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Securities Law Developments

Top Financial Regulators Propose Indirect Regulation of Hedge Funds to Constrain Excessive Leverage

Introduction

On April 29, 1999, the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairs of the Federal Reserve Board, the SEC and the CFTC) released its long-awaited report on hedge funds entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management."[1/] On May 6, 1999, the House Banking and Financial Services Committee held a hearing on the Report. This newsletter summarizes significant aspects of the Report and the hearing.

The Working Group study was undertaken to analyze the lessons learned from the difficulties encountered by Long-Term Capital Management ("LTCM") in the face of events in the global financial markets in the summer and fall of 1998 and to analyze what, if anything, should be done differently with respect to the regulation of hedge funds to mitigate systemic risk. The Report's primary finding is that it is excessive leverage that poses unacceptably high levels of systemic risk, an issue which is not limited to hedge funds that generally employ less leverage than other financial institutions, including some banks and securities firms. Based on this conclusion, the Report recommends a number of measures (both public and private) designed to enhance market discipline in constraining excessive leverage, recognizing that "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes."

The Report's recommendations represent a measured, market-oriented approach to the treatment of hedge funds and other financial institutions with a focus on public disclosure of risk

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[1/] Although not members of the Working Group, the following federal agencies participated in the study and support its recommendations and conclusions: the Council of Economic Advisers, the Federal Deposit Insurance Corporation, the National Economic Council, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

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by hedge funds, public companies and other regulated financial institutions and the enhancement of risk-management systems by hedge fund lenders and counterparties (namely, commercial banks and securities firms) through their own initiatives and through prudential oversight by regulators. The Report also calls for changes to the Bankruptcy Code to protect financial institutions (and, therefore, the system as a whole) when a debtor becomes insolvent and for additional risk-assessment authority for regulators over the unregulated affiliates of broker-dealers and futures commission merchants. Although the Report is notable in not calling for increased direct regulation of hedge funds (other than through financial reporting requirements), the Report represents a warning to the private sector -- if these proposals for "indirect regulation of currently unregulated market participants [are] not effective in constraining excessive leverage," then more onerous regulation may well be necessary.

The Report is the broadest public sector response to date on the question of the systemic risk posed by hedge funds and other highly leveraged institutions. It sets forth recommendations for steps that U.S. regulators can take within their current authority and proposes Congressional action on a number of fronts. It is likely to have far-reaching consequences for the behavior of the private sector (which has been cautioned to take appropriate steps to avoid the build-up of excessive leverage) and is likely to influence the actions of legislators and regulators both at home and abroad. In recognition that global markets require a global response, the Report recommends that U.S. regulatory entities and the Treasury Department work with their international counterparts to adopt agreed-upon standards and recommends methods of incentivizing other countries to adopt such standards.

The Report provides only general guidelines for its recommended approach to government enhancements to market discipline, leaving the precise mechanisms to be determined as the recommendations are debated and implemented. The private sector should begin to consider which mechanisms would be most appropriate to achieving the goals set forth by the regulators, namely, constraints on excessive leverage, so that it can provide relevant input at the appropriate time. The private sector, in particular the hedge fund industry, has a vested interest in the success of this measured approach.

Discussion and debate over the Report's recommendations already have begun. During the May 6, 1999, hearing before the House Banking Committee, testimony was given by senior officials from the four Working Group member organizations: Treasury Department Undersecretary for Domestic Finance Gary Gensler; Commodity Futures Trading Commission Chairwoman Brooksley Born; Securities and Exchange Commission Director of the Division of Market Regulation Annette Nazareth; and Federal Reserve Board Division of Research and Statistics Associate Director Patrick Parkinson. The Committee also heard testimony from a second panel of witnesses that included George Crapple, Chairman of the Managed Funds Association (a national trade association representing more than 700 participants in the hedge fund and managed funds industry); Douglas Harris, Partner, Arthur Andersen LLP; John Coffee,

Professor, Columbia University School of Law; and Robert Todd Lang, Partner, Weil, Gotshal & Manges. Several Republican and Democrat House Banking Committee members expressed their views on various aspects of the Report: James A. Leach (R-IA), Chairman; Margaret Roukema (R-NY), Chairwoman of the House Banking Committee's Subcommittee on Financial Institutions and Consumer Credit; Richard Baker (R-LA), Chairman of the House Banking Committee's Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises; and John LaFalce (D-NY), the ranking Democrat on the House Banking Committee.

