity to examine the fundamental question of whether such disclosure is necessary or warranted. Prior to February 2006, some hedge fund managers, particularly managers of large funds, had been registered, however the February 2006 filings made a much larger and less biased sample available. The Form ADV's for this larger sample contain a wealth of information previously unavailable for many managers about fund characteristics such as potential conflicts of interest and past legal and regulatory problems. Both of these relate directly to the stated purpose of the

disclosure which is “deterrence of fraud,” “keeping unfit persons from using hedge funds to perpetrate fraud,” and “adoption of compliance controls,” or more generally the avoidance of operational risk<sup>3</sup>.

By relating the Form ADV disclosures to fund characteristics, we are able, perhaps for the first time, to obtain a quantifiable measure of operational risk that is distinct from market risk. We can then examine whether in fact the Form ADV filing requirement provides material information to investors seeking to mitigate this measure of operational risk. The alternative hypothesis is that the marketplace has already effectively disseminated this information through other means -- ranging from networks of informal contacts, to fee-based due-diligence research services or through investing in funds of hedge fund intermediaries who perform the due diligence on the investor’s behalf. In other words, are Form ADV filings simply redundant and expensive, or do they provide valuable, otherwise inaccessible information to participants in the market for hedge fund services which allows them to avoid investing in potentially fraudulent firms?

This analysis provides an interesting insight into the mechanics of the information disclosure hypothesis which suggests that the market in other contexts rewards a premium to those firms which voluntarily submit to SEC disclosure requirements<sup>4</sup>. Consistent with this argument we find evidence that the information in the form has the potential to add value to the investor decision-making process. Hedge funds operated by managers filing Form ADV in 2006 had better past performance and had more assets than those operated by those who did not file either because they were technically exempt

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<sup>3</sup> These quotations and further discussion can be found in the SEC proposed rules <http://www.sec.gov/rules/final/ia-2333.htm>

<sup>4</sup> This model has been developed to explain the premium awarded foreign firms which choose to register in the United States and submit themselves to stringent SEC disclosure requirements (see Cantale (1996), Doidge, Karolyi and Stulz (2004), Fuerst (1998), and Moel (1999))

from the filing requirement, or because they simply chose not to file. This result suggests that filing alone may be a potential signal of quality<sup>5</sup>. In addition, we find a strong positive association between potential conflicts identified in the Form ADV filing and past legal and regulatory problems. Finally, through a canonical correlation analysis we are able to establish a link between potential conflicts identified in Form ADV filings and operational risk characteristics in the TASS database. This allows us to establish a time series of operational risk for each fund in that database.

To examine whether in fact Form ADV disclosure provides material information for investors concerned about operational risk, we use both hedge fund capital structure and the time-series of investment flows. We hypothesize that equity and debt investors in hedge funds are able to distinguish among funds with differing potential for operational risk given the pre-ADV information available from research services and available databases. Consistent with this theory, we find that funds with past legal and regulatory problems have a more concentrated management structure and less average leverage than their “non-problem” counterparts. This suggests that some market participants, such as equity fund investors and prime brokers extending credit, are able to distinguish problem from non-problem funds.

We next test the proposition that the fund investors themselves are able to distinguish problem from non-problem funds. To do so, we use the well-known flow-performance relationship. All things being equal, the information redundancy hypothesis implies that problem funds with good performance should experience lower net inflows than non-problem funds with good performance. We find no evidence that this is so.

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<sup>5</sup> Interestingly enough we could not find a filing in February for Amaranth Advisors LLC which failed in September. We cannot find the exemption under which they failed to file. This might be a case where failure to file would have been highly informative to the investors in funds managed by Amaranth.

Taken together, these results suggest that the evidence in favor of the information disclosure hypothesis is mixed. Financial institutions and well informed investors may already have the information contained in the Form ADV filing through the normal process of due diligence. Individual investors however may not have access to this information. This supports the argument that hedge fund disclosure may help level the informational playing field. On the other hand we cannot exclude the possibility that these investors have access to this information and choose not to act on it. The bottom line is that mandatory disclosure of operational risk factors has the potential to benefit smaller investors, but, to the extent it shifts the due diligence costs (and compliance risk) from the existing information providers to the hedge funds themselves, it may or may not benefit larger investors.

Although the role of regulation in the investment industry is our primary focus, the empirical analysis also yields other interesting results. The premise of mandated information disclosure is that it helps to mitigate the fundamental problem of agency. We find evidence that agency issues are potentially important determinants of hedge fund performance and hedge fund capital structure.

The rest of the paper is organized as follows. Section II describes the ADV filing and reviews literature on operational risk. Section III describes the data from the SEC and TASS. Section IV presents the testing hypothesis and the empirical results. Finally, Section V concludes the paper.

## **II. Form ADV, Operational Risk and Related Research**

The 2004 SEC investment adviser rule amendments referred to above required, among other things, that any hedge fund manager based in the United States with more

than 14 clients, assets of at least \$25 million and a lockup period less than two years,<sup>6</sup> as well as any internationally based fund with at least fourteen U.S. based investors, file Form ADV<sup>7</sup> with the SEC, which is the same form used by all investment advisers. Form ADV contains information with regards to potential conflicts of interest, both internal and external, any past regulatory or legal problems of both the hedge fund management company and any of its related advisors and a wealth of specific ownership data. Prior to the 2004 rule changes, a smaller set of mostly large hedge fund managers were required to be registered as investment advisers with the SEC.<sup>8</sup> These rule changes were strongly opposed by hedge fund managers who argued that filling in the 35 page form was unnecessarily costly and burdensome<sup>9</sup>

Although onerous, Form ADV requests information potentially highly relevant to assessing the operational risk of the investment manager. The International Association of Financial Engineers defines operational risk as “losses caused by problems with people, processes, technology, or external events.”<sup>10</sup> More specifically, these include the risks of failure in the internal operational, control and accounting systems, failure of the

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<sup>6</sup> The two year lockup period provision was included for the purpose of excluding venture capital and private-equity firm managers from the filing requirement; however, hedge fund managers have been lengthening their lockups to two years to avoid the filing requirement. See [http://www.businessweek.com/magazine/content/04\\_52/b3914039\\_mz011.htm](http://www.businessweek.com/magazine/content/04_52/b3914039_mz011.htm).

<sup>7</sup> <http://www.sec.gov/rules/final/ia-2333.htm>.

<sup>8</sup> These limited hedge fund filings have already been used by academic researchers: Brunnermeier and Nagel (2004) use these filings to analyze the actions of hedge funds during the technology bubble.

<sup>9</sup> According to the Phil Goldstein, the hedge fund manager who successfully challenged the requirement in court, Form ADV “...asked for everything from ‘your last small-pox vaccination to every dirty joke you got on E-mail.’” (*Wall Street Journals* June 28, 2006). Though this may be something of an exaggeration, the SEC estimated in advance of the rule changes that registration would cost around \$45,000, and this does not account for the requirement to hire compliance officers, who command between \$200,000 and \$750,000 (*Wall Street Journal* June 8, 2005), not counting the cost of purchasing software to better monitor trading, establish policies governing their practices and filing required forms with the SEC. This cost would disproportionately affect smaller funds.

<sup>10</sup> INTERNATIONAL ASSOCIATION OF FINANCIAL ENGINEERS, Report of the Operational Risk Committee: Evaluating Operational Risk Controls, CONCLUSIONS AND FINDINGS ON THE TOPIC OF: “How should firms determine the effectiveness of their operational risk controls?”, November 2001, [www.iafe.org](http://www.iafe.org).

compliance and internal audit systems and failure of personnel oversight systems – i.e. employee fraud and misconduct. For example, losses due to rogue traders (e.g. Barings, National Australia Bank and Allied Irish Bank<sup>11</sup>) and failures due to management fraud (e.g. Enron), and reputational injury such as the 2004 mutual fund timing scandal (e.g. Putnam) can all be thought of as operational risk events. These are distinct from market risk such as, for example, Long Term Capital Management’s failure due to credit exposure. Market risks are presumably measurable using quantitative risk models while operational risk has no direct numerical proxy. The challenge is to quantify this factor. Practitioner studies reveal that half of all hedge fund failures occur through operational risk events rather than taking excessive market risk (and losing)<sup>12</sup>

Operational risk assessment often relies upon intangible variables. Assessing personnel risk is perhaps the most difficult. Historical behavior and current opportunity are both potentially important inputs to this assessment. Past manager behavior may include previous fiduciary decisions, as well as previous legal and regulatory actions taken against the manager, and any other variable that might be correlated to the propensity to make future illegal or unethical decisions in one’s own interests at the expense of a client, partner or lender. Such tendencies are, of course, partly manageable within an organization through internal control and external compliance procedures, however the risk of individual fraud is likely to increase with opportunity. In particular, as potential conflicts of interests between manager and investor increase, operational risk

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<sup>11</sup> The management failures associated with the rogue trading losses at National Australia Bank are well documented (APRA 2004, PWC 2004). Allied Irish Bank experienced a loss of almost \$700 million due to trading losses by one trader. See [http://en.wikipedia.org/wiki/AIB\\_Group](http://en.wikipedia.org/wiki/AIB_Group).

<sup>12</sup> See, for example [http://capco.com/alternative\\_investment.html](http://capco.com/alternative_investment.html). However, this observation needs to be qualified. A firm in financial distress due to unfortunate investment outcomes might be more likely to cut corners on compliance and experience an operational risk event. We thank Michael Triguboff for this observation.

increases as well – holding control and compliance constant. Thus, although the questions in Form ADV might seem by some to be unduly personal and burdensome, they reflect the fact that measurement and assessment of operational risk, particularly risk centered on human intent and tendencies to act unethically or illegally, is difficult.<sup>13</sup> In particular, Form ADV requires disclosure of past criminal charges against management personnel, including the nature, severity and disposition of past charges. It also requires disclosure of past regulatory actions taken against the firm or its personnel, including the regulatory body and the nature of the sanction. It also requires disclosure of past civil judicial action, past bond action and past arbitration relating to the firm. While none of these variables in isolation capture personnel-related operational risk, presumably together they provide evidence of past adverse behavior by the firm or by those whom it currently employs.

