

HEDGE FUNDS IN GLOBAL FINANCIAL MARKETS

February 2000

Available at <[http:// www.wilmer.com](http://www.wilmer.com)>

**Brandon Becker
Colleen Doherty-Minicozzi
Wilmer, Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037-1420
(202) 663-6000**

“Hedge Funds: A Reprise of 1999’s ‘Where Do we Go From Here’ Program”
ABA Section of Business Law
2000 Spring Meeting
March 25, 2000
Columbus, Ohio

Mr. Becker is a partner of the law firm of Wilmer, Cutler & Pickering, Washington, D.C. He formerly was Director of the SEC’s Division of Market Regulation. Ms. Doherty-Minicozzi, a former senior counsel in the SEC’s Division of Enforcement, is an associate of the firm. This outline provides general information on the subject matter listed above. It is not designed to, and does not, constitute legal advice on any matter and should not be relied upon for that purpose.

TABLE OF CONTENTS

	Page
I. INTRODUCTION.	1
II. BACKGROUND.	3
A. U.S. Regulation.	3
1. Exemptions from Registration Requirements.	3
a. Registration of Securities.	3
b. Registration of Investment Companies.	4
c. Registration of Investment Advisers.	4
d. Registration of Broker-Dealers.	5
2. Anti-Fraud Provisions.	5
3. Reporting Provisions.	5
4. CFTC Regulation.	5
5. Indirect Regulation.	6
B. Size of the Hedge Fund Industry.	6
C. Structure and Characteristics of the Hedge Fund Industry.	7
1. Common Characteristics.	7
2. Heterogeneity of Hedge Funds.	8
a. Strategies.	9
b. Leverage.	9
c. Size and Market Influence.	12
D. Relationships with Other Market Participants.	14
1. Investors.	14
2. Commercial Banks.	15
3. Securities Firms.	15
4. Internet Information Providers.	16
III. THE DEBATE -- SYSTEMIC RISK AND MARKET INTEGRITY.	16
A. LTCM and Systemic Risk.	16
1. LTCM -- The Basic Facts.	18
2. Was LTCM an Aberration?	19
3. Private Sector Response.	20

4.	Public Sector Response.	23
a.	Congressional Hearings.	23
b.	Reports and Recommendations by Domestic and International Organizations and Regulatory Bodies.	24
c.	Legislation and Rule-Making.	28
d.	Ongoing Efforts and Current Studies.	28
5.	Regulatory Responses.	31
a.	Background -- Market Discipline and Current Forms of Regulation.	33
(i)	Market Discipline and the Debate over the Federal Reserve's Intervention in LTCM.	33
(ii)	Current Regulatory Framework.	36
b.	No Additional Direct Regulation Required of Hedge Funds or Any Market Participants.	36
c.	Indirect Regulation.	45
(i)	President's Working Group Recommendations on Indirect Regulation and Reactions Thereto by Public and Private Sectors.	45
(ii)	Banking Regulators' Guidance to Enhance Bank Risk Management Practices.	53
(iii)	Securities Regulators' Guidance to Enhance Broker-Dealer Risk Management Practices.	57
(iv)	Private Sector Guidance on Methods of Enhancing Risk Management at the Counterparty Level.	59
(v)	Private Sector Guidance on Methods of Enhancing Risk Management at the Hedge Fund Level.	63
(vi)	Banking and Securities Regulator Guidance on Enhancing Market Discipline at Counterparty Level through Public Disclosure of Trading and Derivatives Activities.	64
(vii)	GAO Guidance on Enhancements to Regulatory Oversight.	66
(viii)	Additional Endorsements of Indirect Regulation.	66
d.	Direct Regulation.	70
(i)	President's Working Group Report -- Hedge Fund Disclosure and Reporting.	70

(ii)	Controversy Surrounding Working Group Report's Recommendation.	71
a.	Debate over Public Nature of Reporting.....	72
b.	Debate over Definition.	77
(iii)	Implementation of President's Working Group Report's Recommendations.	78
(iv)	Additional Calls for Enhanced Disclosure and Reporting.	79
(v)	Other Forms of Direct Regulation beyond Disclosure and Reporting.....	84
B.	Hedge Funds -- Market Volatility and Integrity.	84
1.	The Attack -- Market Movers and Manipulators.	86
2.	Defenders -- The Positive Role Played by Hedge Funds.....	87
3.	The Debate -- Economic Theory and Empirical Evidence.	89
a.	Market Influence.	90
b.	Market Stability.	90
(i)	Feedback Trading.	91
(ii)	Herding.	93
c.	Financial Crises.....	94
(i)	IMF Report.	95
(ii)	Brown, Goetzman and Park Study.	96
(iii)	Reserve Bank of Australia.	97
(iv)	Institute of International Finance Report.	98
(v)	International Organisation of Securities Commissions.	99
IV.	CONCLUSION.....	99

I. **INTRODUCTION.** As financial crises have rocked various parts of the world economy during the last decade, hedge funds have become the “leading scapegoat.”^{1/} The Prime Minister of Malaysia has labeled them as manipulators and the “highwaymen of the global economy.”^{2/} They have been stereotyped as “hawk-eyed speculators,”^{3/} have become “symbols of economic evil,”^{4/} have been described as the “new barbarians at the gate,”^{5/} and have been likened to the “Sword of Damocles” hanging over all but the largest economies.^{6/} They have been blamed for modern currency crises -- the crisis affecting the exchange rate mechanism of the European Monetary System in 1992, the Mexican peso crisis in 1994 - 1995, the collapse of the East Asian currencies in 1997, the destabilization of the Australian dollar in 1998 and the Russian rouble crisis in 1998.^{7/} Not only have they been villainized for dominating and manipulating markets for their own benefit at the expense of countries whose currencies they threw into crises, but they have also been attacked for undertaking excessive risks in the pursuit of profits which can threaten the entire global economy if their gamble is wrong. Defenders of hedge funds respond to these charges by arguing that hedge funds are no different from many other financial market participants, that market discipline generally guards against default, and that hedge funds add liquidity and stability to the markets in which they operate.

In the wake of the well-publicized Long-Term Capital Management episode in the fall of 1998, renewed attention has been focussed on the role of hedge funds in the global economy and the risks posed by these largely unregulated entities. The United States Congress has held six separate hearings. Both the public sectors at home and abroad have begun to study whether additional regulation of hedge funds or other market participants with whom hedge funds interface (namely, commercial banks and securities firms) is warranted, and, if so, what form that regulation should take. Various public sector reports have been issued containing a wide array of

^{1/} Jeremy Philips & James Hooke, Opinion, *In Defence of the Hedge Funds*, Australian Fin. Review, Oct. 7, 1998.

^{2/} Mahathir Bin Mohamad, Editorial, *We Don't Need Manipulators*, Wall St. J. Europe, Sept. 23, 1997; *A Hitchhiker's Guide to Hedge Funds: The Villains of Global Finance Deserve a Better Reputation*, Economist, Vol. 347; Issue: 8072, June 13, 1998.

^{3/} Ravi Velloor, *Should Hedge Funds Be Regulated*, The Strait Times (Singapore), Jan. 24, 1999.

^{4/} Editorial, *G-7 Financial Meeting*, Mainichi Daily News, Feb. 25, 1999.

^{5/} Burton G. Malkiel & J.P. Mei, Editorial, *Hedge Funds: The New Barbarians at the Gate*, Wall St. J., Sept. 29, 1998, at A22.

^{6/} Dan Atkinson, Hedge Funds “*Should Be Controlled*”: Finance Chief Says Lessons of Asian Crisis Could Be Forgotten, The Guardian, November 3, 1999.

^{7/} *A Hitchhiker's Guide to Hedge Funds: The Villains of Global Finance Deserve a Better Reputation*, The Economist, Vol. 347; Issue: 8072, June 13, 1998; Reserve Bank of Australia, *The Impact of Hedge Funds on Financial Markets*, June 1999 (“June 1999 Reserve Bank of Australia Report”), available at <[http:// www.rba.gov](http://www.rba.gov)>.

recommendations. Legislation has been introduced in the U.S. Congress in response to these reports. Various private sector groups, in an effort to avoid past mistakes and additional regulation, have issued reports suggesting practices that would help to bolster the stability of the financial system and prevent systemic risk. To date, events in the fall of 1998 have not resulted in a wholesale reconfiguration of the regulatory landscape with respect to hedge funds and the recommendations for reform contained in public sector reports generally do not call for such a reconfiguration.