Hedge Funds are Not the Problem

According to the Report, it is excessive leverage, not hedge funds or leverage itself, that raises systemic risk concerns. The Report recognizes the positive role that hedge funds play in financial markets through providing liquidity and reallocating financial risk. The Report also recognizes that leverage provides an important risk allocation function in financial markets, allowing risk-adverse investors to shed risks which investors with higher risk appetites wish to assume.

Hedge funds, like other market participants, use leverage. While the Report notes that hedge funds use leverage more aggressively than mutual funds, private pension funds, and bank personal trusts, the Report also recognizes that other financial institutions, including some banks and securities firms, are larger than hedge funds, and generally more highly leveraged, than hedge funds.

The Report states that the LTCM episode "illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume." In a volatile market, high levels of leverage increase the likelihood that a leveraged entity will fail. Such a failure can result in both direct losses to creditors and trading counterparties and indirect consequences to other market participants through the disappearance of investors willing to bear higher risks and the potential contraction in credit and liquidity.

Market discipline provided by creditors, counterparties and investors generally serves to prevent undue risk-taking. The Report explains, "[i]n principle, if a firm seeks to assume greater risks, either by increasing the riskiness of its assets or by increasing its leverage, creditors will respond by increasing the cost or reducing the availability of credit to the firm." According to the Report, market discipline broke down in the case of LTCM and the "same market and credit risk management weaknesses that permitted LTCM to achieve its extraordinary leverage were evident in other market participants." Although the private sector responded to the incident by tightening credit risk management practices with respect to highly leveraged institutions, the Report emphasizes that the incident demonstrates the need for lasting changes to enhance market discipline because "market history indicates that even painful lessons recede from memory with time."

Constraining Excessive Leverage Through Disclosure and Transparency

One of the primary methods that the Report recommends for constraining excessive leverage is increased transparency to the public. Such transparency "should help market participants make better, more informed judgments about market integrity and the creditworthiness of borrowers and counterparties." Rep. Baker expressed his general agreement with the viewpoint that enhanced transparency is the most appropriate means to regulate hedge funds. According to Baker, "government intervention to any significant degree in this marketplace" is not warranted.

The enhanced transparency recommended by the Report would take two forms: (i) specific reporting requirements for hedge funds; and (ii) disclosure by public companies, including financial institutions, of their direct material exposures to significantly leveraged financial institutions. The first form of disclosure would require Congressional action, and the second form would require new SEC rules. As discussed below, the recommendation that hedge funds be required to file public reports has generated significant controversy on two fronts. First, various commentators have criticized the recommendation as over broad. Second, various commentators have testified that the public nature of the reporting serves no purpose and is, in fact, detrimental.

1. Reporting Requirements for Hedge Funds

The Report calls for quarterly public reports for hedge funds which would provide meaningful and comprehensive measures of market risk. Importantly, the Report recognizes that the reports should not require the disclosure of a hedge fund's proprietary information on strategies or positions, a disclosure which, if required, could well drive hedge funds offshore.

Certain hedge funds are already subject to reporting requirements. Under the Commodity Exchange Act ("CEA"), to the extent that a hedge fund with U.S. investors trades futures and option contracts on a futures exchange, such a fund is considered a commodity pool under the CEA and the operator of the pool, a Commodity Pool Operator ("CPO") is subject to certain reporting requirements. Currently, CPO's exceeding a certain *de minimis* size must make annual reports. These reports are not, however, public documents. The Report recommends that at least for hedge funds that are commodity pools, the best means for requiring additional and more up-to-date information to the public may be through enhanced CPO filings.

With respect to hedge funds which are not subject to CEA reporting requirements, the Report recommends that Congress enact legislation that would require quarterly reports containing meaningful disclosure of risk. The Report suggests the possibility that all hedge fund

reporting (including that currently governed by the CEA) could be consolidated into one reporting scheme.