Another key set of variables we study in this paper help to address conflicts of interest. This issue has been the subject of considerable research in the setting of investment banking. Dugar and Nathan (1995) and Michaely and Womack (1999) among others have examined how investment banking conflicts affect stock analyst recommendations. They find clients of analysts are more likely to receive positive coverage. In contrast, Lin and McNichols (1998) find no difference between the recommendations of analysis when comparing the clients and non-clients groups. Gompers and Lerner (1997) find little evidence of conflict of interest in the venture

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<sup>13</sup> Despite being difficult to quantitatively assess, there is ample evidence that operational risk is considered important in the financial marketplace. Fontnouvelle et al. (2003a, 2003b) find operational losses for banks are large and significant. In fact, the authors find the capital charge for operational risk is often larger than the charge for market risk. Lewis and Lantsman (2005) study the use of unauthorized trading insurance. They find banks and insurance companies value unauthorized trading differently, which has caused a slow adoption of this operational risk insurance product.

capital industry: the investment bank's affiliation to the public offering has no negative impact on the initial offering's performance.

A number of variables relating to potential conflicts of interest are required by Form ADV. In particular, the form asks whether any employee or entity controlled by the firm is affiliated with another type of financial institutions such as a broker-dealer, mutual fund or limited partnership. It asks about participation in clients' transactions; including proprietary interest in transactions, sales interest in transactions, brokerage discretion, and custody of client assets. In each of these cases, the potential exists for the manager to influence client decisions, or make decisions on the client's behalf that benefit the manager at the expense of the client.

Another set of variables we examine in this paper relate to the ownership and governance structure of the hedge fund. Most of the current research on this relationship focuses on the mutual fund industry, where such information is readily accessible. Cremers et. al. (2005) find that mutual funds with high director share ownership perform better. Ding and Wermers (2006) find that the ratio of independent directors on mutual fund boards predicts out-of-sample performance. Khorana and Servaes (2006) find that out-of-sample performance is correlated with managerial ownership. Although there is widespread belief in the hedge fund industry that the size of the managerial stake in the fund is a potential proxy for good governance, such information is not generally available from hedge fund information vendors and no academic study to our knowledge has been able to empirically examine this issue. Form ADV requires detailed information both about direct ownership of the firm and indirect ownership of the firm.

### III. Data

We obtained data for this study from two sources. The first is the Lipper TASS, Inc. database from various time periods. We use the February, 2006 TASS data to match management companies with the SEC Form ADV filings. The TASS database contains information on 4,019 live hedge funds and 2,491 defunct hedge funds, along with their management companies. Data on individual hedge funds include their returns, assets (in most cases), lock up period, subscription and redemption periods, indication of a high water mark and other characteristic data. TASS files also include the management company name and address. In addition to the February, 2006 TASS dataset, we also use eight previous TASS datasets. These nine datasets together cover the 1998 to 2006 period, which allow us to capture the changes of fund characteristic data over time.

The second major source of data is the SEC investment adviser website.<sup>14</sup> Each Form ADV contains information on an investment adviser. The filing consists of twelve items and also includes at least three schedules.<sup>15</sup> Items 1 through 6 contain descriptive information on the firm, including its address, structure, number of employees in various positions and a breakdown of investor types. Items 7 and 8 look at potential conflicts of interest of the firm. Item 9 examines the custody of various assets while Item 10 looks at the control persons of the firm. Item 12 is for the SEC to look at the regulation's effect on "small businesses."

Item 11 is of particular interest as it identifies any "problems" its management or related advisory affiliates have, including felonies, investment related misdemeanors or

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<sup>14</sup> See [http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd\\_SiteMap.aspx](http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx), the SEC investment adviser website.

<sup>15</sup> There are additional forms if the company has a "problem" as defined later in the paper or if the company also filed with a state agency.

any agency, SEC, CFTC, or self-regulatory issues. If the firm answers yes to any of the questions on Item 11, it must also file a Disclosure Reporting Page [DRP], which expands on the problem identified in Item 11.<sup>16</sup> Schedule A includes the direct owners and executive officers of the firm, Schedule B lists the indirect owners of the firm and Schedule D includes a list of other business locations, other locations of records, previously non-listed control persons and a list of the limited partnerships in which the firm participates (see appendix for details).

Form ADV data were downloaded directly from the SEC website and imported automatically into a useable dataset.<sup>17</sup> To identify Form ADV belonging to hedge fund companies, a two phase search was implemented. Using the management company information in TASS, we first searched for the management company listed for each fund.<sup>18</sup> If that search was unsuccessful, we then searched for any unique names that appeared in the fund's name. In a majority of cases the company was identified using just the management company information.<sup>19</sup> Note since the requirement to register began on February 1, 2006, our searches only encompassed the live database. To insure matches, one fund listed in the TASS dataset had to be matched to a fund listed on Form ADV.<sup>20</sup>

We identified 879 management companies out of 1,697 listed in TASS or 51.8% of the TASS database. These management companies represent 2,299 (57.2%) of the

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<sup>16</sup> In some cases, the amount of information included on the DRP form was limited.

<sup>17</sup> Data were downloaded in March and April 2006. It is important to note the ADVs are dynamic in that the SEC will update the information on the investment advisor website as soon as new information is available. Thus, the data downloaded in the future will not exactly match the data used in this study.

<sup>18</sup> A few of the funds also listed an investment advisor with a different name than the management company. We also included these companies in our search if the management company was not located.

<sup>19</sup> We did not explicitly keep track of this breakdown, but estimate fewer than 15% of all matches were made using the fund name.

<sup>20</sup> Some of the ADV filings did not list any funds. In these cases, the name and address of the ADV was used to verify a match.

4,019 live funds in the live TASS database. The unmatched TASS funds include funds with less than the \$25 million in assets (22% of unmatched funds), funds with lockups longer than two years (2%), and foreign companies with less than fourteen or more US investors (73%).<sup>21</sup>

<Insert Table I about here>

Table I provides descriptive statistics for both the matched and live TASS databases as well as their differences. While the returns and standard deviations of the matched dataset differ slightly, the Sharpe ratios of registered funds are significantly higher than those of the overall TASS dataset. Skewness and kurtosis are also insignificantly different; however, the autocorrelation of matched funds is significantly higher, perhaps indicating more illiquid portfolios.<sup>22</sup> The average size of the matched funds as well as the average minimum investment amount, is also not significantly different for the matched and total TASS samples.

Several other variables show differences, however. Three liquidity measures – lockup period, subscription frequency period and redemption frequency period – are all significantly longer for the matched funds, which may be due to more of the matched funds being onshore, as onshore funds have more share restrictions. The average high water mark level is higher for the matched database. Management fees are slightly but significantly lower for the matched fund sample while incentive fees are significantly

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<sup>21</sup> As of the beginning of April 2006, we were unable to match around 100 management companies in TASS with US addresses and over \$25 million in assets. There are a variety of reasons for these companies not to be registered, including a lockup period change, a reduction in assets or an error in the TASS database.

<sup>22</sup> See, for example, Getmansky, Lo and Makarov (2004).

higher. These differences suggest that filing funds are of higher quality than non-filing funds.

#### **IV. Tests and Results**

##### *A. Defining “Problem” Funds*

In order to examine the relationship between conflict of interest variables and legal and regulatory problems, we first need to define funds as “problem” funds and “non-problem” funds. These are reported in Table II.

<Insert Table II about here>

Problem funds are those whose management companies answered yes to any of the questions on Item 11 in Form ADV while non-problem funds answered no to all of the same questions. Problems covered on Item 11 of the Form ADV include any past felony or financial related misdemeanor changes or convictions. The form also includes questions concerning any SEC, CFTC, federal or state agency or other regulatory disciplinary action as well as civil lawsuits. Of the 2,299 funds in our sample, 368 have management firms that answered yes to at least one question on Item 11 or approximately 16.0% of our sample.<sup>23</sup> The percentage of funds with problems is not being driven by only a few management companies. Of the 879 management companies, 126 companies, or 14.3%, answered affirmatively to a question on Item 11.

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<sup>23</sup> These results were also run excluding fund of funds as their structure is different than hedge funds. There are no material differences between those results and the reported results.

This incidence rate may seem high, but it is actually comparable to the entire ADV sample. Using all Form ADV data from the SEC website compiled by a third party company, we were able to determine the problem rate for the entire Form ADV universe.<sup>24</sup> out of 10,295 ADV registrations, 1,526 indicated some type of problem. This is 14.8% of all Form ADVs, which is almost identical to the 14.3% of our hedge fund sample. This is a potentially useful perspective on the relative operational risks in the hedge fund industry compared to the larger investment management universe – it supports the contention by the hedge fund industry that its operational problems are no greater than in other investment management businesses. One possible caveat to this conclusion is that management companies with associated mutual funds might have a longer history of regularity scrutiny, which might lead to a higher incidence of violations and lawsuits. To examine that hypothesis we removed all funds with managers that have associated mutual fund companies and recalculated Table 2. The results were unchanged.<sup>25</sup>

Panel A of Table II examines the performance differences and fund characteristics between problem and non-problem funds. There is no significant difference in terms of standard deviation or autocorrelation of returns, however both the mean return and the Sharpe ratio are significantly lower for funds with a problem.<sup>26</sup> This performance differential in raw returns is somewhat mitigated when returns are adjusted for TASS

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<sup>24</sup> This data was compiled by the company on March 17<sup>th</sup>, 2006.

<sup>25</sup> Liang (2003) indicates that small funds are more likely to suffer auditing problems. The sample here doesn't contain smaller funds under \$25 million in assets. Hence, 14.3% could be an underestimate for hedge funds.

<sup>26</sup> In unreported results, we removed the first 18 months of returns to control for backfill bias. While the removal of a large number of observations (about 25%) did decrease the power somewhat, the results are in agreement with those reported here and are still significant. This applies both at the overall level and also in the year-to-year context.

style category averages.<sup>27</sup> Once we trim outliers from the data, the performance differential is no longer significant at traditional confidence levels. With regard to size, problem funds are, on average, larger but the difference is not significant. Problem funds are significantly older, and their average incentive fee is lower than non-problem funds. High water marks are also significantly lower for problem funds.