Hedge fund detractors, mainly government officials in Asian countries struck by the recent financial crises, criticize the pace of reform, arguing that the threat posed by hedge funds has not diminished and the lessons learned from recent events will soon be forgotten.^{8/} In the fall of 1999, hedge funds were reported to have launched attacks on various currencies, including the Philippine peso, the Thai baht and the Indonesian rupiah.^{9/} As the volatility in the bond markets in early February 2000 demonstrate, the markets are still spooked by the events of last fall, underscoring that the events have not been forgotten even if the necessary fixes have not been put into place. With rumors spreading that some hedge funds and other financial institutions were about to collapse due to losses in the bond markets, the Federal Reserve took the unusual step of denying a rumor that it was meeting as it had done with LTCM to assess damage to financial institutions.^{10/}

This outline explores the various studies and reports relating to the role that hedge funds play in financial markets and the risks hedge funds pose to economic order. It also explores the viewpoints expressed by U.S. and foreign regulators, politicians, academics, international organizations, think tanks, and market participants relating to the future treatment and regulation of hedge funds.

^{8/} See, e.g., *Daim: G-7 Impeding Progress on Financial System Reforms*, AFX - Asia, January 27, 2000; Peter Chan, *Yam Warns of Peg Flaws*, South China Morning Post, January 14, 2000; Dan Atkinson, *Hedge Funds "Should Be Controlled": Finance Chief Says Lessons of Asian Crisis Could Be Forgotten*, The Guardian, November 3, 1999; *Malaysian Minister Calls for Speedier Finance Plan*, Asia Pulse, September 24, 1999.

^{9/} *Like East Timor's Militias, Hedge Funds Must Be Controlled*, BusinessWorld (Philippines), September 16, 1999; *Hedge Funds Target the Baht*, Australian Financial Review, September 10, 1999.

^{10/} See, e.g., Greg Ip, Gregory Zuckerman, and Jacob M. Schlesinger, *Turmoil in Bonds Sends Investors Scrambling: Rumors of Big Losses in Treasury Trading Fray Nerves on Street*, Wall St. J., Feb. 4, 2000; Gretchen Morgenson and Patrick McGeehan, *Bonds' Rise Puts Traders in Turmoil*, New York Times, Feb. 4, 2000.

II. BACKGROUND. The term “hedge fund” is used to describe a wide variety of institutional investors employing a diverse set of investment strategies. Although 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. As a general matter, the term “hedge fund” refers to unregistered, private investment partnerships for wealthy, sophisticated investors (both natural persons and institutions) that use some form of leverage to carry out their investment strategies. The regulation of these funds in the United States, the size, structure, and characteristics of the industry, and the industry’s relationships with other market participants are discussed below.

A. U.S. Regulation. By design, hedge funds operating in the United States are subject to minimal regulatory oversight.^{11/} Hedge funds are intentionally structured to take advantage of various exemptions from certain registration requirements of the federal securities laws. Accordingly, hedge funds are subject to certain constraints in order to be relieved of burdens associated with being registered investment vehicles selling registered securities. Moreover, even as unregistered investment vehicles, hedge funds continue to be subject to the broad anti-fraud provisions of the various securities laws and are subject to various reporting requirements imposed by these laws. In addition, some hedge funds are subject to regulation by the Commodity Futures Trading Commission (“CFTC”). Hedge funds are also subject to “indirect regulation” through the regulation of financial institutions that act as creditors of, or counterparties to, these funds.

1. Exemptions from Registration Requirements. As a general matter, under the federal securities laws, securities, investment companies, investment advisers and broker-dealers must be registered unless an exemption or exclusion is available. Hedge funds generally avail themselves of exemptions and exclusions from these registration requirements.

a. Registration of Securities. Under the Securities Act of 1933 (“Securities Act”), shares in hedge funds are securities. Hedge funds avoid the time consuming and expensive process of registering these securities by limiting the method of distribution of the securities and limiting the type of investors to whom the securities are offered. Hedge funds generally rely on the exemption from registration for private offerings under Section 4(2) of the Securities Act and Rule 506 of Regulation D thereunder. Rule 506 is a nonexclusive safe harbor for issuers relying on the Section 4(2) exemption that permits private placements to an unlimited number of accredited investors,^{12/} but to no more than 35 nonaccredited investors.

^{11/} To the extent that hedge funds are not organized in the United States and do not employ the requisite jurisdictional means, U.S. laws do not apply. One source indicates that 49% of hedge funds are based outside the United States. *See Hedge Funds and Financial Market Dynamics*, Occasional Paper 166, International Monetary Fund (May 1998) at 29 (“IMF Report”) (citing to a Managed Account Reports, Inc. database).

^{12/} Accredited investors are viewed as sophisticated investors. An accredited investor is defined in Regulation D to include, among others, any saving and loan association; any broker-dealer; any employee benefit plan with total assets in excess of \$5 million; any private business

b. Registration of Investment Companies. Mutual funds under the Investment Company Act of 1940 (“Investment Company Act”) are subject to a host of regulations including restrictions on liquidity, leverage, derivatives strategies and compensation and are subject to disclosure and reporting requirements. Hedge funds avoid the definition of an investment company under the Act (and, hence, regulation under the Act) by either limiting the number or type of investors to whom a private offering is made. Section 3(c)(1) of the Investment Company Act, in relevant part, provides an exception from the definition of investment company for funds with no more than 100 beneficial owners. Section 3(c)(7) of the Act, in relevant part, provides an exception for sales to “qualified purchasers” (who fall into the category of sophisticated investors).^{13/} As one commentator noted, “it is the exception from the definition of investment company that provides the latitude in setting investment strategies, a freedom that is the hallmark of hedge funds.”^{14/}

c. Registration of Investment Advisers. The Investment Advisers Act of 1940 (“Advisers Act”) protects advisory clients (including collective investment vehicles) through the regulation of investment advisers. Registered investment advisers are subject to extensive recordkeeping requirements and to restrictions on the receipt of performance-based compensation. Although some hedge fund advisers are required to register under the Advisers Act, many avoid registration by relying on the “private adviser” exemption from registration under Section 203(b)(3) for advisers with fewer than 15 advisory clients.

d. Registration of Broker-Dealers. The Securities Exchange Act of 1934 (“Exchange Act”) regulates broker-dealers. Registered broker-dealers, among other things, must maintain records relating to their own financial positions and their customers’ accounts, file detailed reports with the SEC, and satisfy minimum capital requirements. Most hedge funds avoid registration as broker-dealers by availing themselves of the trader exemption for entities trading securities solely for their own accounts and not on behalf of other persons and not carrying on a public securities business.

development company; any organization, corporation, trust, or partnership not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5 million; any natural person with individual net worth, or joint net worth with that person’s spouse, of \$1 million; any natural person with individual income of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of these years, and with a reasonable expectation of reaching the same income level in the current year; and any entity in which all the equity owners are accredited investors.

^{13/} Qualified purchasers are defined to include: (1) any individual owning \$5 million in investments (as well as that individual’s spouse if they invest jointly); (2) specified family-owned companies with at least \$5 million in investments; (3) trusts that are established and funded by qualified purchasers if investment decisions are made by a qualified purchaser; and (4) any person who, acting for its own account or the account of other qualified purchasers, in the aggregate owns and invests on a discretionary basis not less than \$25 million in investments.

^{14/} IMF Report at 64.

2. **Anti-Fraud Provisions.** Hedge funds and their advisers, regardless of whether they are registered, are still subject to the broad anti-fraud provisions of the Securities Act, the Exchange Act and the Advisers Act which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship. Hedge funds, like other market participants, are prohibited from engaging in activities such as market manipulation and insider trading which threaten to undermine market integrity.

3. **Reporting Provisions.** Hedge funds, like other market participants, are subject to certain reporting requirements designed to increase market transparency. The Exchange Act requires a person, who directly or indirectly, acquires more than 5% of the shares of a registered security to file a report with the SEC within 10 days of such acquisition.^{15/} It also requires institutional investment managers exercising discretion over accounts containing more than \$100 million in exchange-traded and NASDAQ-quoted securities on the last trading day of any month of any calendar year to provide a quarterly report on the securities in the portfolio, the names of the issuers and the numbers of shares or principal amounts.^{16/} The U.S. Treasury Department monitors participants in the foreign exchange markets, including hedge funds, requiring weekly and monthly reports for certain large participants. The Treasury Department also imposes reporting requirements on entities having large positions in to-be-issued or recently issued treasury securities.