Several important questions are left unanswered. First, the Report does not address to which regulator(s) the reports would be filed, perhaps saving that battle for another day. Both Professor John Coffee and Todd Lang, in their testimony before House Banking Committee on May 6, 1999, recommended that any reporting by hedge funds be made available to all the regulators that are members of the President's Working Group.[2/] A second question the Report does not address is how the term hedge fund would be defined for these reporting purposes, which is where the debate is likely to center regarding whether the recommendation is over broad.

a. Debate Over Definition

Currently, there is no formal definition of "hedge fund." Hedge funds are largely defined by what they are not and by the regulations to which they are not subject. In an appendix, the Report recognizes that "[g]iven the difficulties of formulating a precise definition of the term 'hedge fund,' drafting limitations that apply solely to hedge funds would be exceedingly difficult." A definition which captures all "hedge funds" may well capture entities for which additional reporting is not necessary or appropriate, including hedge funds which do not raise systemic risk concerns because they are not of sufficient size and/or are not highly leveraged. Significantly, during the hearing before the House Banking Committee, both Rep. Roukema and Todd Lang, Partner at Weil, Gotshal and Manges, argued that the reporting requirement should not be applied to all hedge funds:

- **Rep. Roukema** proposed that the quarterly reporting requirement apply only to hedge funds that are large enough to pose systemic problems, but was unsure as to what constituted a large hedge fund: "Is the cut off $10 billion in capital or $1 billion in capital? Are we talking about 5 hedge funds or 500 hedge funds?" She also suggested that it may be prudent to have the requirement triggered by a certain leverage ratio.

- **Todd Lang** testified that "any filing requirement in order to provide information that is meaningful to the objective of these recommendations [the Working Group recommendations] should be limited to highly leveraged institutions which engage in specified relevant activities, as they may be defined, who are not otherwise subject to regulation." Because many hedge funds are not highly leveraged, "[t]his would

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[2/] *Hearing on the President's Working Group Study on Hedge Funds Before the House Banking and Fin. Servs. Comm.,* 106th Cong. (1999) ("May 6, 1999 *Hearing*") (statement of John C. Coffee, Jr., Professor, Columbia University School of Law ("Coffee Statement"); statement of Todd Lang, Partner, Weil, Gotshal & Manges ("Lang Statement")).

> mean that operators of most so-called hedge funds would not make such filings . . . To provide otherwise would subject private investment entities whose activities pose no threat to the system to make public disclosure of their private information." Lang further argued that there should be "size test, namely, an exception from the filing requirement for smaller entities" because "the burden and cost of filing should only be incurred to the extent that the activities of the institution may have some impact on the market." In addition, he suggested that "the filing requirement might exclude certain categories of leveraged entities which engage in specified activities" where such activities are not "of significance in terms of the impact of excess leveraging on the market."[3]

b. Debate over Public Nature of Reporting

Another area of debate surrounds the Report's call for the reporting to be public. It is not entirely clear who is benefitted by the public nature of the reports. Presumably, the only members of the public to whom the reports would be of interest are those market participants with whom hedge funds interact, namely, sophisticated investors, counterparties and lenders. These market participants, however, can require (and certainly have incentives to demand) accurate risk information from hedge funds as a condition of doing business with such funds and should be able to obtain such information on a more timely basis than provided by quarterly reports. In fact, the Report admonishes creditors and counterparties to monitor hedge funds on an ongoing basis because the risk profiles and trading strategies employed by hedge funds can change so rapidly. As for the regulators, the public nature of the reporting would appear to restrict the information (namely, proprietary information) that can be provided without harm to the industry, thereby diminishing the usefulness of the report.

The Working Group has justified the public nature of the hedge fund reporting requirement on the grounds that such public disclosure should "contribute to the goal of strengthening market discipline."[4] Patrick M. Parkinson, the Associate Director of the Division of Research and Statistics of the Board of Governors of the Federal Reserve, testified before the House Banking Committee that the public reporting has the following benefits:

> Quarterly release to the public of enhanced information on a broader group of hedge funds (not limited to those that trade futures) would help inform public opinion about the role of hedge funds in our financial system. Equally important, by making clear that public disclosure is the sole objective of any reporting

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[3] May 6, 1999 *Hearing* (Lang Statement).