Panel B focuses on external relationships that represent potential conflicts of interest.<sup>28</sup> It reports the frequencies for questions such as whether the manager has a related broker/dealer, investment company, investment adviser commodities broker, bank or insurance company, or is the sponsor of an LLP. The frequency with which problem funds answered yes to these questions is universally higher than for non-problem funds. For example, while 73.9% of problem funds have a related Investment Adviser, only 41.6% of non-problem funds have the same issue. A similar dispersion exists for whether the firm has a related investment company – 50.3% versus 15.8% for problem and non-problem funds respectively.

Panel C focuses on internal potential conflicts of interest. The variable AgencyCrossTrans for example, asks whether a broker-dealer buys and sells broker clients' securities to advisory clients. Only 2.3% of non-problem funds have this potential conflict of interest while over 30% of problem funds do. Recommending securities to clients in which a related party has some ownership interest (RecSecYouOwn) also has a large difference with 25% more problem funds exhibiting

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<sup>27</sup> There is no systematic pattern in the problem fund group that concentrates on one particular style. The numbers adjusted by the style average: Problem funds: Excess Sharpe ratio = -0.045, Excess average monthly return = -0.049. Non-Problem Funds: Excess Sharpe ratio = 0.008, Excess average monthly return = 0.010. *p*-value: Excess Sharpe ratio = 0.03, Excess average monthly return = 0.14.

<sup>28</sup> There is a high correlation between all of the conflicts of interest variables.

this conflict. As in Panel B, all of the differences between problem and non-problem funds are statistically significant. The striking result of Panels B and C is the strong relationship between legal and regulatory problems and various measures of internal and external conflicts of interest. “Other Research” for example is a conflict variable in that it represents services obtained from a broker-dealer that the fund uses for its transactions. It is strongly significant. It would suggest that the potential for conflicts of interest can lead to operational risk events, as measured by legal and regulatory problems. This may be due to an actual higher incidence of fraudulent activity by managers of problem funds, or alternatively it could be due to the fact that the simple presence of apparent conflicts of interest attracts more regulatory scrutiny and litigation.

Panel D examines the ownership and capital structure differences between the two groups. The first part of the panel provides information about the equity ownership of the firm. Problem funds have a higher number of direct and controlling owners.<sup>29</sup> Interestingly, the number of direct owners in the form of non-individual domestic entities (directdomestic) is higher for problem funds than it is for non-problem funds. This implies that problem firms are more likely to be structured as a venture or partnership with another institution. It also has the effect of allowing owners to hide their names from the ownership list, although it does not exempt them from reporting. Finally, the percentown75% variable, which is the percentage of owners that own 75% of the company, is larger for problem funds. Theoretical results suggest that fear of expropriation – one source of operational risk – will make the management more

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<sup>29</sup> The definition of a controlling owner is set by the SEC. This is not a flag set by the company itself.

concentrated than less concentrated<sup>30</sup>. These results are confirmed in our data. Problem funds tend to have more concentrated management. There tends to be one large owner rather than a group of smaller owners.

Panel D also provides information about the debt of the firm. It is well established that external financing is more problematic where agency costs are extreme. Indeed, Harvey Lins and Roper (2003) argue that external debt has an important role to play as a governance mechanism in such circumstances. It is therefore not surprising to find that problem firms have lower leverage and less margin than non-problem firms. We investigate this relationship in more detail below.

Given that an affirmative answer on Item 11 could reflect anything from involvement in a civil suit to conviction of a felony, it is useful to examine whether the type of offense makes a difference. Are the differences between problem and non-problem funds driven by one specific type of violation? To address this question we classified the responses on Item 11 into four groups. Group 1 includes managers who responded affirmatively to being charged or convicted of a felony or a finance-related misdemeanor. Group 2 includes managers who have had their rights to trade revoked at some time in the past. Group 3 includes managers with some form of regulatory violation, including a falsification or fabrication. Group 4 includes managers involved in a civil suit. These classifications are non-exclusionary – one manager may show up in all four categories. For the sake of brevity, the results of this analysis are not presented in table form, however they clearly indicate that the differences between problem and non-

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<sup>30</sup> See, for example, Morgan (2004) who argues that individuals anticipating an unfair distribution mechanism in the case that the partnership dissolves may be reluctant to enter into the partnership in the first place. This would imply concentration of management when agency costs are extreme. This is particularly an issue in emerging economies. See Almeida and Wolfenzon (2006) and Harvey Lins and Roper (2003).

problem funds are not driven by a single category of violation.<sup>31</sup>

<Insert Table III about here>

The frequency of association between affirmative responses to Item 11 on Form ADV and affirmative responses to potential conflicts is interesting, but this correlation is not a direct test of the determinants of problem vs. non-problem funds. For example, one important issue in Table II is that the differences between problem and non-problem funds may be driven by differences in style or fund type. For instance, perhaps funds-of-funds attract more regulatory scrutiny, or have a different capital structure simply because their business is different than that of direct managers. Table III reports the results of a probit estimation with the dependent variable being one if the fund is a problem fund and zero if the fund is a non-problem fund. All models in the estimation include style dummies (unreported) to control for style differences. Model 1 includes only the manager and fund characteristic variables. Size is not significant while the lack of a high water mark and lower incentive fees are related to a fund having a problem. The association between past problems and lower incentive fees is interesting in the context of the redundancy hypothesis because it might indicate that that the market rationally incorporates the information about the fund's past problems and requires compensation for future operational risk in the form of lower fees. This relationship is

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<sup>31</sup> One potential selection bias in the sample of Form ADV filers is that managers might have been sued simply because their funds had low returns. To examine this we tested whether the returns to firms in the fourth category (i.e. civil lawsuits) had significantly lower returns than the overall group of problem funds. They did not.

not driven by the fact that funds-of-funds have lower fees. One of the style categories used for control purposes in the probit is the fund-of-fund classification.

Model 2 adds the first operational risk variable. The relationship variable is one if the fund has one of the external relationship conflicts of interest listed in Table III and zero otherwise. RecSecYouOwn is one if the fund recommends securities in which a related party has an ownership interest, BuySellYourOwn is one if the company buys and sells between itself and clients and OtherResearch is one if the fund uses external research. The coefficients on all of these variables are large, positive and statistically significant, indicating a positive relationship between potential conflicts of interest and legal or regulatory problems.

Model 3 adds two ownership variables to the model and exchanges the AgencyCrossTrans variable for the BuySellYourOwn variable. These two variables are highly correlated and unreported results indicate the AgencyCrossTrans variable dominates the BuySellYourOwn variable. AgencyCrossTrans is one if the fund performs agency cross transactions. Percentowner75 is the percentage of direct owners who own at least 75% of the company. If there is only one owner, the percentage is 100% versus 0% for a company with no large owner. Direct Domestic is the number of domestic entities listed as direct owners.

The AgencyCrossTrans variable is highly significant and positive, which again indicates internal conflicts of interest are related to fund problems. The two ownership variables are also positive and significant. Funds with concentrated management are more likely to be problem funds and funds with more domestic corporations listed as owners are more likely to be problem funds. In the context of the redundancy hypothesis,

this suggests that it may be difficult to find large equity partners to take a significant stake if you have a checkered legal and regulatory past.<sup>32</sup> This finding is potentially useful in future studies of ownership structure and investment performance, because it implies that the capital structure of investment partnerships is likely to be endogenously determined; not only by the technology it employs and the markets in which it trades, but also with respect to the exposure of the firm to operational risk.

One question one might have regarding the results in the table is whether they are affected by survival bias. Because the filing requirement for Form ADV and the most recent data from TASS are from the same time, only live funds filed ADVs. To overcome this limitation, we supplemented our original dataset with the TASS dataset from February 2005 in the hope some funds filed early or voluntarily. We examine which funds from the Live database in February 2005 moved to the Defunct database in our original dataset from February 2006. After excluding funds with no management information in either dataset, we found 126 funds that died over the nearly one year period. While the sample size is small with only 46 matched funds from TASS (8 problem and 38 non-problem), and significance levels thus lower, the results for this select sample of “disappeared” funds were substantially the same as for the broader sample.<sup>33</sup> For robustness, we also performed the same tests on other sub-samples. We estimated the probit on each of the four sub-categories of problem identified above.

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<sup>32</sup> See, for example, Morgan (2004). The problem of the fair division of an ongoing concern is one of the oldest problems in finance. Sylla (2003) quotes a translation of Huygens’ “On Reckoning in Games and Luck,” The quote is an apt one for hedge funds: “Since Gaming is becoming a Trade, I think it fit the Adventurers should be upon the Square...”

<sup>33</sup> We performed a number of additional robustness checks. First, we considered whether more recent legal and regulatory problems were more relevant than older ones. We found this to be the case: the correlation between conflicts of interest and legal and regulatory problems was lower for funds with problems that occurred before 2002. We checked to see if extreme returns were driving results by winsorizing the top and bottom 1% of returns. Results again were unaffected.

These gave weaker but quantitatively similar results. We removed managers with a large number of funds, to verify that the results are not driven by a few large managers. They are not. We also removed managers with affiliated mutual fund companies to see if this made a difference to the results. For this sample, most of the documented relationships between conflicts and problems in Table III were quantitatively unaffected, although the differences in ownership structure are attenuated, as expected.

### *B. Leverage and Operational Risk*

One test of the redundancy hypothesis is whether financial institutions such as prime brokers are able to distinguish between funds with higher and lower operational risk. To examine this, we explored differences in the leverage of problem and non-problem funds. In Table II, we noted a significantly different frequency in the reported use of leverage by problem and non-problem funds. This zero-one variable does not take into account the degree of leverage, however, nor does it control for fund style. Given the wide disparity in the market risk of different hedge fund styles, this control is crucial. In particular, funds-of-funds are less likely to employ leverage, and more likely to be problem funds.