4. **CFTC Regulation.** Although the Commodity Exchange Act (“CEA”) does not define the term “hedge fund,” 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 will be subject to regulation as a commodity pool operator (“CPO”). CPOs are subject to registration, recordkeeping and reporting requirements and fraud prohibitions under the CEA and the CFTC’s regulations. Although there is no general exception from regulation under the CEA, hedge funds subject to such regulation may be exempt from some disclosure and reporting requirements to investors based upon the sophistication of the investors. If hedge funds are significant traders in the futures markets, they also become subject to the CFTC’s large trader reporting system which requires the reporting of certain information on exchange-traded contracts to the CFTC for purposes of market surveillance.

5. **Indirect Regulation.** Financial institutions, namely, broker-dealers and commercial banks, that serve as creditors of, or counterparties to, hedge funds are subject to regulation by the securities and banking regulators. Regulations that serve to limit the risk that such entities take or the credit that these institutions provide serve as an indirect form of regulation of hedge funds. On the securities side, broker-dealers are subject to net capital and margin rules. Under the net capital rules, a broker-dealer must deduct from net worth 100% of the value of loans that are not fully collateralized by liquid securities, which serves to insulate broker-dealers from credit risk.^{17/} The margin rules require customers to provide collateral based

^{15/} Section 13(d) of the Exchange Act and Rule 13d-1 thereunder.

^{16/} Section 13(f) of the Exchange Act and Rule 13f-1 thereunder.

^{17/} Exchange Act Rule 15c 3-1.

on the market risk of the position.^{18/} On the banking side, regulators promote sound risk management practices by banks through on-site reviews, examinations and the issuing of supervisory guidance.^{19/}

B. Size of the Hedge Fund Industry.^{20/} Precise figures on the size of the hedge fund industry measured by the number of hedge funds or the total value of assets under their management are not available because there is no mandatory reporting requirement in this regard. A number of vendors (including Managed Account Reports Inc., Hedge Funds Research, and Van Hedge Fund Advisors), however, gather data on the hedge fund industry based on voluntary reporting. The estimates from these vendors indicate that the industry has experienced explosive growth in both the number of funds and the size of assets under management since the mid-1980s. One vendor, Van Hedge Fund Advisors, estimates that the number of hedge funds worldwide grew from 1,373 in 1988 to 5,500 in 1997 and that the assets under management grew from \$42 billion to approximately \$300 billion in that same time frame. Van Hedge Fund Advisors estimates that in 1998 over 300 new funds were formed and the total equity under management grew to an estimated \$311 billion.^{21/} Hedge Funds Research estimates that the number of funds in 1997 was 3000 with \$368 billion in assets under management. In October 1999, Managed Account Reports estimated that for 1999 the number of hedge funds is 3000 and the assets under management is about \$205 billion.^{22/} In its recent hedge fund report, the President's Working Group on Financial Markets (consisting of the heads of the Treasury, SEC, CFTC and Federal Reserve), noted that a number of estimates indicate that "as of mid-1998 there

^{18/} The Federal Reserve Board administers margin rules and the SEC enforces them.

^{19/} See, e.g., *Bank Lending to and Other Transactions with Hedge Funds: Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services*, 106th Cong. (1999) ("March 24th Hearing") (statement of Laurence H. Meyer, Board of Governors, Federal Reserve System) ("Meyer statement").

^{20/} See, e.g., *Background Note on Hedge Funds, Highly Leveraged Investment Strategies and Financial Markets*, Organization for Economic Cooperation and Development, Directorate for Financial, Fiscal and Enterprise Affairs, Committee on Financial Markets (Nov. 1998) ("OECD Study"); IMF Report at 28-29; *Hearing on Hedge Funds, Long-Term Capital Management LP Before the House Committee on Banking and Financial Services*, 105th Cong. (1998) ("Oct. 1st Hearing") (statement of Richard R. Lindsey, Director, Division of Market Regulation, SEC) ("Lindsey statement").

^{21/} VAN Hedge Fund Advisors International, *Number of Hedge Funds Increases for Tenth Consecutive Year*, September 21, 1999, available at <[http:// www.vanhedge.com](http://www.vanhedge.com)>.

^{22/} Lois Peltz, *MAR Puts Hedge Fund Asset Base at \$205 Billion*, available at <[http:// www.marhedge.com](http://www.marhedge.com)>.

were between 2,500 and 3,500 hedge funds managing between \$200 billion and \$300 billion in capital, with approximately \$800 billion to \$1 trillion in total assets.”^{23/}

C. **Structure and Characteristics of the Hedge Fund Industry.** While hedge funds are a diverse group in many regards, they also share a number of common characteristics. These similarities and differences are important to an understanding of the role they play in financial markets. It is also important to understand the characteristics and structure of the hedge fund industry relative to other institutional investors. In terms of their market activities, hedge funds generally “are not fundamentally different from other sophisticated financial institutions, such as internationally active commercial banks or proprietary trading desks of investment banks, a consideration which has important implications from a policy perspective.”^{24/} Institutional investors such as mutual funds, insurance companies and university endowments are among the most important investors in hedge funds.^{25/} Accordingly, any demarcation between hedge funds and other institutional investors is “increasingly arbitrary.”^{26/} Moreover, certain characteristics of hedge funds generally serve to limit the amount of risk that they take relative to their regulated counterparts (e.g., regulated banks) and cause them to have greater incentives to engage in stabilizing trading activities than other market participants (e.g., mutual funds).

1. **Common Characteristics.**^{27/} Hedge funds are generally organized as limited partnerships (for tax purposes) or limited liability companies and, as discussed above, structured to minimize regulatory burdens. Managers of a fund are compensated primarily on the basis of performance, generally receiving 15-20 percent of the fund’s profits and 1 or 2 percent of the net assets. Usually a “high-water mark” provision is in place that prevents a manager from obtaining his performance fee until any previous losses have been recovered. Moreover, hedge fund managers are generally partners in the funds and have their own capital invested in the funds. Most investors in hedge funds are subject to lock-up periods during which they cannot withdraw their money, although the redemption periods vary widely.

As the IMF’s recent report noted, these shared characteristics have important implications for the behavior of hedge fund managers. As investors in the fund, the managers’ interests are generally aligned with those of the other investors. The method of compensation, including the return on their own investments, provides managers with incentives to maximize profits without taking on excessive risk that could jeopardize their own investments. When compared to the proprietary trading desks of regulated banks, hedge fund managers may have less incentive to take on risk than a bank trader who is not risking his own capital.^{28/} Several academics have

^{23/} President’s Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, April 1999 (“Working Group Report”).

^{24/} OECD Study at 1; *see also*, IMF Report at 28.

^{25/} IMF Report at 4-5.

^{26/} IMF Report at 4-5.

^{27/} *See generally*, OECD Study at 2; IMF Report at 34; Working Group Report.

^{28/} IMF Report at 34.

warned, however, that “there are extreme circumstances where the disproportional payout from the incentive fee may outweigh the risk of losing personal wealth even if reputational risks are taken into account.”^{29/}

The existence of redemption periods beyond one day (as is the case with mutual funds) allows hedge fund managers to have longer investment horizons and reduces their incentives to engage in momentum trading (selling into a falling market or purchasing in a rising market). On the contrary, mutual fund managers have incentives to engage in momentum trading. In a bull market, it is likely that they will have significant funds flowing into the fund and that cash will need to be invested. Conversely, in a bear market, a mutual fund manager can anticipate heavy redemptions which will increase his incentive to sell securities to meet such redemptions.^{30/}

2. **Heterogeneity of Hedge Funds.** Although a large proportion of hedge funds share certain common elements in their investment strategies (namely, shorting, leverage, concentration and derivatives),^{31/} hedge funds have a diverse array of strategies, objectives and policies. Hedge funds include funds of “high leverage and low risk, low leverage and high risk, and high leverage and high risk.”^{32/} As the Director of the SEC’s Division of Market Regulation has recognized, hedge funds vary widely in terms of size, trading strategies, degrees of leverage and market influence.^{33/}

a. **Strategies.** Market participants generally identify two basic classes of hedge funds: (1) macro funds that take large unhedged positions in national markets based on macroeconomic and financial conditions; and (2) relative value funds that make bets on the relative prices of closely related securities.^{34/} One vendor which collects data on hedge funds, Managed Account Reports, classifies hedge funds into eight broad categories.^{35/}

^{29/} William Fung and David A. Hsieh, A Primer on Hedge Funds, August 1999, available at <<http://www.duke.edu/~dah7/index.htm>>.