[4] May 6, 1999 *Hearing* (statement of Patrick Parkinson, Associate Director, Division of Research and Statistics, Federal Reserve).

> requirements, any false impression that the regulatory agency operating the reporting system is conducting prudential oversight of hedge funds would be discouraged. Such a false impression can be dangerous because it weakens private market discipline without any hope that government oversight is making up for what is lost.[5]

Many arguments have been advanced on the other side of the debate. These arguments emphasize that such public reporting is either unnecessary or counterproductive.

- **Robert Todd Lang, Partner at Weil, Gotshal and Manges**, questions the logic of making the reports public, when investors, lenders and counterparties with whom the "private" hedge funds interact already have access to hedge fund financial information on a more up-to-date basis and the regulators could obtain the information on a confidential basis:

  > There is a question as to why the quarterly financial information should be publicly available. These by definition are private entities. Investors obtain the financial information by contract under the various partnership arrangements. I concur that the information may be of meaning to various regulatory authorities who are concerned with the integrity of the capital markets. However, they could have access to the information confidentially. While the information itself may be of interest to counterparties and lenders, it is presumed that before credit is extended due diligence would be undertaken which would be more extensive than the information which is publicly filed and undoubtedly more contemporaneous.[6]

- **Douglas E. Harris, Partner, Arthur Anderson LLP,** raised the concerns that the public nature of the reporting would cause confusion, does not benefit the public, would result in the revelation of proprietary information if the reporting was meaningful, and would cause a false sense of security:

  > [T]he Report of the Working Group suggests that disclosure (both with respect to the funds themselves and the exposure that public institutions have to funds) should be made *public*. I see a few problems with this suggestion. First, different institutions, using different risk models and different assumptions, compute risk in various ways. Therefore, there

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[5] *Id.*

[6] May 6, 1999 *Hearing* (Lang Statement).

> will not necessarily be a way to compare the disclosure provided by two separate institutions to come to a conclusion that one is pursuing a more risky strategy than the other. Second, what would be the benefit of providing such information to the public? In the case of the hedge funds themselves, the public does not have exposure to them, either as lenders, trading counterparties or investors. So one can validly ask, "what would the public do with this information?" Third, truly meaningful disclosure to the public could give those who have no need to know and who, in fact, might be in a position to profit from it, information about a firm's position and trading strategy. Finally, such disclosure could at times give us a false sense of security, i.e., that because we have information, we don't need to be concerned. How would the public disclosure of the positions and risk exposure of LTCM have prevented the events of last fall?[7/]

- **George Crapple, Chairman of Managed Funds Association,** attacked the public nature of the report on multiple grounds. He argued that the public nature of the reporting is "inconsistent with the private nature of hedge fund offerings" and "may create incentives for funds to move offshore." In addition, "the information which would be reported would be of highly questionable utility to its recipients" because the type of "snapshot data" contemplated would be "as likely to distort as to advance understanding" and would "direct attention to inherently stale data." Moreover, the contemplated information would not be beneficial to hedge fund counterparties and lenders:

> [A] new disclosure framework of the nature contemplated would not help to provide a solution to the concern the Report itself identifies as central to the LTCM event; it would not be designed to -- nor would it serve to -- augment the risk management of the parties who made possible LTCM's market positions. It would not enhance the quality of the lending and counterparty relationships that are key to the concerns presented by LTCM. These lending and counterparty relationships will not be served by a newly devised information "dump" on the public and the regulators; they require the close review of a complex of individualized, risk-related data -- more comprehensive and timely data than any public reporting system is or should be calculated to produce.[8/]

[7/] May 6, 1999 *Hearing* (statement of Douglas E. Harris, Partner, Arthur Andersen LLP).

[8/] May 6, 1999 *Hearing* (statement of George Crapple, Vice Chairman, Managed Funds Association) ("Crapple Statement").