<Insert Table IV about here>

Table IV reports the results of several tests of the relationship between fund leverage and measures of operational risk. Panel A reports tests for mean differences in

three leverage measures between problem and non-problem funds. The first [Leveraged] uses a zero-one variable reported by TASS as the measure of leverage. The second [Avg. Leverage] is the average fund leverage reported by TASS. The third [Maximum Leverage] is the maximum leverage of the fund reported by TASS. The test is applied to all funds in the matched sample, then to a sub-set which excludes funds-of-funds, and finally to a set for which the top 5% in terms of leverage are dropped from the sample. Notice that the difference in the zero-one leverage variable is largely explained by funds-of-funds. Once these are excluded from the analysis, the leveraged variable is insignificant, but differences in average leverage and maximum leverage are both significant at traditional confidence levels. Winsorizing at the 5% level of leverage shows that the significance is not driven by outliers.<sup>34</sup>

Panel B of Table IV reports two multi-variate regressions using different specifications for operations risk. For each year, we use TASS data to construct an operational risk measure (z-score).<sup>35</sup> This independent variable is calculated using the raw coefficients from the previous canonical analysis. This procedure is described in more detail later in the paper (see subsection D). We then perform cross-sectional regressions to predict leverage, controlling for style differences. Thus, the operational risk score is a function of contemporaneously observable data, rather than of retrospective 2006 ADV-disclosed data. The dependent variable in each regression is the average fund leverage. Both the average leverage and operational risk z-score are updated

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<sup>34</sup> These results are not driven by one category. Out of ten style categories, problem funds have lower leverage in seven, approximately the same leverage in two and higher leverage in only one. See Table V.

<sup>35</sup> Altman (1968) creates the Z-score model to study credit scoring.

each year using each fund's new values.<sup>36</sup> Unreported style dummies, as defined by TASS, and style dummies using a clustering-based style classification procedure are included for to control for style differences.<sup>37</sup> The inclusion of style dummies controls for the average leverage of each hedge fund style. Thus, for example, if fixed income funds typically used more leverage than merger arbitrage funds, this would be captured by the style dummies.

The results in Panel B of Table IV clearly show that problem funds and funds with high operational risk scores constructed from database variables observable at the time are correlated to differences in leverage and further that these differences in leverage are not due to fund style differences, defined in various ways. Although the way that style is defined (either self-reported or classified by a clustering algorithm) makes a difference in overall explanatory power, both approaches yield significant coefficients on risk. Table V shows how leverage differs by fund style. The consistency of the differences in average leverage across different fund styles is striking. Only one category (equity market neutral) has significantly higher average leverage for problem funds higher than for non-problem funds. In all other categories except for global macro (with less than one percent problem cases) the average leverage of problem funds is lower.

<Insert Table V about here>

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<sup>36</sup> Prior to 2001, the data from TASS in the average leverage field was not standardized. Data was reported in a variety of specifications and formats. Thus, we were only able to run the analysis for five years.

<sup>37</sup> The style classification developed in Brown and Goetzmann (1997) and applied to hedge funds in Brown and Goetzmann (2003) is likely to err on the conservative side by attributing more leverage effects to style than economically justified. To the extent that higher levered funds within a style move more together, this classification will potentially group them as an independent cohort. The advantage is that this approach relies on returns and thus is not biased by any systematic mis-reporting of style.

### *C. Returns and Operational Risk*

Up to this point we have documented strong cross-sectional relationships among variables disclosed in Form ADV by hedge funds, and have modeled the likelihood of legal and regulatory problems as a function of incentives, conflict of interest variables and ownership structure. These tell us little so far about the actual returns to investment.

Table VI reports the result of a regression in which the monthly fund return is the dependent variable, and the set of explanatory variables includes those identified in the probit as determinants of legal or regulatory problems. As with the probit model, style dummies are included to control for style differences. Returns are the average monthly return of the fund over its entire life. Variables that have been previously found to be related to returns are also used for control purpose: fund size (logassets), the standard deviation of the fund (stdev), and onshore (1 if the fund is based in the US and zero otherwise) are used as controls and a base specification in Model 1. Fund returns are positively related to all of these variables. Model 2 adds management and fund quality variables as well as the relationship variable<sup>38</sup>.

<Insert Table VI about here>

We see that the relationship variable, which is indicative of a potential external conflict of interest, is negative and significant at the 1% level. These conflict relationships are related to a 0.085% per month loss of return, or just over 1% per year. The last model adds ownership variables while continuing to use the same set of control

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<sup>38</sup> . Since find that legal and regulatory problems are associated with leverage, we added average leverage to the regressions. The effect is insignificant and does not affect any results. We do not report these results in Tables VI and VII

variables. The relationship variable, as in Model 2, is positive and significant. The inclusion of ownership characteristics slightly decreases the coefficient to 0.064% per month or 0.77% per year. Since our analysis suggests that ownership may reflect rational expectations of operational risk, this reduction in significance is not surprising.

The addition of a domestic entity as a direct owner reduces returns by 0.070% per month or just under 1% per year. Finally, the more concentrated a fund's management the lower the returns. Both of these variables may indicate a lack of management oversight, an additional layer of protection in case of fraud or the attempt of management to hide the background of certain owners. Overall, operational risk, as measured by conflicts of interest and management structure, has a negative affect on investor returns.

One strong argument to justify the use of related entities for transactions, and internal conflicts is that these provide a means to reduce costs. Although affiliates and multiple managerial responsibilities for clients may represent potential conflicts of interest, when used by ethical managers with good operational risk controls, they may alternatively represent a benefit to investors. Past tests of this proposition have provided inconsistent results on the question whether conflicts of interest affect financial performance positively or negatively. Our sample affords an opportunity to further explore this issue. If the hypothesis of related entities and overlapping services providing positive benefits in the hands of good managers is correct, we would expect to find significant differences between problem and non-problem funds with respect to the effect of conflicts of interest on performance. To examine this, we split the data into problem and non-problem groups and re-run the third model from Table VI. As before, style dummies are included to control for style differences and returns are the average returns

over the life of the fund. The results for the combined model are reported for ease of comparison. These results are reported in Table VII<sup>39</sup>.

<Insert Table VII about here>

When comparing the results of problem funds to non-problem funds, we perform a Chow test to determine if the two models provided significantly better results than the single model. The  $p$ -value of the Chow test was less than 0.01, indicating the returns of these two groups react significantly differently to these variables. Both the relationship variable and the internal conflict variable are significantly different for problem vs. non-problem funds. The sign on both of these conflict variables is consistent with the hypothesis that conflicts have the potential to benefit investor returns as well as the potential to harm them.

Agency theory also makes predictions about the effect of ownership concentration on performance. Here, a simple linear model may be insufficient to capture predicted effects. Having a large shareholder with a significant stake in a publicly traded firm provides benefits to smaller shareholders due to coat-tail effects, however if the shareholder is big enough, he or she is able to enjoy all the benefits of control.<sup>40</sup> Since

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<sup>39</sup> To examine whether the reported results were an artifact of periods, styles or length of return history, we also considered style mean adjusted returns and a variety of dummies controlling for both style and seasoning, as well as for individual year effects. The (unreported) results from this analysis were almost identical to the results reported in Tables VI and VII.

<sup>40</sup> For example, Morck, Shleifer and Vishny (1988), Holderness, Krosner and Sheehan (1999) and McConnell and Servaes (1990) find evidence of a non-linear relationship between percentage of insider ownership and Tobin's Q. Firm ownership structure is of course determined endogenously. Himmelberg, Hubbard and Palia (1999) and Demsetz and Villalonga (2001) test for ownership effects on performance and find none, a result consistent with endogenous capital structure determination. The latter provides a useful summary of related studies.

hedge funds are not organized like public corporations, predictions about the sign of the coefficient on ownership concentration are not clear. We might conjecture that having a single controlling owner leaves fewer checks on adverse behavior by other owners. On the other hand reputational effects might cause such a major stakeholder to behave in shareholder best interests. As with the literature of the ownership structure of public corporations, the ownership structure is, at least to some extent, endogenously determined. As we found above, endogenous factors influencing capital choice are likely to extend to the past regulatory and legal problems of the owner, as well as the markets traded and the technology developed by the firm.

In Table VI both problem and non-problem funds react the same to the existence of an owner with more than 75% of firm equity, although the coefficient is only statistically significant for non-problem funds. Concentrated ownership is related to lower returns for both samples. The direct domestic corporate variable is significantly negative for non-problem funds, but is not significant for problem funds. By sorting on the problem funds we presumably have already proxied on fund management quality and thus, this particular variable loses its ability to predict returns with a sample of mostly poor quality funds.<sup>41</sup>

Taken together, these results provide some evidence that potential conflicts are not universally bad. They support the theory that related entities and overlapping services have the potential to provide benefits to clients. In other words, lack of

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<sup>41</sup> The problem versus non-problem distinction is at the fund advisor level. Therefore, it is possible that not all of the funds for one particular management company are in the problem group. This should not systematically bias our results going forward. However, we also examine two subsets of our data to control for this issue. The first subset is management companies with five or fewer funds in TASS and the second is management companies with three or fewer funds. The funds in these management companies would most likely have higher correlations in terms of personnel and hence, it is more likely all funds would be problem funds. The results are consistent with those reported in the text, although the significance levels drop as a significant portion of our sample is removed.

constraints may be used either for good or ill, depending upon the quality and ethics of the manager. The results further suggest that a simple model of the effects of potential conflicts of interest may be insufficient and that interaction of these conflicts with legal and regulatory problems makes a difference.<sup>42</sup>

#### *D. Observable Proxies for Operational Risk*

The results in Tables VI and VII indicate ADV proxies for operational risk are negatively related to historical returns. They thus represent an important possible forecasting variable for investors. Although these variables were not reported in publicly available databases prior to 2006, other variables were. Information such as fund style, size, age, types of investments and so forth could be obtained from leading data vendors such as TASS. In this section, we examine the potential for constructing an instrument for operational risk using these observed variables. This allows us to retrospectively examine the performance of “problem” funds. In addition, given the most recent court decision regarding SEC requirements for hedge fund managers to file Form ADV as part of the registration process, the instrument based on TASS or other databases may be a useful additional tool going forward with which to assess operational risk. Although many funds now have the option to de-register, it remains to be seen how many, and what sort of funds choose to do so. Finally, the observable instrument allows us to examine the extent to which past publicly available information alone might have been able to capture operational risk.