^{30/} IMF Report at 34.

^{31/} *The Reality of Hedge Funds*, Warburg Dillon Read (Oct. 30, 1998) at 10-11 (“Warburg Dillon Read Study”).

^{32/} *Hearing on Hedge Funds Before the Subcommittee on Capital Markets of the House Banking and Financial Services Committee*, 106th Cong. (1999) (“March 3rd Hearing”) (statement of Ernest T. Patrikis, Special Advisor to Chairman, American International Group) (“Patrikis statement”).

^{33/} Oct. 1st Hearing (Lindsey statement).

^{34/} IMF Report at 4.

^{35/} IMF Report at 29.

- Macro funds -- which take positions on global economic conditions as reflected in equity prices, currencies and interest rates;
- Global funds -- which include funds investing in emerging markets and those dedicated to specific regions in the world;
- Long only funds -- which are similar to traditional equity mutual funds but are structured with hedge fund characteristics;
- Market neutral funds -- which attempt to reduce market risk by taking offsetting long and short positions, and invest in a wide variety of instruments;
- Sectoral funds -- which focus on particular industries;
- Dedicated short sale funds -- which focus on selling short securities deemed to be overvalued;
- Event-driven funds -- which seek to capitalize on special situations such as distressed securities funds or risk-arbitrage funds; and
- Fund of funds -- hedge funds which invest their portfolios in other hedge funds.

Funds may fall into one or more categories and employ hybrid strategies. Other institutional investors engage in similar strategies.^{36/}

b. Leverage. One feature of hedge funds on which particular attention has now been focussed is that of leverage. Leverage can be defined in two ways: (i) balance sheet leverage, which is the ratio of assets to net worth; and (ii) as a form of risk, in which leverage is measured as economic risk relative to capital. Hedge funds obtain leverage by buying securities on margin, using collateralized borrowing in repo markets, and/or putting up collateral^{37/} and through the use of short positions and derivatives contracts.^{38/} The degree of leverage varies widely among funds, a fact which U.S. regulators have recognized.^{39/} Generally, a hedge fund's degree of leverage is tied to the riskiness of its investments. For a given risk level, the degree of leverage tends to be higher for relatively safer investments.^{40/} A recent Deutsche Bundesbank report, however, notes that there is reason to be concerned that with the

^{36/} IMF Report at 28.

^{37/} IMF Report at 7.

^{38/} Working Group Report.

^{39/} *Id.*

^{40/} OECD Study at 8.

elimination of market imperfections which hedge funds seek to exploit, the “bets” placed by hedge funds will become increasingly riskier (through the use of leverage) as the ability to earn the same returns without such risk decreases.^{41/}

Some experts on the hedge fund sector suggest that many hedge funds (roughly a third) use no leverage at all. This same hedge fund advisory group estimates that more than half of the hedge funds use leverage ratios of less than 2-to-1 on average. Of the approximately 16% of hedge funds that have leverage ratios greater than 2-to-1, only a very few are leveraged greater than 10-to-1.^{42/} Most hedge funds filing with the CFTC have leverage ratios of less than 2-to-1.^{43/} However, according to September 1998 filings with the CFTC, at least 10 hedge funds with capital exceeding \$100 million have leverage ratios greater than 10-to-1.^{44/} U.S. regulators have testified that Long-Term Capital Management (“LTCM”) was unique in terms of leverage.^{45/} The SEC’s Director of Market Regulation testified that LTCM’s leverage ratio was in excess of 50-to-1 in August 1998.^{46/}

A recent report by the Reserve Bank of Australia, however, warns that the conclusions reached on the levels of hedge funds’ leverage are of limited value. Many hedge funds do not report their levels of leverage to industry bodies tracking such leverage and the reported leverage is balance sheet leverage, which does not include off-balance sheet techniques.^{47/}

A recent IMF Report emphasizes that hedge funds are not the only market participants to use leverage:

It is misleading to single out hedge funds because of the use of leverage in their investment strategies. Other institutional investors . . . -- in particular the proprietary trading desks of commercial and investment banks -- use leverage in investment activities, much as hedge funds do. The traditionally more conservative institutional investors such as mutual and pension funds have also

^{41/} Deutsche Bundesbank Monthly Report, *Hedge Funds and Their Role in the Financial Markets*, March 1999, (“Deutsche Bundesbank Report”).

^{42/} OECD Study at 7-8 (citing to statistics of Van Hedge Fund Advisors as of December 1997).

^{43/} March 3rd Hearing (statement of Lee Sachs, Deputy Assistant Secretary, U.S. Treasury Dept.) (“Sachs statement”).

^{44/} Working Group Report.

^{45/} See, e.g., *Id.*; see also, March 24th Hearing (statement of Laurence Meyer, Member of Board of Governors of the Federal Reserve System) (“Meyer statement”).

^{46/} Oct. 1st Hearing (Lindsey statement).

^{47/} Reserve Bank of Australia, *The Impact of Hedge Funds on Financial Markets*, June 1999 (“June 1999 Reserve Bank of Australia Report”).

begun to increasingly employ currency and market-risk hedges. . . . Finally, it should be noted that traditional commercial banks are some of the most leveraged players in financial markets. With commercial banks' average capital ratios (unadjusted for credit risk) ranging in industrial countries between 3.5 percent and 8 percent, their implied gearing or leverage ratios are between 12 and 29.^{48/}

According to the President's Working Group Report, at year-end 1998, the five largest commercial bank holding companies had an average leverage ratio of nearly 14-to-1 and the five largest investment banks had a 27-to-1 ratio.^{49/} The financial press has recognized that it is banks and Wall Street firms, not hedge funds, that are the most leveraged.^{50/}

The fact that hedge funds are not unique in their use of leverage has important regulatory implications. The President's Working Group, in analyzing the lessons to be learned by LTCM, concluded that concerns relating to excessive leverage are not limited to hedge funds, which generally employ less leverage than other financial institutions, including some banks and securities firms. Banking regulators examining the lessons to be learned by LTCM have focussed on the need for banks to enhance their risk management with respect to all "highly leveraged institutions," not just hedge funds.^{51/} The head of the Australian Treasury Department is reported to have said that "less than 10 percent of the highly leveraged institutions of concern to finance officials and central bankers are hedge funds."^{52/}

The private sector, both hedge fund managers as well as hedge fund counterparties and lenders, have stressed that the concept of leverage must be viewed in context. Leverage alone, which presents both definitional and measurement difficulties, is not a meaningful measure of risk. According to the Counterparty Risk Management Policy Group, the focus should not be on leverage alone, but rather on how leverage amplifies market, funding, and asset liquidity risk.^{53/}

^{48/} IMF Report at 36 (citation omitted).

^{49/} Working Group Report.

^{50/} Robert Clow & Riva Atlas, *Wall Street and Hedge Funds*, Institutional Investor, Dec. 1998 ("Not all, or even most, leverage stems from hedge fund activity, of course; and most hedge funds are not highly levered Indeed, the institutions that are most leveraged, and most threatened by systemic risk, are the giant intermediaries, the banks and Wall Street firms. Brokerage assets-to-equity ratios soared from 10-to-1 in 1988 to 23-to-1 in this year's third quarter, according to Sanford C. Bernstein & Co. research. And those figures are *net* - not counting repos and securities borrowed. The gross ratios are far higher.").

^{51/} Basel Committee on Banking Supervision of Banking for International Settlements, Press Release, *Banks' Interactions with Highly Leveraged Institutions* (Jan. 28, 1999), available at <<http://www.bis.org/press/p990128.htm>>.

^{52/} Tony Boyd, *Banks Lurking in the Hedge*, Australian Fin. Review, Mar. 31, 1999.

^{53/} Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices*, June 1999 ("CRMPG Report").

Similarly, in their recent report on “Sound Practice for Hedge Fund Managers,” the consortium of five hedge fund managers concluded that:^{54/}

Hedge Fund Managers must recognize that leverage is important, not in and of itself, but because of the impact it can have on market risk, credit risk and liquidity risk - i.e., leverage influences the rapidity of changes in value of the portfolio due to changes in market risk, credit risk, or liquidity risk factors. Consequently, the most relevant measures of leverage are “risk-based” measures that relate the riskiness of a portfolio to the ability of the Fund to absorb that risk.