- **John C. Coffee, Professor, Columbia University Law School,** suggested that a private reporting regime whereby "large institutional investors (including hedge funds) that engage in certain risky speculative strategies would be required to report their positions and exposures to a centralized authority" would be the "optimal answer to the problem of excessive leverage." He believes that disclosure of this type of information should be private, and not public, because the information is proprietary. Essentially, Professor Coffee has adopted the position that in order for the information to be of any use to the regulators it must contain proprietary information which "is not information to which rival traders deserve access."[9]

2. Reporting Requirements for Public Companies

The second method the Working Group proposes for enhancing transparency is through requiring public companies, including financial institutions, to publicly disclose their exposures to significantly leveraged institutions, including hedge funds, commercial banks, investment banks and insurance companies, on a sector by sector basis to the extent such exposure is material. Public disclosure of this nature "could serve to reinforce private market discipline upon these firms," which could indirectly reduce the amount of leverage available to significantly leveraged institutions.

The implementation of this requirement would involve rule-making by the SEC, which includes a public comment process. Much of the detail with respect to this proposal remains to be supplied. Likely areas of debate include the definition of "significantly leveraged institutions," the proper measurement of risk and exposure, and the extent to which exposure is "material."

Constraining Excessive Leverage through Enhanced Risk Management at Counterparty Level and at Borrower Level

Another key component of the Report's plan for constraining excessive leverage is the enhancement of the credit risk management systems of the counterparties and creditors to highly leveraged institutions. Both the private and public sector are urged to take an active role in this form of indirect regulation of highly leveraged institutions. The Report also recommends that hedge funds should develop better methods of policing themselves by developing their own set of best practices for risk management and internal controls.

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[9] May 6, 1999 *Hearing* (Coffee Statement).

Private Sector -- Risk Management at the Counterparty Level

Acting in its own self-interest, the private sector (banks and securities firms) already has taken significant steps to improve its systems and to study means through which the systems can be improved. The Report commends the private sector for these actions and recommends that the private sector continue to play an active role in policing itself, including the publishing of enhanced standards for risk management. In particular, the Report cites the efforts of the Counterparty Risk Management Policy Group (a group of twelve major banks and securities firms developing standards for strengthened risk management practices), the International Swaps and Derivatives Association (for its study of collateral management practices which recommended 22 methods of enhancing such practices),[10/] and the Institute of International Finance (for its report on risk assessment).[11/] The Report also suggests that it could be helpful for counterparties to collect and share credit information through the creation of an international centralized credit database. Such a database would enable lenders and counterparties to obtain better information upon which to base credit decisions.

Public Sector -- Risk Management at the Counterparty Level

The Report also commends the actions taken by the public sector and recommends that the banking, securities and futures regulators continue to provide guidance on risk management practices of the entities they regulate and ensure that this guidance is being followed. Such guidance will help to lock in the progress which has been made by the private sector. The Report cites to the guidance already provided by various banking regulators (the Basle Committee on Banking Supervision; the Federal Reserve; the Office of the Comptroller of the Currency; and the New York State Banking Department) and notes that the International Organization of Securities Commissions is currently studying risk management, internal controls, and disclosure issues as they relate to securities firms' interactions with highly leveraged institutions. Supervision over risk management programs is a dynamic, ongoing undertaking. The Report notes that "[s]upervisors must remain alert to the conditions which can lead institutions to suspend prudent risk management practices, and tailor their supervisory efforts to require institutions to correct risk management weaknesses so as to reduce the likelihood that such weaknesses will pose a systemic threat."

[10/] International Swaps and Derivatives Association, Inc., *ISDA 1999 Collateral Review* (visited May 24, 1999) <http://www.isda.org/colrev99.pdf>.

[11/] Institute of International Finance, Inc., *Report of the Task Force on Risk Assessment* (Mar. 1999) <http://www.iif.com/PublicPDF/riskMar99.pdf>.

Hedge Funds

The Report recommends that hedge funds follow the lead of other industry groups and form their own group to establish best practices for risk measurement and internal controls. The development of such best practices is certainly in the industry's self-interest from both a business and legal perspective.