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<sup>42</sup> In unreported results, we remove the first 18 months of returns to control for backfill bias. The results are in agreement with those reported here. The only change in significance is for the internal conflict, whose significance is removed. However, the signs are consistent with the reported results.

To construct the instrument, we use a matched data set to perform a canonical correlation analysis using the Form ADV disclosures in 2006 together with TASS variables that have been observed over a number of years<sup>43</sup>. We first identify TASS variables that prior research has shown to be associated with the probability of fund failure. We then define a linear combination of these variables that maximally correlate with the cross section of Form ADV disclosures in February 2006 which match to the TASS sample. Finally, we use this linear combination to proxy for unobserved Form ADV information in the years prior to February 2006 using a time series of TASS fund characteristics.

<Insert Table VIII about here>

Panel A of Table VIII reports the results of the canonical analysis. Average monthly returns from the previous year, monthly standard deviation from the previous year, size at the beginning of the period, fund age and whether or not the fund reports assets are included in the analysis as they have been previously related to fund death (Liang (2000), Brown, Goetzmann and Park (2001), Getmansky (2005)). The reported asset variable is a binary variable with a value of one if the fund reports assets and zero if it does not. Other characteristic data from TASS, which relate to fund quality, are also included.

The correlation between the rotation of the TASS and rotation of the Form ADV variables is 0.41 and is significant at 1%. Hence the TASS variables, while not a perfect

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<sup>43</sup> This canonical correlation procedure was first proposed by Hotelling (1936). A good textbook treatment can be found in Press (1972). For another Finance application, see Brown et al (2002).

proxy, do have some correlation with a rotation of the Form ADV variables. Also reported in Panel A are the correlation between the TASS variables and their canonical representation and the correlation between Form ADV variables and their canonical representation. The Form ADV variables are almost all positively correlated with the canonical variable, indicating a higher value has more operational risk.<sup>44</sup> Higher returns, standard deviation and incentive fee are all negatively correlated with the TASS canonical variable, indicating these are negatively correlated with operational risk. Thus, the canonical correlation suggests that, even though the ADV variables were not publicly available in the past, the information they capture about operational risk had at least some observable correlates.

Using the raw coefficients from the canonical analysis, we are able to examine the historical relationship between returns and an operational risk proxy. Instead of assuming the TASS characteristic data was static over time, we utilize nine different TASS datasets<sup>45</sup> over a period of nine years to use the most accurate characteristic data related to each fund at each time period. We use returns from the most recent TASS dataset however, as they are the most complete and accurate.<sup>46</sup>

From 1994 to 2005, we compute the canonical coefficient each year using the raw coefficients from our original analysis on the matched sample. This variable will be related to the operational risk of the fund as defined by Form ADV. We then regress this operational risk variable on fund returns and include unreported style dummies to control

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<sup>44</sup> The magnitudes of these correlations are moderate though.

<sup>45</sup> We have a TASS dataset each year from 1998-2006. We use the 1998 dataset for 1994-1997.

<sup>46</sup> This procedure would also eliminate much of the backfill bias. If the fund was not included in the TASS dataset for a particular year, the fund will be removed from the analysis even if there are now returns for that particular year in the latest return file.

for style differences.<sup>47</sup> As with the leverage analysis, both TASS and cluster-based style dummies are used. We begin in 1994 as TASS began keeping defunct funds in their dataset that year. Panel B of Table VIII reports the results of this analysis.

Over the entire twelve year history, both specifications result in a negative, significant z-score coefficient. Hence, just as was found in our limited one-year cross-sectional sample for 2006, operational risk is negatively related to fund returns. Of the twelve years, the operational risk variable is negatively related to returns in ten of the years. The two years in which the variable is positive are 1998, which was an extremely difficult year for hedge funds due to the Russian debt crisis and the near collapse of the LTCM, and 2000 when the technology bubble burst. They are also years of great attrition of hedge funds, which would eliminate *ex-post* some of the riskiest funds in the sample – a selection bias that is known to induce a spurious *ex-post* cross-sectional relationship between risk and return.

These results suggest that, while it may be difficult to construct a perfect proxy for Form ADV conflict variables going forward, in the absence of such filings there may still be some capacity to forecast differences in future hedge fund returns based on observable characteristics. An important caveat is, of course, that return differentials are not adjusted for market risk.

#### *E. Investor Flows and Operational Risk*

In the analysis thus far, we have found evidence that the operational risk variables in Form ADV filings by hedge fund managers are potentially relevant to expectations

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<sup>47</sup> Alternative specifications of the canonical analysis were performed, including specifications including adjusted returns. These alternative specifications did not change the relationship between operational risk and returns.

about returns. At the same time we have also found evidence that equity investors and lenders to problem funds are able to differentiate them from non-problem funds. Problem funds are more likely to have less average and maximum leverage, and are more likely to have an owner with an ownership stake greater than 75%. These results are consistent with the redundancy hypothesis i.e. that, absent Form ADV filings, information exists which would allow major debt and equity investors to separate funds along the dimension of operation risk. Our canonical correlation analysis shows one such separating mechanism that relies upon existing (albeit costly) hedge fund databases. In this section we ask whether individual investors are able to differentiate between problem and non-problem funds absent the Form ADV filing information. We have already found some evidence consistent with this ability. Problem funds have lower incentive fees, perhaps because they have to compensate for reputational issues. A more powerful test of the redundancy hypothesis, however, is to check whether investor flows respond equally to good performance by problem and non-problem funds.

<Insert Table IX about here>

Table IX reports the result of a flow-performance regression applied separately to problem and non-problem funds.<sup>48</sup> Yearly flow is defined as the percentage change in assets in a given year net of asset returns assuming end of year investment. This is regressed on the rank for the fund within style, separated into three segments to allow for

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<sup>48</sup> See, for example, Sirri and Tufano (1998), Chevalier and Ellison (1999) who apply this to mutual funds. Agarwal et al. (2006) and Ding et al. (2006) apply this to hedge funds.

High, Middle and Low performance<sup>49</sup>. This separation is due to considerable previous evidence in the mutual fund sector that the flow-performance relationship is stronger for higher-ranked funds. Next we include the operational risk score constructed via canonical correlation, and a set of interaction terms taking the product of the operation risk score with the rank. Note that there is no apparent or significant difference between the flow-performance and the operational risk score, nor is there a consistent pattern in the interaction terms. Operational risk factors do not appear to influence fund flow. The fact that investors do not take these factors into account was the motivation behind the SEC rule change that mandated disclosure of information material to a determination of operational risk.

## **V. Conclusion**

The hedge fund industry has enjoyed tremendous growth over the past several years. This growth led to an in-depth review of hedge fund activities by the SEC that resulted in 2004 in new rules and rule amendments being adopted that greatly expanded the number of hedge fund managers required to register with the SEC as investment advisers and file Form ADV. The SEC argued that Form ADV disclosure was necessary to provide material information to hedge fund investors concerned about operational risk. These rule changes were resisted by the hedge fund industry which argued that the Form ADV filing requirement was unnecessarily burdensome given that the information

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<sup>49</sup> The results are robust to this specification of performance. We re-ran the analysis splitting the ranks into 4 and 5 groups without any appreciable difference in the results reported in Table IX.

disclosed could be obtained in other ways. Shortly after the first filing date in February 2006, the Federal Courts struck down this filing requirement.

By matching every Form ADV filed in February 2006 to the TASS hedge fund database, we are able to show that these disclosures do indeed contain information that can be used to measure operational risk. Legal, regulatory and other problems are highly associated with measures of conflict of interest reported on those forms. But is this information material to investors? To answer this question, we examine the hypothesis that the disclosures provided redundant information to equity investors, lenders and share investors in hedge funds.

We tested the redundancy hypothesis in several ways. We examined differences in ownership structure and found that problem funds had a higher likelihood of an owner with a stake greater than 75 percent, and more indirect ownership. This is consistent with less access to equity capital by problem funds. We next examined differences in leverage. Controlling for the effects of style and the issues of retrospective definition of operational risk, we found strong evidence that problem funds and funds with higher operational risk tended to have lower average leverage. Since the ownership structures and degree of leverage antedate Form ADV disclosure, we conclude that this disclosure is not material to well informed capital market participants.

Finally, we test whether hedge fund investors are able to distinguish among problem and non problem funds. In contrast to the earlier findings, operational risk indicators have no influence on the well-documented flow performance relationship. This suggests that Form ADV disclosures contain information not generally available to investors. While registration is not costless, an argument can be made that the

information disclosed is indeed material to investors and that mandatory disclosure would level the informational playing field. However, mandatory disclosure in February 2006 did not help the investors at Amaranth Advisors LLC, the well known hedge fund that collapsed in September 2006<sup>50</sup>. This fund does not appear to have filed Form ADV in February. Given that Amaranth was not exempt from the filing requirement, failure to file should have been highly informative. We cannot exclude the possibility that the high net worth individuals and institutions continued to invest in Amaranth despite knowing all that there was to know about this company. In other words, disclosure might meet the stated purpose of providing information that allows investors to avoid operational risk. However, it might not be material information if investors, having access to this information, choose not to act upon it.

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<sup>50</sup> *Wall Street Journal* September 29, 2006

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**Table I: Descriptive Statistics of TASS Data**

This table presents descriptive statistics for funds whose management companies filed Form ADV and are reported on the TASS database as of December 31 2005. The cross section sample mean and median of these descriptive statistics are compared with those of the entire live TASS database as of the same date, together with the difference in sample means and a measure of the significance of the difference. . . Return is the average return over the life of the fund. Autocorr is the 1<sup>st</sup> order autocorrelation of the fund's returns. Mfee is the management fee reported in percent. Ifee is the incentive fee also reported in percent. Min Invt is the minimum investment of the fund and assets are the assets of the fund in \$mm. Leverage, Margin and High water Mark are one if the fund uses leverage, uses margin or has a high water mark, respectively. Lockup Period is measured in months. Sub frequency is the subscription frequency measured in days and red freq is the redemption frequency also measured in days.