In its September 1999 World Economic and Financial Survey, the IMF aptly recognized that leverage is of concern due to its capacity to increase risk. Leverage both “creates and enhances the risk of default by market participants” and also “increases the potential for rapid deleveraging . . . which can cause major disruptions in financial markets by exaggerating market movements.”^{55/}

c. *Size and Market Influence.* Hedge funds range in size from a few million dollars to several billion dollars.^{56/} According to the President’s Working Group Report, “most hedge funds are relatively small, with the vast majority controlling less than \$100 million in invested capital” and “perhaps only a few dozen . . . that have a capital base larger than \$1 billion, and only a small handful that exceed \$5 billion.”^{57/} The size and influence of such funds is “greatly magnified” by their use of highly active trading strategies and leverage (which, as discussed above, varies widely among funds)^{58/} and may be magnified by the alleged “herding” dynamic in which hedge funds act together and/or lead other market participants. Given the size and growth of the industry, there is little debate that hedge funds are major market participants worthy of examination.^{59/} In recent years, hedge funds’ size and leverage have been blamed for

^{54/} *Sound Practices for Hedge Fund Managers*, February 2000, at 19, available at <<http://www.hfmsoundpractices.com>> (“Hedge Fund Manager Report”).

^{55/} Charles Adams, Donald J. Mathieson, and Garry Schinasi, *World Economic and Financial Surveys: International Capital Markets - Developments, Prospects, and Key Policy Issues*, September 1999 at 152 (“IMF International Capital Markets Report”).

^{56/} Oct. 1st Hearing (statement of Bradley P. Ziff, Director and Principal, Arthur Anderson LLP) (“Ziff statement”).

^{57/} Working Group Report.

^{58/} *Id.*

^{59/} In a 1994 hearing before Congress, SEC Chairman Arthur Levitt acknowledged that “the trading activity of a handful of very large, aggressive hedge funds has become a matter of legitimate national inquiry and importance.” *Hearing on Risks That Hedge Funds Pose to the Banking System Before the House Committee on Banking, Finance and Urban Affairs*, 103rd Cong. (1994) (“April 13th Hearing”).

moving markets.^{60/} Their ability to move markets (or their unique ability to influence markets), however, is the subject of debate. Individually and as an industry, hedge funds are a relatively small segment of the market.^{61/} As the IMF Report notes, “while hedge funds sometimes take sizable positions, so do banks, corporations [sic], and institutional investors, all of whom manage assets many times larger than those of the hedge funds”^{62/} and “[t]his creates doubt that hedge funds can dominate, or corner, particular markets under most circumstances.”^{63/} The Federal Reserve Governor John P. LaWare testified before the House Banking Committee in 1994 that “[i]t would be wrong to single out hedge funds as being responsible for moving global prices of financial assets.”^{64/} The controversy (and empirical evidence) surrounding hedge funds’ ability to move markets (either as malignant manipulators or as more benign market leaders) is discussed in Section III.B below.

D. Relationships with Other Market Participants. In assessing the role that hedge funds play in, and the risks they pose to, the global economy, it is helpful to understand their relationships with other market participants, namely, investors, banks, and securities firms. In connection with the LTCM episode, the threat that hedge funds pose to banks and securities firms has been a primary area of inquiry in the public and private sectors. As discussed below, one consistent theme that has emerged from the LTCM incident is the need for enhanced transparency with respect to hedge funds. Interestingly, Internet information providers are responding to the thirst for information about hedge funds, with the help of hedge funds themselves.

1. Investors. Although formal reporting requirements relating to investors in hedge funds do not exist, recent reports by the IMF and the Organization for Economic Cooperation and Development (“OECD”) provide information relating to their investor base.^{65/} At least in part due to the regulatory constraints noted above, hedge funds have “historically been targeted to sophisticated individual investors (80 percent [sic] of hedge fund assets according to some estimates).”^{66/} Although high net worth individuals continue to provide a source of capital

^{60/} Michelle Celarier, *How the Banks Caught Hedge Fund Fever*, Global Finance (Mar. 1994) at 52.

^{61/} Working Group Report. The Report notes that while the hedge fund industry is estimated to have had \$1 trillion in total assets as of mid-1998, various other industries had far higher total assets at the end of 1998: commercial banks with \$4.1 trillion; mutual funds with \$5 trillion; private pension funds with \$4.3 trillion; state and local retirement funds with \$2.3 trillion; and insurance companies with \$3.7 trillion.

^{62/} IMF Report at 16.

^{63/} IMF Report at 6.

^{64/} April 13th Hearing (statement of John P. LaWare, Board of Governors of the Federal Reserve System).

^{65/} IMF Report at 35; OECD Study at 5.

^{66/} OECD Study at 5.

to such funds, institutional investors also have begun investing in such funds. In the United States, “institutional investors are said to have accounted for nearly 30 percent [sic] of new money flowing into hedge funds in the past few years.”^{67/} Cerulli Associates Inc. has estimated that nearly 25% of the money now invested in hedge funds is from institutional investors.^{68/}

These institutional investors include pension funds, mutual funds, insurance companies, university foundations and endowments and commercial and investment banks.^{69/} A recent report by Goldman, Sachs & Co and Financial Risk Management Ltd. details the potential role of hedge funds in pension funds, concluding that “plan sponsors may be able to utilize certain hedge fund strategies to broaden their sources of return and improve their risk-adjusted returns, thereby creating more efficient portfolios.”^{70/} In late 1999, California Public Employees Retirement System (CalPERS), the largest public pension plan in the U.S., announced that it would invest up to \$2 billion in hedge funds.^{71/} Major universities are also joining the hedge fund bandwagon. In 1999, Harvard University announced it would invest \$500 million in a hedge fund formed by a former endowment manager.^{72/} One commentator has suggested the trend in institutional investments is fueled not only by institutional investor demand for alternative investments, but also by hedge funds’ need for long-term funding. The liquidity crisis in the fall of 1998 “taught hedge fund managers how critical it is to lock in long-term funding,” which is more easily accomplished with institutional investors. Accordingly, hedge funds are “wooing” institutional investors.^{73/} One of the benefits of such institutionalization is that it forces “greater transparency, disclosure and stability.”^{74/}

2. **Commercial Banks.** Banks serve as creditors of, and counterparties to, hedge funds. Banks provide hedge fund customers with loan and credit enhancements; serve as over-the-counter counterparties in derivative transactions; engage in fiduciary activities

^{67/} OECD Study at 5.

^{68/} Richard Bookbinder, *Investors Force Hedge Fund Changes*, American Banker, December 30, 1999.

^{69/} IMF Report at 35.

^{70/} Goldman, Sachs & Co. and Financial Risk Management Ltd., *Hedge Funds Demystified: Their Potential Role in Institutional Portfolios*, Pension & Endowment Forum (July 1998) at 1-2.

^{71/} *The True Story Behind the CalPERS Allocation*, Hedge, December 1999, Issue No. 72.

^{72/} *University Endowments Continue to Invest in Hedge Funds*, HedgeWorld Daily News, November 30, 1999, available at <[http:// www.hedgeworld.com](http://www.hedgeworld.com)>.

^{73/} Riva Atlas, *Founders Keepers: Hedge Funds Are Trying to Transform Themselves into Diversified Institutions. Can They Outlast Their Creators and Still Excel?*, Institutional Investor, September 1999.

^{74/} *Hedge Funds, An Institution*, HedgeWorld Daily News, January 27, 2000, available at <[http:// www.hedgeworld.com](http://www.hedgeworld.com)>.

involving private banking, securities lending, execution, clearance and settlement of trades; and provide custodial and cash management services.^{75/} Banks' exposure to hedge funds arises from both their counterparty and lending relationships.^{76/}

3. **Securities Firms.** Broker-dealers, like banks, may act as creditors of, or counterparties to, hedge funds and are exposed to hedge funds through these activities.^{77/} Large investment banks provide lucrative prime brokerage services to hedge funds (including custody, clearance, securities lending, financing, portfolio accounting, investment banking, and trading services).^{78/} Wall Street benefits from its relationship with hedge funds in other regards. Through this "close relationship," Wall Street has a "greater ability to place securities" and has access to "great sources of information."^{79/}

4. **Internet Information Providers.** In the last half of 1999, a number of companies launched websites on the Internet to provide information regarding hedge fund performance based on information provided through hedge fund managers. Tremont Advisers, Inc. and Credit Suisse First Boston launched a monthly hedge fund index located at <<http://www.hedgeindex.com>>. As of November 1999, 284 U.S. and offshore funds had agreed to provide audited financial information for purposes of inclusion in the index.^{80/} In December 1999, Standard & Poor's Corp. and Ernst & Young LLP launched PlusFunds.com to provide real-time information on the performance and risk profiles of hedge funds.^{81/} Similarly, HedgeFund.net plans to provide daily net asset values for as many as 300 hedge funds by collecting trading results electronically from prime brokers without obtaining the proprietary

^{75/} March 24th Hearing (statement of Michael L. Brosnan, Deputy Comptroller for Risk Evaluation) ("Brosnan statement").