The Chairman of the Managed Funds Association ("MFA"), a national trade association representing more than 700 participants in the hedge fund and managed funds industry, has testified before House Banking Committee that the MFA embraces this recommendation and "is prepared to take a leadership role in such an initiative, which would include representation from throughout the hedge fund industry."[12/]

Constraining Excessive Leverage through Risk-Sensitive Approach to Capital Adequacy at the Counterparty Level

The capital requirements at banks and securities firms serve to limit the risk that these entities take, and indirectly limit the risk taken by the highly leveraged institutions to whom they serve as creditors and counterparties. The Report recommends that banking and securities regulators promote the development of more risk-sensitive approaches to capital adequacy, which align capital requirements with the actual risks taken by the institutions. The Basle Committee is currently examining whether to increase capital requirements for loans to hedge funds.

Constraining Excessive Leverage through Reporting and Recordkeeping Requirements for Unregulated Affiliated Entities of Broker-Dealers and Futures Commission Merchants

The Report calls for Congress to expand the risk-assessment authority of the SEC, the CFTC and the Treasury Department with respect to the material, unregulated affiliated entities of broker-dealers and futures commission merchants ("FCMs"). Such expanded authority would close a loophole in the regulation of the counterparties to highly leveraged institutions. The Report calls for expanded reporting, recordkeeping, and examination authority with respect to these material, unregulated affiliates in order "to monitor the risks posed by these market participants and the highly leveraged institutions which are their counterparties." Presumably, by requiring such entities to provide information about their levels of risk, increased discipline will be imposed on their risk profiles, thereby indirectly imposing discipline upon their highly leveraged counterparties.

[12/] May 6, 1999 *Hearing* (Crapple Statement).

More specifically, the Report recommends that Congress expand the authority of the three regulators to allow them to require broker-dealers, FCMs and their unregulated affiliates to report credit risk information by counterparty. The authority would also include the ability to require reporting of data on concentrations by industry sector, financial instrument, and region as well as the reporting of trading strategies and risk models. To ensure the accuracy of the reports, the expanded authority would include examination authority.

Interestingly, Chairman Greenspan did not endorse this recommendation, but deferred to the judgment of the regulators to whom the information would be reported. This apparent disagreement may provide fodder for debate before Congress on this recommendation.

In contrast to the quarterly hedge fund reports, it appears that the Working Group is not recommending that the reporting by these unregulated affiliates would be made public. It is not clear why this distinction would be made. In connection with not calling for the reports to be public, the regulators appear to be requesting more detailed information relating to the entities' risk profiles. The proposed affiliated entity reports would include trading strategies, a piece of information which the Working Group specifically states would not be included in the proposed hedge fund reports due to the proprietary nature of such information.

Protecting the Financial System through Changes to the Bankruptcy Code

In addition to its various proposals for constraining excessive leverage, the Report also makes several recommendations for Congressional action with respect to the Bankruptcy Code that would help to protect the financial system against systemic risk in cases of a counterparty's insolvency. The Report recommends the adoption of improvements to the netting regime under the Bankruptcy Code. This regime allows financial contracts to be terminated and allows the netting of the amounts due upon the insolvency of a counterparty despite the Bankruptcy Code's automatic stay. These recommended improvements involve (i) clarifying the definitions of financial contracts eligible for netting and (ii) allowing counterparties to net across different types of contracts. The Report also recommends the adoption of several measures to provide greater legal certainty that U.S. bankruptcy law protections would be available in the case of the insolvency of a highly leveraged entity doing business in a number of markets throughout the world where collateral is located in the U.S. or the principal place of business of the entity is the U.S.

Other Public Policy Issues Raised by Hedge Funds and the LTCM Episode

In addition to questions of systemic risk, hedge funds also have raised questions relating to market integrity. As financial crises have rocked various parts of the world economy during the last decade, hedge funds have become the leading scapegoat. Several emerging countries have blamed hedge funds for their currency crises and turbulence in their securities markets, with

Malaysia taking the lead. The Working Group did not undertake to study the role that hedge funds and other highly leveraged institutions may have played in financial market crises, noting that the Financial Stability Forum recently established by the G-7 countries (the United States, Japan, Germany, France, Britain, Italy and Canada) is planning to focus on this issue. The Report does note, however, that a number of independent studies (one by the IMF and one by several academics)[13/] have found that highly leveraged institutions do not appear to have played a significant role in these recent financial market crisis.