	Matched Funds				All TASS Live Funds				Diff	p-value
	N	Mean	Median	Std Dev	N	Mean	Median	Std Dev		
Return	2282	0.96	0.83	0.79	3998	0.93	0.79	0.88	0.03	0.22
Std Dev	2279	2.71	1.99	2.27	3992	2.78	2.06	2.38	-0.07	0.11
Skewness	2270	0.01	-0.05	1.14	3975	0.01	-0.06	1.11	0.00	0.87
Kurtosis	2261	2.62	1.02	6.59	3958	2.57	0.97	6.21	0.05	0.81
Autocorr	2240	0.14	0.14	0.20	3919	0.12	0.13	0.20	0.02	0.00***
Sharpe Ratio	2279	0.39	0.30	0.72	3992	0.34	0.28	0.59	0.05	0.01**
Mfee	2298	1.38	1.50	0.51	4019	1.44	1.50	0.58	-0.06	0.00***
Ifee	2298	17.13	20.00	6.18	4019	16.27	20.00	6.87	0.86	0.00***
Min Invt	2295	1.23	0.50	8.01	4012	3.84	0.40	112.93	-2.61	0.15
Assets	1989	186.64	55.00	427.16	3503	181.11	48.00	439.36	5.53	0.65
Leverage	2298	0.56	1.00	0.50	4019	0.56	1.00	0.50	0.00	0.51
Margin	1733	0.46	0.00	0.50	2938	0.44	0.00	0.50	0.02	0.18
High water Mark	2298	0.80	1.00	0.40	4019	0.76	1.00	0.43	0.04	0.00***
Lockup Period	2298	4.36	0.00	6.63	4019	3.55	0.00	7.00	0.81	0.00***
Sub Freq	2279	36.02	30.00	25.40	3972	34.43	30.00	25.22	1.59	0.01**
Red Freq	2284	83.00	90.00	85.88	4001	69.21	30.00	75.76	13.79	0.00***

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table II: Comparison of “Problem” and “Non-Problem” Funds**

This table reports cross sectional means, , medians and difference in means of descriptive statistics for both “Problem” and “Non-Problem” funds in our population of hedge funds filing Form ADV.. “Problem” funds are any TASS fund whose management company answered “Yes” to any of the questions on Item 11 of Form ADV. “Non-Problem” funds are all other TASS funds that filed Form ADV.. Panel A reports results for performance statistics. Avg Return, std dev, 1<sup>st</sup> order AC and Sharpe ratio are the average return of the fund, the standard deviation, the first order autocorrelation and Sharpe Ratio of fund over its life. Panel B reports results for external conflicts of interest, while Panel C breaks down internal conflict data. Broker/Dealer is one if the fund has a related broker/dealer. Investment Comp is one if the fund has a related Investment Company. Investment Adviser, Commodities Broker, Bank, Insurance and Sponsor of LLP are one if the fund is related to one of these companies respectively. BuySellYourOwn is one if the company buys and sells between itself and clients. BuySellYourselfClients is one if a related party buys/sells securities also recommended to the fund. RecSecYouOwn is one if the fund recommends securities in which a related party has an ownership interest. AgencyCrossTrans is one if the fund performs agency cross transactions. RecUnderwriter is one if a related party recommends securities to clients in which they are the underwriter. RecSalesInterest is one if a related party recommends securities with a sales interest. OtherResearch is one if the fund uses external research. Panels D and E look at fund/manager characteristics and governance/ownership variables respectively. High water Mark, leveraged and margin are one if the fund has a high water mark, uses leverage or uses margin. Diect Owners is the number of direct owners. Controlling is the number of controlling owners. Percent own 75% is the percentage of owners that own at least 75% of the fund. Domestic Direct Corp is the number of domestic corporations listed as direct owners. Indirect owners is the number of indirect owners.

**Panel A: Performance Statistics and Fund/Manager Characteristics**

	“Problem” Funds			“Non-Problem” Funds			Diff	p-value
	N	Mean	Median	N	Mean	Median		
Avg Return	365	0.89	0.80	1915	0.98	0.84	-0.09	0.05**
Std Dev	363	2.58	1.76	1914	2.73	2.08	-0.15	0.22
1 <sup>st</sup> order AC	358	0.14	0.15	1880	0.14	0.14	0.00	0.92
Sharpe Ratio	363	0.34	0.29	1914	0.40	0.30	-0.06	0.02**
AUM (\$mm)	334	217.32	59.18	1653	179.96	54.00	37.36	0.20
Age (Years)	367	5.60	4.50	1929	4.96	3.83	0.64	0.01***
Min Investment (\$mm)	367	0.96	0.50	1926	1.28	0.50	-0.32	0.33
Management Fee (%)	367	1.37	1.50	1929	1.38	1.50	-0.01	0.71
Incentive Fee (%)	367	15.25	20.00	1929	17.49	20.00	-2.24	0.00***
High Water Mark	367	0.69	1.00	1929	0.82	1.00	-0.13	0.00***
Lockup Period (months)	367	4.00	0.00	1929	4.43	0.00	-0.43	0.21

**Panel B: External Conflicting Relationships**

With:	"Problem" Funds		"Non-Problem" Funds		Diff	p-value
	N	% Yes	N	% Yes		
Broker/Dealer	368	73.1	1929	23.7	49.4	0.00***
Investment Comp	368	50.3	1929	15.8	34.5	0.00***
Investment Adviser	368	73.9	1929	41.6	32.3	0.00***
Commodities Broker	368	53.5	1929	20.7	32.8	0.00***
Bank	368	40.5	1929	9.8	30.7	0.00***
Insurance	368	39.9	1929	8.3	31.6	0.00***
Sponsor of LLP	368	56.8	1929	21.5	35.3	0.00***

**Panel C: Internal Conflicts**

	"Problem" Funds		"Non-Problem" Funds		Diff	p-value
	N	% Yes	N	% Yes		
BuySellYourOwn	368	30.7	1929	8.3	22.4	0.00***
BuySellYourselfClients	368	84.8	1929	69.3	15.5	0.00***
RecSecYouOwn	368	75.5	1929	50.4	25.1	0.00***
AgencyCrossTrans	368	30.7	1929	2.3	28.4	0.00***
RecUnderwriter	368	69.0	1929	47.0	22.0	0.00***
RecSalesInterest	368	22.6	1929	15.7	6.9	0.00***
RecBrokers	368	46.7	1929	38.0	8.7	0.00***
OtherResearch	368	81.0	1929	70.5	10.5	0.00***

**Panel D: Ownership/Capital Structure**

	"Problem" Funds			"Non-Problem" Funds			Diff	p-value
	N	Mean	Median	N	Mean	Median		
Direct Owners	368	9.96	9.00	1929	7.33	6.00	2.63	0.00***
Controlling	368	8.28	7.00	1929	5.97	5.00	2.31	0.00***
Percent own 75%	366	0.73	1.00	1929	0.50	0.50	0.23	0.00***
Domestic Direct Corp	368	0.80	1.00	1929	0.49	0.00	0.31	0.00***
Indirect Owners	368	2.33	1.00	1929	1.37	0.00	0.96	0.00***
Leveraged	367	0.51	1.00	1929	0.57	1.00	-0.06	0.03**
Margin	280	0.35	0.00	1451	0.49	0.00	-0.14	0.00***
Personal Capital (\$mm)	109	1.26	0.00	622	2.62	0.00	-1.36	0.02**

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table III: Probit Model Analysis on the “Problem” Variable**

Probit results are reported in this table. The dependent variable in all Models is one if the fund has a “problem,” while it is zero if the fund does not have a “problem.” The model is modeled such that the results aim to fit the “problem” set of data (ie. 1). Log(Assets) is the log of the assets under management in dollars. High water mark is a one if the fund has a high water mark. The mean return is the average return over the life of the fund. Incentive fee is the fund’s incentive fee in percent. Relationship is one if the fund has any external conflict of interest listed in Table 3. AgencyCrossTrans is one if the fund performs agency cross transactions. RecSecYouOwn is one if the fund recommends securities in which a related party has an ownership interest. BuySellYourOwn is one if the company buys and sells between itself and clients. OtherResearch is one if the fund uses external research. Percentowner75 is the percentage of direct owners who own at least 75% of the company. Direct Domestic is the number of domestic corporations listed as direct owners. Unreported style dummies were included to control for style differences.

	Model 1		Model 2		Model 3	
	coefficient	Chi-Sq	coefficient	Chi-Sq	coefficient	Chi-Sq
Log(Assets)	0.014	0.49	-0.022	1.08	-0.007	0.00
High Water Mark	-0.199	5.36**	-0.114	1.487	-0.149	2.31
Mean Return					0.059	1.23
Incentive Fee	-0.037	21.44***	-0.038	20.29***	-0.036	16.82***
Relationship			0.759	66.17***	0.652	44.44***
AgencyCrossTrans					1.400	121.65***
RecSecYouOwn			0.345	17.70***	0.374	19.32***
BuySellYourOwn			0.695	49.38***		
OtherResearch			0.294	8.43***	0.226	4.53**
Percentowner75					0.551	38.15***
Direct Domestic					0.134	9.60***
Pseudo R-squared	3.89%		16.59%		25.30%	
Num Obs	1986		1986		1969	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table IV: Problems, Operational Risk and Leverage**

Table IV reports the results of several tests of the relationship between fund leverage and measures of operational risk. Panel A reports tests for mean differences in three leverage measures between problem and non-problem funds. The three measures are “Leveraged” which is a zero-one variable reported by TASS. The second [Avg. Leverage] is the average fund leverage reported by TASS. The third [Maximum Leverage] is the maximum leverage of the fund reported by TASS. The test is applied to all funds in the match sample, then to a sub-set which excludes funds-of-funds and finally to a set for which the top 5% in terms of leverage are dropped from the sample. Panel B reports two multivariate regressions using different specifications for operations risk. The dependent variable in each is the average leverage of each fund as reported by TASS. The independent variable is calculated using the raw coefficients from the previous canonical analysis. Both the average leverage and operational risk z-score are updated each year using each fund’s new values. Unreported style dummies, as defined by TASS, and style dummies using the Brown Goetzmann style classification procedure are included for control for style differences.