^{76/} March 24th Hearing (statement of William J. McDonough, President, Federal Reserve Bank of New York) ("McDonough statement").

^{77/} Oct. 1st Hearing (Lindsey statement).

^{78/} Matthew Schiffrin, *Nobody Wants to Kill the Golden Goose*, Forbes, Dec. 14, 1998; OECD Study at 6.

^{79/} Robert Clow and Riva Atlas, *Wall Street and Hedge Funds*, Institutional Investor, Dec. 1998 (providing an in depth discussion of Wall Street's relationship with hedge funds).

^{80/} Sara Calian, *Deals & Dealmakers: Tremont Advisers, First Boston Plan Hedge- Fund Index*, Wall St. J., November 17, 1999; *A Cottage Industry Grows Up*, HedgeWorld Daily News, November 17, 1999.

^{81/} Joshua Chaffin and William Lewis, *S&P, Ernst & Young Will Operate Web Site Tracking Hedge Funds*, Financial Times, December 8, 1999.

information regarding their assets.^{82/} Other online databases include HedgeWorld (www.hedgeworld.com) and Altvest (www.altvest.com).^{83/}

III. THE DEBATE -- SYSTEMIC RISK AND MARKET INTEGRITY. A recent IMF Report aptly noted that the regulation of collective investment vehicles such as hedge funds can be justified on three grounds: consumer protection, systemic risk, and market integrity.^{84/} The debate surrounding the regulation of hedge funds has centered around the need to avoid systemic risk and to safeguard market integrity. The recent LTCM episode has pushed the systemic risk question to the forefront. In the following pages, this outline will (i) explore the parameters of the debates; and (ii) describe the conclusions that have been reached by various groups; the reaction of market participants; the steps that have been taken to remedy perceived problems; and the studies which are in progress.

A. LTCM and Systemic Risk. One regulator has concluded that the LTCM incident has “made clear that certain hedge funds may be capable, through aggressive strategies involving leverage, of creating risks both to the financial markets and to other market participants.”^{85/} The questions presented are what lessons can be learned from the incident and what, if anything, should be done differently in the future with respect to the regulation of hedge funds. The public and private sectors are studying the problem.

The banking regulators in both the United States and on an international level, namely, the **Federal Reserve**, the **Office of Comptroller of the Currency**, and the **Bank of International Settlements** (“BIS”), have already reached certain conclusions and have provided guidance relating to the enhancement of credit risk management by banks, which serves to indirectly discipline borrowers such as hedge funds. The BIS has also issued reports on the management of credit risk and credit risk disclosure; has proposed revisions to the Capital Accord to better align risk with capital requirements; and has conducted an anniversary review relating to its suggestions for enhancements to credit risk management with respect to HLIs. With respect to securities firms, the **SEC, NYSE and NASD** issued a joint statement on broker-dealer risk management practices. The **President’s Working Group of Financial Markets** has recently released its important study relating to hedge funds, providing a set of specific recommendations for public and private sector actions to enhance market discipline in constraining excessive leverage.

Moreover, the **General Accounting Office** issued a report on LTCM, and the **International Organization of Securities Commissions** (“IOSCO”) issued a report on hedge funds and other highly leveraged institutions. Certain conclusions have also been reached by

^{82/} Joshua Chaffin, *Online Group in Hedge Fund Move*, Financial Times, January 26, 2000.

^{83/} Jaye Scholl, *Virtual Data for Hedge Funds, Elusive No Longer: Fund Information is Now on the Web*, Asian Wall Street Journal, November 26, 1999.

^{84/} IMF Report at 1.

^{85/} Oct. 1st Hearing (Lindsey statement).

various international organizations (e.g., the **International Monetary Fund** and the **European Council**); think tanks (e.g., **Milken Institute**); and market participants (e.g., **Counterparty Risk Management Policy Group**, the **Consortium of Five Hedge Fund Managers**, **International Swaps and Derivatives Association**, **The Bond Market Association**, and the **Institute of International Finance**) and steps have been taken by industry participants.

But, the jury is still out on the ultimate course of action that will be taken at home and abroad. Richard Strasser, Assistant Director of the SEC's Division of Market Regulation, was reported to have said that "[t]he debate is still raging over whether or not hedge funds need to be regulated and whether or not that will be done."^{86/} Although the President's Working Group has issued a set of specific recommendations, some of the recommended measures require Congressional action and regulatory rule changes and the generalized nature of the recommendations leave the details to be debated. To date, no such legislative or regulatory rule changes have been made, although developments have occurred in this respect. Several bills have been introduced in Congress in response to suggestions contained in the President's Working Group Report (namely, the **"Baker bill"**) and the GAO Report (namely, the **"Dorgan/Markey bill"**). Both the SEC and the CFTC have indicated that they plan to take steps to implement the regulatory rule changes recommended by the President's Working Group Report.

Certain important studies on the topic, however, are still in progress, both at home and abroad, (namely, the studies by the **Financial Stability Forum** and the **Multidisciplinary Working Group on Enhanced Disclosure**) and Congress as various groups that have already issued reports continue their examination. The question of systemic risk is international in scope.^{87/} In recognition that global markets require a global response, the President's Working Group Report recommends that U.S. regulatory entities and the Treasury Department work with their international counterparts to adopt agreed-upon standards for regulating hedge funds and recommends methods of incentivizing other countries to adopt such standards.

1. **LTCM -- The Basic Facts.** LTCM specialized in fixed-income and equity convergence strategies. As the global financial crisis deepened in August and September of 1998 and Russia defaulted on its debt, "it became clear to LTCM that many of the assumptions inherent in the arbitrage positions it held were incorrect. Due to LTCM's leverage (which at one point had exceeded 50-to-1), those incorrect assumptions resulted in substantial losses for the firm and eroded its capital base."^{88/} CFTC Commissioner Barbara P. Holum testified in

^{86/} Margaret Boitano, *Some Investors Focus on Hedge Fund Exposure, Not Disclosure*, Dow Jones News Service, Apr. 7, 1999.

^{87/} See Brandon Becker and David A. Westbrook, *Confronting Asymmetry: Global Financial Markets and National Regulation*, *International Finance*, Vol. 1, No. 2, (Dec. 1998), for a discussion of global markets, systemic risk and global financial policy.

^{88/} Oct. 1st Hearing (Lindsey statement); see also, International Monetary Fund, *World Economic Outlook and International Capital Markets: Interim Assessment*, World Economic and Financial Surveys (Dec. 1998) at 54 ("IMF Survey"); Michael Lewis, *How the Eggheads*

December 1998 before the United States Senate Committee on Agriculture, Nutrition and Forestry that the “real cause of LTCM’s losses . . . [was] a fallible investment strategy combined with an overextension of credit.”^{89/}

On September 23, 1998, a consortium of 14 major international financial institutions (all of which were counterparties to, creditors of, or investors in the hedge fund) agreed to invest \$3.6 billion in LTCM in return for a 90% equity stake in LTCM and full authority to direct LTCM’s overall strategy and manage its exposures. The Federal Reserve Board of New York helped to organize and coordinate the private investment in LTCM. According to Chairman Greenspan,

[i]t was the judgment of officials at the Federal Reserve Bank of New York, who were monitoring the situation on an ongoing basis, that the act of unwinding LTCM’s portfolio in a forced liquidation would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM.^{90/}

If the failure of LTCM had “triggered the seizing up of markets,” then the “economies of many nations” could have been “potentially impaired.”^{91/} Under these special facts and circumstances, the Federal Reserve helped to facilitate the private rescue.^{92/}

2. **Was LTCM an Aberration?** Chairman Greenspan testified to the House Banking Committee shortly after the LTCM episode that “[w]hat is remarkable is not this episode, but the relative absence of such examples over the past five years. Dynamic markets periodically engender large defaults.”^{93/} The question from a regulatory standpoint is whether the LTCM incident was unique in the context of the hedge fund industry. The Director of the SEC’s Division of Market Regulation testified before Congress at the same hearing that

Cracked, N.Y. Times Magazine, Jan. 24, 1999; Oct 1st Hearing (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) (“Greenspan statement”).