The Report also notes that the LTCM incident "highlights a number of tax issues with respect to hedge funds, including the tax treatment of total return equity swaps and the use of offshore financial centers." Because significant numbers of hedge funds are located offshore in tax havens, attention has been focused on "whether offshore hedge funds are associated with illegal tax avoidance and are taking advantage of their offshore situs for other inappropriate purposes." These issues were outside the scope of the Working Group's study and are being reviewed by the Treasury Department.

Furthermore, hedge funds raise questions regarding the regulation of derivatives and derivatives dealers given that hedge funds are significant participants in the derivatives market. The President's Working Group is currently studying the OTC derivatives market and questions regarding the regulation of derivatives dealers.

The Federal Reserve's involvement in the LTCM incident has engendered controversy. Some have argued that the Federal Reserve's involvement has undermined market discipline by creating "moral hazard." Chairman Leach criticized the President's Working Group Report for not taking a stand against "publicly assisted bailouts": "I would welcome a stronger policy statement from the Treasury Department, the Fed and the other Working Group members that publicly assisted bailouts of hedge funds is an unacceptable public policy option."[14/] Similarly, Rep. Ken Bensten (D-Texas) called the failure of the Working Group Report to address the bailout issue a "glaring omission."[15/]

[13/] Barry Eichengreen and Donald Mathieson, Hedge Funds and Financial Market Dynamics (International Monetary Fund Occasional Paper No. 166, May 1998); Stephen J. Brown, William N. Goetzmann, & James Park, Hedge Funds and the Asian Currency Crisis of 1997 (NBER Working Paper No. W6427, Feb. 1998).

[14/] May 6, 1999 *Hearing* (Opening Statement of Rep. James A. Leach, Chairman, House Banking and Fin. Servs. Comm. ("Leach Opening Statement")).

[15/] Marc Selinger, *Hedge Funds: Leach Says Hedge Fund Report Should Have Taken Stand on Public Bailouts*, BNA Securities Law Daily, May 7, 1999.

Conclusion

The Report's recommended course of action represents a moderate approach based on the recognition that self-interest and market discipline generally serve to constrain excessive leverage and that government intervention should merely serve to enhance, rather than replace, such discipline. The Report recognizes that placing direct constraints on leverage presents difficulties and that the direct government regulation of hedge funds could have the counterproductive result of driving such funds offshore outside the reach of U.S. regulators. Nonetheless, the Report provides a stern warning that if the indirect, market-oriented approach is unsuccessful, the government will consider various forms of direct regulation of the private sector.

The private sector should also remain mindful that the Report represents the views only of regulators and not legislators. Although House Banking Committee Chairman James A. Leach has called the Report's recommendations "thoughtful and appropriately moderate," and Rep. Baker (Chairman of the House Banking Committee's Subcommittee on Capital Markets) appears to have endorsed indirect regulation through increased transparency, other important legislators have not made up their minds or have questioned whether the Report's recommendations will adequately address the problem. Rep. John J. LaFalce, the ranking Democrat on the House Banking Committee, has said that the Report's recommendations are "quite significant," although he will not render a verdict on the Report until he has reviewed the Working Group's eagerly-awaited report on derivatives and the Treasury Department's work on hedge fund tax issues.[16/] Rep. Margaret Roukema, Chairwoman of the House Banking Committee's Subcommittee on Financial Institutions and Consumer Credit, has characterized the Working Group's legislative and regulatory recommendations as a "good start," but is not sure they go far enough to avoid another systemic risk situation.

Although the private sector is likely to expend significant energy in helping to shape the details of the proposals made in this Report and in objecting to various aspects of such proposals, the private sector should not lose sight of the Report's clear message that it needs to police itself nor lose sight of the fact that Congress has not clearly indicated its endorsement of this moderate approach. This is the private sector's opportunity to demonstrate that it can put its own house in order.

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If you would like a copy of the President's Working Group Report or more information on this Report, please contact Brandon Becker at (202) 663-6979 or Colleen Doherty-Minicozzi at (202) 663-6198.

[16/] *Id.*

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