**Panel A: Univariate Tests**

	All Funds in Matched Sample				Diff	$\rho$ -value
	“Problem” Funds		“Non-Problem” Funds			
	N	Mean	N	Mean		
Leveraged	367	0.51	1929	0.57	-0.06	0.03**
Avg. Leverage	280	52.20	1451	85.31	-33.11	0.00***
Maximum Leverage	280	96.82	1451	140.68	-43.86	0.00***

  

	Only Hedge Funds				Diff	$\rho$ -value
	“Problem” Funds		“Non-Problem” Funds			
	N	Mean	N	Mean		
Leveraged	271	0.61	1535	0.61	0.00	0.87
Avg. Leverage	225	63.73	1201	95.57	-31.84	0.01***
Maximum Leverage	225	118.27	1201	158.80	-40.53	0.04**

  

	All Funds in Matched Sample - Winsorized top 5%				Diff	$\rho$ -value
	“Problem” Funds		“Non-Problem” Funds			
	N	Mean	N	Mean		
Avg. Leverage	280	43.34	1451	65.15	-21.81	0.00***
Maximum Leverage	280	81.46	1451	108.33	-26.87	0.00***

**Panel B: Canonical Risk Measure Predicting Leverage**

Year	TASS style Dummies		B-G Style Dummies	
2005	-18.48	-4.17***	-6.42	-6.83***
2004	-29.12	-5.92***	-35.08	-8.26***
2003	-25.33	-4.90***	-33.52	-7.23***
2002	-18.45	-3.50***	-27.52	-5.81***
2001	-22.87	-4.17***	-28.07	-5.48***
Average	-22.85	-11.15***	-26.12	-5.08***
Avg Adj. R-sq.	13.79%		2.66%	
Avg. Obs.	2279		2279	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table V: Fund Distribution and Leverage by Style**

This table reports the breakdown of matches and leverage by style. The first two columns report the percentage of funds in each style for both the entire matched ADV sample and the problem group. The later two columns report the average of the average leverage for funds in each style. The third column reports the average leverage for problem funds in each style while the last column reports the average leverage for non-problem funds in each style.

Category	Matched	Problem	Problem Avg	Non-Problem Avg
Convertible Arb	4.22%	7.07%	118.04	170.24
Dedicated Short	0.70%	0.00%	n/a	72.22
Emerging Markets	4.22%	2.99%	0.00	18.60
Equity Neutral	6.26%	5.71%	185.31	61.18
Event Driven	11.92%	13.59%	51.30	51.37
Fixed Arb	6.05%	3.26%	287.50	415.89
FOF	21.31%	26.09%	6.47	36.04
Global Macro	3.57%	0.81%	140.00	134.24
Long-Short HE	34.71%	32.61%	23.85	44.91
Managed Futures	3.48%	4.08%	19.34	91.01
Multi-Strat	3.52%	3.53%	40.00	120.70

**Table VI: Conflicts, Ownership and Fund Returns**

This table reports regression results with a fund's monthly mean return as the dependent variable.  $\text{Log(Assets)}$  is the log of the assets under management in dollars. Std Dev is the standard deviation of a fund's returns over the life of the fund. Onshore is one if the fund is based in the United States. Incentive fee is the fund's incentive fee in percent. High water Mark is a one if the fund has a high water mark. Relationship is one if the fund has any external conflicts of interest. Direct Domestic is the number of domestic corporations listed as direct owners. Percentowner75 is the percentage of direct owners who own at least 75% of the company. Unreported style dummies were included to control for style differences.

	Model 1		Model 2		Model 3	
	coefficient	t-value	coefficient	t-value	coefficient	t-value
Log(Assets)	0.092	11.50***	0.094	11.80***	0.094	11.78***
Std Dev	0.166	24.26***	0.166	24.19***	0.166	24.27***
Onshore	0.082	2.86***	0.073	2.47**	0.080	2.77***
Lockup Period			0.003	1.32		
Incentive Fee			0.004	1.13		
High Water Mark			0.061	1.63	0.079	2.27**
Relationship			-0.085	-2.85***	-0.064	-2.13**
Direct Domestic					-0.070	-4.36***
Percentowner75					-0.098	-3.23***
Adjusted R-squared	35.27%		35.74%		36.53%	
Num Obs	1973		1973		1969	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table VII: Conflicts, Ownership and Returns: Problem vs. non-Problem Funds**

This table reports results with “Problem” funds and “Non-Problem” treated separately. As in Table 5, the fund’s mean return is the dependent variable. Log(Assets) is the log of the assets under management in dollars. Std Dev is the standard deviation of a fund’s returns over the life of the fund. Onshore is one if the fund is based in the United States. Incentive fee is the fund’s incentive fee in percent. High water Mark is a one if the fund has a high water mark. Relationship is one if the fund has any external conflicts of interest. Direct Domestic is the number of domestic corporations listed as direct owners. Percentowner75 is the percentage of direct owners who own at least 75% of the company. Unreported style dummies were included to control for style differences. Also unreported is a specification with average leverage in place of Fund Age. Average Leverage was insignificantly related to returns in any of the three samples.

	“Problem” Funds		“Non-Problem” Funds		Combined	
	coefficient	t-value	coefficient	t-value	coefficient	t-value
Log(Assets)	0.106	4.81***	0.103	11.53***	0.106	12.77***
Fund Age (Years)	-0.027	-2.89***	-0.019	-4.23***	-0.020	-5.10***
Std Dev	0.162	8.23***	0.179	23.40***	0.176	24.72***
Onshore	0.059	0.84	0.115	3.62***	0.105	3.61***
Incentive Fee	-0.005	-0.67	0.007	1.70*	0.004	1.04
High Water Mark	-0.030	-0.33	-0.008	-0.18	-0.007	-0.17
Relationship	-0.655	-5.53***	-0.030	-0.91	-0.072	-2.34**
Internal Conflict	-0.044	-0.60	0.101	2.58***	0.051	1.50
Direct Domestic	0.011	0.22	-0.078	-4.62***	-0.070	-4.35***
Percentowner75	-0.142	-1.57	-0.087	-2.63***	-0.099	-3.23***
Chow test $p$ -value	<0.01					
Adjusted R-squared	38.46%		38.69%		37.34%	
Num Obs	330		1639		1969	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

**Table VIII: Canonical and Time Series Analysis of TASS and ADV Data**

This table reports the results of a canonical analysis relating operational risk ADV data to the observable TASS data. Panel A reported the results of the canonical analysis using 2,279 matched funds. Panel B reports regression results from 1994 to 2005 using 9 different TASS datasets. The dependent variable is the yearly return of each. The independent variable is calculated using the raw coefficients from the canonical analysis. This value is updated each year using each fund's new values. Returns, are the average monthly returns from the previous year and standard deviation is the monthly standard deviation from the previous year. Age and size are the values from the end of the previous period. Other characteristic data is from the same period as the analysis. Reports Assets is a binary variable with a value of one if the fund reports assets and zero if they do not. Unreported style dummies were included in Panel B.

Panel A: Canonical Correlation Results

TASS Variables		ADV Variables	
Previous Returns	-0.27**	AgencyCrossTrans	0.06**
Previous Std. Dev.	-0.35***	RelBrokerDealer	0.28***
Fund Age	-0.07***	RelInvestComp	0.24***
Log of Assets	0.13***	RelInvAdviser	0.24***
Reports Assets	0.12***	RelCommod	0.44***
Incentive Fee	-0.88***	RelBank	0.38***
Margin	-0.29***	RelInsur	0.44***
Audited	-0.19***	RelPartSponser	0.30***
Personal Capital	-0.29***	BuySellYourOwn	0.08**
Onshore	-0.05***	BuySellYourselfClient	-0.08***
Open to Inv.	0.08	RecSecYouOwn	0.33***
Accepts Managed Accts	-0.13***	RecUnderwriter	0.26***
		RecSalesInterest	0.28***
		RecBrokers	-0.33***
		OtherResearch	-0.70***
		PercentOwner75	0.15***
Correlation Between TASS and ADV Panels	0.42***	DirectDomestic	0.31***

Panel B: Regression Results - Operational Risk Coefficient

Year	TASS Style Dummies		B-G Style Dummies	
	coefficient	t-value	coefficient	t-value
1994	-2.55%	-3.25***	-1.63%	-2.53**
1995	-1.12%	-1.22	-0.98%	-1.26
1996	-2.05%	-2.66***	-1.02%	-1.62
1997	-4.63%	-6.07***	-3.34%	-5.70***
1998	2.61%	3.11***	0.56%	0.86
1999	-5.10%	-1.95*	-2.33%	-1.24
2000	2.76%	3.28***	0.07%	0.12
2001	-1.85%	-3.38***	-0.94%	-2.50**
2002	-3.32%	-7.31***	-2.07%	-6.69***
2003	-6.53%	-5.90***	-3.39%	-4.14***
2004	-2.01%	-6.00***	-0.25%	-1.05
2005	-1.23%	-3.39***	-0.15%	-2.44**
Average Value	-2.09%	-2.61**	-1.30%	-3.53***
Avg. Adjusted R-squared	9.32%		36.77%	
Average Observations	1,338		1,338	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

### Table IX: Operational Risk and Flow Analysis

Table VIII reports flow results using data from 1994-2005. Flows are computed annually using the following formula:

$$\text{Flow}_t = \frac{(\text{Assets}_t - \text{Assets}_{t-1} * \text{Return}_t)}{\text{Assets}_{t-1}}$$

Assets and returns are computed in the fund's native currency to avoid exchange rate affects. Low Rank, Mid Rank and High Rank are computed as  $\text{Min}(\text{Rank}_{t-1}, 0)$ ,  $\text{Min}(\text{Rank}_{t-1} - \text{Low Rank}, 0)$  and  $\text{Min}(\text{Rank}_{t-1} - \text{Mid Rank} - \text{Low Rank}, 0)$  respectively, where  $\text{Rank}_{t-1}$  is the percentile level of the previous year's performance in the fund's TASS style. Std. Dev. is the previous year's monthly standard deviation. Flows to Category are the average flow to that fund's particular style in year t. Log Assets is the log of the previous end of period's assets and Management fee is the current management fee level. Operational Risk z-score is computed each year per the previous specification. Model A includes the operational risk z-score only whereas Model B also includes three interaction terms. Both models are run using the Fama and MacBeth (1973) framework.