^{89/} *President’s Working Group Over-The-Counter Derivatives and Hedge Funds Study Before the Senate Committee on Agriculture, Nutrition and Forestry*, 105th Cong. (1998) (“Dec. 16th Hearing”) (Statement of Barbara P. Holum, Commissioner, Commodity Futures Trading Commission) (“Holum Statement”).

^{90/} Oct. 1st Hearing (Greenspan statement).

^{91/} *Id.*

^{92/} Oct. 1st Hearing (Greenspan and McDonough statements).

^{93/} Oct. 1st Hearing (Greenspan statement).

“[b]efore we can make specific recommendations, we would need to determine whether LTCM’s activities were unusual, or whether they were representative of the industry as a whole.”^{94/}

Several commentators, including regulators, legislators and market participants, have concluded that LTCM was unique in terms of both size and leverage. Bradley Ziff, a director and principal in Arthur Anderson’s Global Derivatives and Treasury Risk Management practice, testified before Congress that LTCM is “by virtually any measure a unique fund in a unique situation” -- unique in terms of its large size, the sophistication of trading strategies and high degree of leverage.^{95/} George E. Crapple, Chairman of the Managed Funds Association, testified before Congress that “LTCM was an extreme, apparently unique, case” and that “the concerns as to size and leverage raised by LTCM are more aptly associated with other types of large institutional traders, such as the proprietary trading desks of commercial and investment banks, than with hedge funds generally.”^{96/} Similarly, in its recent report, the consortium of five hedge fund managers, noted that “[t]he scale of LTCM’s trading activity and the extent of leverage applied by LTCM at the time of its near collapse were unique.”^{97/} Rep. Margaret Roukema, Chairwoman of the House Banking Committee’s Subcommittee on Financial Institutions and Consumer Credit, agreed with this assessment: “I want to emphasize that not all hedge funds are like LTCM. LTCM was one of the 5 largest funds in the industry. It had \$125 billion in assets. It used much more leverage 30 to 1 - by a large margin - than the typical hedge fund.”^{98/} Lee Sachs, Treasury Deputy Assistant Secretary, testified that “LTCM appears to have been unique among hedge funds in terms of its combination of size and leverage” and the “LTCM episode does not necessarily suggest that there are problems with the entire industry.”^{99/} He also testified, however, that the episode does “raise significant concerns” and “demands that both market participants and financial regulators, both here and abroad, understand how LTCM became so

^{94/} Oct. 1st Hearing (Lindsey statement).

^{95/} Oct. 1st Hearing (Ziff statement).

^{96/} *Hearing of the House Banking and Financial Services Committee on the President’s Working Group Report on Hedge Funds*, 106th Cong. (1999) (“May 6th Hearing”) (statement of George Crapple, Chairman of the Managed Funds Association) (“Crapple Statement”). In a recent report, the Managed Fund Association concluded, “In size, leverage, degree of position concentration and access to credit, LTCM had few or no parallels in the universe of hedge funds. LTCM should be viewed as an instance of ‘pilot error,’ not as evidence of a structural defect in the hedge fund industry.” Managed Funds Association, *Hedge Funds: Issues For Public Policy Makers*, April 1999.

^{97/} Hedge Fund Manager Report at 2.

^{98/} March 24th Hearing (statement of Rep. Marge Roukema, R-NJ-5th) (“Roukema statement”).

^{99/} March 3rd Hearing (Sachs statement); *see also*, March 24th Hearing (Meyer statement).

highly leveraged and what market practices and disciplines contributed to this incident.”^{100/} It is “excessive leverage of this nature” which could “contribute to systemic risk in the future.”^{101/}

After an extensive study of the LTCM incident, the President’s Working Group concluded that “[o]verall, the distinguishing features of the LTCM Fund were the scale of its activities, the large size of its positions in certain markets, and the extent of its leverage, both in terms of balance-sheet measures and on the basis of more meaningful measures of risk exposure in relation to capital.”^{102/} Despite the distinguishing features, the Group concluded that the incident suggested the need for both public and private sector action to enhance market discipline in constraining excessive leverage which can pose systemic risk. The Group’s recommendations are discussed below.

3. **Private Sector Response.** In the aftermath of the LTCM episode, the banking regulators have seen “renewed market discipline” which has reduced “excessive leverage.”^{103/} Acting in their own “self-interest,” banking institutions “appear to be well underway in making enhancements to their credit risk management systems.”^{104/} There is “some evidence that banks and other suppliers of credit to highly leveraged financial institutions are demanding more collateral or requiring larger ‘haircuts’ (effectively margin) on their repurchase agreements and derivative transactions.”^{105/} The Bank of International Settlements issued a press release in January 1999 stating that most financial institutions with exposures to highly leveraged institutions “appear to be tightening their standards following the events of last autumn” and a “key reason” for issuing the sound practice guidance to banking institutions is to “ensure that these improvements are ‘locked in’ over time.”^{106/} Moreover, “market participants are already demanding more disclosure from hedge funds”^{107/} and “[i]ncreasingly, hedge funds recognize

^{100/} *Id.*; see also, IMF Survey at 16 (noting that the key issue raised by the LTCM incident is “how very large leveraged positions could be built up across a large number of financial institutions to the point where systemic risk was raised to extraordinary levels.”).

^{101/} *Id.*

^{102/} Working Group Report.

^{103/} March 3rd Hearing (Sachs statement).

^{104/} March 24th Hearing (Meyer statement).

^{105/} March 3rd Hearing (Sachs statement); see also, March 24th Hearing (Brosnan statement (describing steps being taken by national banks to reduce their exposures to hedge funds)).

^{106/} Basel Committee on Banking Supervision of Banking for International Settlements, Press Release, *Banks’ Interactions with Highly Leveraged Institutions* (Jan. 28, 1999), available at <[http:// www.bis.org/press/p990128.htm](http://www.bis.org/press/p990128.htm)>.

^{107/} Dec. 16th Hearing (statement of Roger L. Anderson, Treasury Deputy Assistant Secretary for Federal Finance).

that they need to provide their counterparties with more information.”^{108/} According to the Economist, this new openness by traditionally secretive hedge funds is fueled by the desire to attract institutional investors and to reduce the costs of financing positions.^{109/} Laurence Meyer testified that “[a]lthough market discipline may not have worked in preventing the LTCM event in the first place, the marketplace has reacted appropriately. . . .”^{110/} In a January 2000 “report card,”^{111/} the Basel Committee on Banking Supervision noted that overall progress has been made by banks and banking supervisors in “responding to the risk posed by Highly Leveraged Institutions (HLIs) following the lessons learnt from the near collapse of Long Term Capital Management in 1998,” although more work remains to be done to “lock in and strengthen improvements in banks’ risk management approach towards HLIs.”^{112/}

In addition, the private sector (banks, securities firms, and hedge funds) has already taken significant steps to study means through which its risk management systems can be improved. In January of 1999, a group of twelve “globally active commercial and investment banks” announced the formation of the **Counterparty Risk Management Policy Group (CRMPG)**.^{113/} The CRMPG is comprised of major international banks, securities firms and hedge funds.^{114/} The CRMPG was formed, with the support of Chairman Levitt, Chairman Greenspan and Secretary Rubin, “for the purpose of developing flexible standards for strengthened risk management practices at banks, securities firms and other major players active in international financial markets.”^{115/} The CRMPG’s intent “is to promote enhanced best practices in counterparty credit and market risk management” in general, which will include an analysis of derivatives and hedge fund relationships.^{116/} The CRMPG completed its report on “Improving Counterparty Risk Management Practices” in June 1999.^{117/} It continues to work towards

^{108/} March 24th Hearing (Meyer statement).

^{109/} *Hedge Funds: Growing Up*, The Economist, November 20, 1999.

^{110/} *Id.*

^{111/} *Basel Committee on Banking Supervision, Banks’ Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee’s Sound Practices Paper*, January 2000, available at <[http:// www.bis.org](http://www.bis.org)>.

^{112/} Basel Committee on Banking Supervision, Press Release, *HLI Report -- Anniversary Review*, January 25, 2000, available at <[http:// www.bis.org](http://www.bis.org)>.

^{113/} March 3rd Hearing (statement of E. Gerald Corrigan and Stephen G. Thieke, Co-Chairmen, Counterparty Risk Management Policy Group) (“Corrigan and Thieke statement”).