	Model 1		Model 2	
	Coefficient	t-value	Coefficient	t-value
Low Rank	0.596	5.15***	0.634	6.16***
Mid Rank	0.977	6.01***	0.981	6.29***
High Rank	0.905	6.11***	0.886	4.71***
Std. Dev. of monthly returns	-0.022	-5.44***	-0.023	-6.12***
Flows to Category	0.685	8.44***	0.686	8.32***
Log Assets	-0.117	-6.66***	-0.118	-6.73***
Management Fees	-0.045	-3.71***	-0.044	-3.53***
Operational Risk Z-score	-0.010	-1.58	0.025	1.00
Low Rank/Z-score interaction			-0.019	-0.15
Mid Rank/Z-score interaction			-0.202	-1.93*
High Rank/Z-score interaction			0.085	0.69
Adjusted R-squared	14.00%		14.16%	
Number of Observations	966		966	

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% respectively

## Appendix: Variable Definitions

Variable Name	Num	Question on ADV
RelBrokerDealer	746 7.A.1	You have a <i>related person</i> that is a broker-dealer, municipal securities dealer, or government securities broker or dealer
RelInvestComp	489 7.A.2	You have a <i>related person</i> that is an investment company (including mutual funds)
RelInvAdviser	1074 7.A.3	You have a <i>related person</i> that is an other investment adviser (including financial planners)
RelCommod	597 7.A.4	You have a <i>related person</i> that is a futures commission merchant, commodity pool operator, or commodity trading adviser
RelBank	338 7.A.5	You have a <i>related person</i> that is a banking or thrift institution
RelAcct	73 7.A.6	You have a <i>related person</i> that is an accountant or accounting firm
Rellawyer	122 7.A.7	You have a <i>related person</i> that is a lawyer or law firm
RelInsur	327 7.A.8	You have a <i>related person</i> that is an insurance company or agency
RelPension	96 7.A.9	You have a <i>related person</i> that is a pension consultant
RelRealEst	150 7.A.10	You have a <i>related person</i> that is a real estate broker or dealer
RelPartSponsor	643 7.A.11	You have a <i>related person</i> that is a sponsor or syndicator of limited partnerships
BuySellYourOwn	274 8.A.1	Do you or any <i>related person</i> buy securities for yourself from advisory <i>clients</i> , or sell securities you own to advisory <i>clients</i> (principal transactions)?
BuySellYourselfClients	1649 8.A.2	Do you or any <i>related person</i> buy or sell for yourself securities (other than shares of mutual funds) that you also recommend to advisory <i>clients</i> ?
RecSecYouOwn	1251 8.A.3	Do you or any <i>related person</i> recommend securities (or other investment products) to advisory <i>clients</i> in which you or any <i>related person</i> has some other proprietary (ownership) interest (other than those mentioned in Items 8.A(1) or (2))?
AgencyCrossTrans	157 8.B.1	Do you or any <i>related person</i> as a broker-dealer or registered representative of a broker-dealer, execute securities trades for brokerage customers in which advisory <i>client</i> securities are sold to or bought from the brokerage customer (agency cross transactions)?
RecUnderwriter	1161 8.B.2	Do you or any <i>related person</i> recommend purchase of securities to advisory <i>clients</i> for which you or any <i>related person</i> serves as

RecSalesInterest	385	8.B.3	underwriter, general or managing partner, or purchaser representative? Do you or any <i>related person</i> recommend purchase or sale of securities to advisory <i>clients</i> for which you or any <i>related person</i> has any other sales interest (other than the receipt of sales commissions as a broker or registered representative of a broker-dealer)?
RecBrokers	905	8.D	Do you or any <i>related person</i> recommend brokers or dealers to <i>clients</i> ?
OtherResearch	1638	8.E	Do you or any <i>related person</i> receive research or other products or services other than execution from a broker-dealer or a third party in connection with <i>client</i> securities transactions?
ReferralComp	1689	8.F	Do you or any <i>related person</i> , directly or indirectly, compensate any <i>person</i> for <i>client</i> referrals?
ConvictedFelony	6	11.A.1	In the past ten years, have you or any <i>advisory affiliate</i> been convicted of or plead guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to any <i>felony</i> ?
ChargedFelony	8	11.A.2	In the past ten years, have you or any <i>advisory affiliate</i> been <i>charged</i> with any <i>felony</i> ?
ConvictedInvMisd	1	11.B.1	In the past ten years, have you or any <i>advisory affiliate</i> been convicted of or plead guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to a <i>misdemeanor</i> involving: investments or an <i>investment-related</i> business, or any fraud, false statements, or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses?
ChargedInvMisd	0	11.B.2	In the past ten years, have you or any <i>advisory affiliate</i> been <i>charged</i> with a <i>misdemeanor</i> listed in 11.B(1)? (Question above)
SECFalseStat	25	11.C.1	Has the SEC or the Commodity Futures Trading Commission (CFTC) ever <i>found</i> you or any <i>advisory affiliate</i> to have made a false statement or omission
SECViolation	66	11.C.2	Has the SEC or the Commodity Futures Trading Commission (CFTC) ever <i>found</i> you or any <i>advisory affiliate</i> to have been <i>involved</i> in a violation of SEC or CFTC regulations or statutes?
SECCausedDenyAuth	2	11.C.3	Has the SEC or the Commodity Futures Trading Commission (CFTC) ever <i>found</i> you or any <i>advisory affiliate</i> to have been a cause of an <i>investment-related</i> business having its

SECOderAgainst	40	11.C.4	authorization to do business denied, suspended, revoked, or restricted? Has the SEC or the Commodity Futures Trading Commission (CFTC) ever entered an <i>order</i> against you or any <i>advisory affiliate</i> in connection with <i>investment-related</i> activity?
SECCivilMoneyPenalty	66	11.C.5	Has the SEC or the Commodity Futures Trading Commission (CFTC) ever imposed a civil money penalty on you or any <i>advisory affiliate</i> , or <i>ordered</i> you or any <i>advisory affiliate</i> to cease and desist from any activity?
AgencyFalseStat	38	11.D.1	Has any other federal regulatory agency, any state regulatory agency, or any <i>foreign financial regulatory authority</i> ever <i>found</i> you or any <i>advisory affiliate</i> to have made a false statement or omission, or been dishonest, unfair, or unethical?
AgencyViolation	170	11.D.2	Has any other federal regulatory agency, any state regulatory agency, or any <i>foreign financial regulatory authority</i> ever <i>found</i> you or any <i>advisory affiliate</i> to have been <i>involved</i> in a violation of <i>investment-related</i> regulations or statutes?
AgencyCausedDenyAuth	7	11.D.3	Has any other federal regulatory agency, any state regulatory agency, or any <i>foreign financial regulatory authority</i> ever <i>found</i> you or any <i>advisory affiliate</i> to have been a cause of an <i>investment-related</i> business having its authorization to do business denied, suspended, revoked, or restricted?
AgencyOrderAgainst	162	11.D.4	Has any other federal regulatory agency, any state regulatory agency, or any <i>foreign financial regulatory authority</i> in the past ten years, entered an <i>order</i> against you or any <i>advisory affiliate</i> in connection with an <i>investment-related</i> activity?
AgencyRevokeLicense	12	11.D.5	Has any other federal regulatory agency, any state regulatory agency, or any <i>foreign financial regulatory authority</i> ever denied, suspended, or revoked your or any <i>advisory affiliate's</i> registration or license, or otherwise prevented you or any <i>advisory affiliate</i> , by <i>order</i> , from associating with an <i>investment-related</i> business or restricted your or any <i>advisory affiliate's</i> activity?
SelfFalseStat	10	11.E.1	Has any <i>self-regulatory organization</i> or commodities exchange ever <i>found</i> you or any <i>advisory affiliate</i> to have made a false statement or omission?
SelfViolation	98	11.E.2	Has any <i>self-regulatory organization</i> or commodities exchange ever <i>found</i> you or any <i>advisory affiliate</i> to have been <i>involved</i> in a violation of its rules (other than a violation

SelfCausedDenyAuth	11	11.E.3	designated as a "minor rule violation" under a plan approved by the SEC)? Has any <i>self-regulatory organization</i> or commodities exchange ever <i>found</i> you or any <i>advisory affiliate</i> to have been the cause of an <i>investment-related</i> business having its authorization to do business denied, suspended, revoked, or restricted?
SelfRevokeLicense	27	11.E.4	Has any <i>self-regulatory organization</i> or commodities exchange ever disciplined you or any <i>advisory affiliate</i> by expelling or suspending you or the <i>advisory affiliate</i> from membership, barring or suspending you or the <i>advisory affiliate</i> from association with other members, or otherwise restricting your or the <i>advisory affiliate's</i> activities?
OtherProfRevoked	0	11.F	Has an authorization to act as an attorney, accountant, or federal contractor granted to you or any <i>advisory affiliate</i> ever been revoked or suspended?
Ongoing	58	11.G	Are you or any <i>advisory affiliate</i> now the subject of any regulatory <i>proceeding</i> that could result in a "yes" answer to any part of Item 11.C., 11.D., or 11.E.?
CourtEnjoined	17	11.H.1A	Has any domestic or foreign court in the past ten years, <i>enjoined</i> you or any <i>advisory affiliate</i> in connection with any <i>investment-related</i> activity?
CourtViolation	31	11.H.1B	Has any domestic or foreign court ever <i>found</i> that you or any <i>advisory affiliate</i> were <i>involved</i> in a violation of <i>investment-related</i> statutes or regulations?
CourtDismissed	5	11.H.1C	Has any domestic or foreign court ever dismissed, pursuant to a settlement agreement, an <i>investment-related</i> civil action brought against you or any <i>advisory affiliate</i> by a state or <i>foreign financial regulatory authority</i> ?
CountOngoing	76	11.H.2	Are you or any <i>advisory affiliate</i> now the subject of any civil <i>proceeding</i> that could result in a "yes" answer to any part of Item 11.H(1)?