^{114/} March 24th Hearing (Meyer statement).

^{115/} March 3rd Hearing (Corrigan and Thieke statement).

^{116/} *Id.*

^{117/} CRMPG Report.

implementing the recommendations in its report and to work with the public sector in crafting appropriate responses to the lessons learned from the events in the fall of 1998.

A group of hedge funds (**Soros Fund Management, Tudor Investment Corp., Moore Capital Management Inc., Caxton Corp. and Kingdon Capital Management**) has developed its own set of sound practices for risk management in response to a recommendation in the April 1999 Report of the President's Working Group that hedge funds follow the lead of the Counterparty Risk Management Policy Group in developing best practices in light of the LTCM episode. The hedge funds issued their report, "Sound Practices for Hedge Fund Managers," in February 2000.^{118/}

Studies by two other private sector organizations also have been completed. The **International Swaps and Derivatives Association**, a global trade association representing participants in the privately negotiated derivatives industry, issued a report in March 1999 regarding its study of collateralization and collateral management programs for OTC derivatives during periods of market volatility in 1997-1998. The Report recommends 22 methods of enhancing the effectiveness of collateral management programs as a means of reducing credit risk.^{119/} The **Institute of International Finance**, a global association of financial institutions, issued a March 1999 report regarding its recommended best practices for risk management, including management for credit risk.^{120/} Moreover, in February 2000, **The Bond Market Association**, released a new Cross-Product Master Agreement to help reduce systemic risk associated with the default of a counterparty.^{121/}

Although there was concern that investors would desert hedge funds after the LTCM crisis, investors have continued to invest.^{122/} George Van of Van Hedge Fund Advisers estimated that \$290 billion was invested in hedge funds at the start of 1999, down only 2% from the previous year.^{123/} Managed Account Reports reported that net inflow numbers for July and

^{118/} Hedge Fund Manager Report.

^{119/} International Swaps and Derivatives Association, Inc., *ISDA 1999 Collateral Review*, 1999 ("ISDA Study").

^{120/} Institute of International Finance, Inc., *Report of the Task Force on Risk Assessment: Recent Experiences, Lessons, and Recommendations*, March 1999 ("Risk Assessment Report").

^{121/} Cross-Product Master Agreement, February 2000, available at <<http://www.bondmarkets.com>>.

^{122/} Alan Kohler, *Hedging: Long and Short of It*, Australian Fin. Review, Apr. 1, 1999.

^{123/} *Hedge Funds: Trimmed, Not Axed*, The Economist, Vol. 350; Issue: 8108 (Feb. 27, 1999).

August 1999 potentially indicate “an end to the negative effects of Long-Term Capital Management.”^{124/}

4. **Public Sector Response.** The public sector, including politicians and regulators at home and abroad, has been making an effort to determine what lessons can be learned from the LTCM incident and the public policy implications of the incident. Congress has held multiple hearings, various groups have issued reports and recommendations, legislation has been introduced, regulatory rule changes are being considered, and studies continue to be undertaken.

a. **Congressional Hearings.** The U.S. Congress has held six separate hearings in which it has received testimony from representatives from the CFTC, SEC, Federal Reserve, OCC, and Treasury Department as well as representatives from the financial sector and academia:

- October 1, 1998 Hearing of the House Banking and Financial Services Committee on Hedge Funds, Long-Term Capital Management;
- December 16, 1998 Hearing of the Senate Committee on Agriculture, Nutrition and Forestry on President’s Working Group Over-The-Counter Derivatives and Hedge Funds Study;
- March 3, 1999 Hearing of the House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services on Hedge Funds;
- March 24, 1999 Hearing of the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services on Banking Lending To and Other Transactions with Hedge Funds;
- May 6, 1999 Hearing of the House Banking and Financial Services Committee on the President’s Working Group Report on Hedge Funds; and
- June 24, 1999 Hearing of the House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services on the Counterparty Risk Management Policy Group Report.

b. **Reports and Recommendations by Domestic and International Organizations and Regulatory Bodies.** Various banking regulators, securities regulators and government offices in the U.S. and abroad, as well as groups of such regulators, have issued reports and recommendations concerning steps that should be taken to reduce systemic risk.

In early 1999, certain banking regulators issued guidance regarding banks’ enhancement of risk management procedures in dealing with highly leveraged institutions:

^{124/} Lois Peltz, *MAR Puts Hedge Fund Asset Base at \$205 Billion*, available at <<http://www.marhedge.com>>.

- **Board of Governors of the Federal Reserve System** issued supervisory guidance regarding counterparty credit risk management on February 1, 1999;^{125/}
- **Office of Comptroller of the Currency**: issued supplemental guidance regarding the risk management of financial derivatives and trading activities, including counterparty credit risk, in January 1999;^{126/}
- **Basel Committee on Banking Supervision of the Bank for International Settlements**:^{127/} issued a report analyzing banks' interactions with highly leveraged institutions together with guidance on sound practices in such dealings in January 1999;^{128/} and it conducted an anniversary review of the implementation of the sound practices in January 2000;^{129/} and
- **State of New York Banking Department**:^{130/} issued a report on major New York banks' hedge fund activities in March 1999.^{131/}

^{125/} Board of Governors of the Federal Reserve System, *Supervisory Guidance Regarding Counterparty Credit Risk Management*, S.R. 99-3 (Feb. 1, 1999), available at <<http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9903.HTM>>.

^{126/} Office of Comptroller of the Currency, *Risk Management of Financial Derivatives and Bank Trading Activities*, Bulletin 99-2 (Jan. 25, 1999), available at <<http://www.occ.treas.gov/ftp/bulletin/99%2D2.txt>>.

^{127/} The Basel Committee on Banking Supervision of the Bank of International Settlement is comprised of the bank supervisors from the G-10 countries who develop supervisory policy for internationally active banks. William J. McDonough, the President of the Federal Reserve Bank of New York, is the Chairman of the Basel Committee on Banking Supervision.

^{128/} Basel Committee on Banking Supervision, *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (Jan. 1999), available at <http://www.bis.org/publ>; Basel Committee on Banking Supervision, *Banks' Interactions with Highly Leverage Institutions* (Jan. 1999), available at <<http://www.bis.org/publ>>.

^{129/} Basel Committee on Banking Supervision, *Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practice Paper*, January 2000, available at <<http://www.bis.org>>.

^{130/} The New York State Banking Department is the regulator for all State-chartered banking institutions and virtually all of the U.S. offices of international banking institutions. See Press Release, *Banking Department Report on Hedge Funds Shows Industry and Examination Concerns*, Mar. 8, 1999, available at <<http://www.banking.state.ny.us/pr990308.htm>>.

^{131/} State of New York Banking Department, *Review of Hedge Fund Activities* (March 4, 1999), available at <<http://www.banking.state.ny.us/hfreport.htm>>.

The **President's Working Group on Financial Markets** (consisting of the Secretary of the Treasury, and the Chairs of the Federal Reserve System Board of Governors, the SEC and the CFTC) issued a report on April 29, 1999, entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management."^{132/} The study was undertaken to analyze the lessons learned from the difficulties encountered by 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 Working Group evaluated the costs and benefits of potential policy options including: relying on market discipline, enhanced by greater regulatory scrutiny of and guidance for regulated suppliers of credit, such as banks; resorting to more direct forms of regulation such as expanded use of margin requirements; and imposing direct regulation on some currently unregulated market participants.^{133/} The study includes a description of hedge funds and the types of trading they engage in, an explanation of the risks faced by hedge funds, the market impact of hedge funds, and the regulatory environment of these funds, as well as discussions of credit risk management, public policy issues, and LTCM.^{134/} The Report's important recommendations for private sector and public sector action (both regulatory and legislative) are described below.

The **General Accounting Office** issued a report in October 1999 entitled "Long Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk" in response to a request by Senators Byron Dorgan, Tom Harkin and Harry Reid and Representative Edward Markey for a review of the issues raised by the near-collapse of LTCM.^{135/} More specifically, the GAO studied: (1) how LTCM's positions became large and leveraged enough to be deemed a potential systemic threat; 2) what federal regulators knew about LTCM and when they found out about its problems; 3) what the extent of coordination among regulators was, and 4) whether regulatory authority limits regulators' ability to identify and mitigate potential systemic risk. The Report's conclusions, recommendations and views regarding the President's Working Group report are discussed below.

The **International Organization of Securities Commissions** issued a report in November 1999 entitled "Hedge Funds and Other Highly Leveraged Institutions" after studying the events surrounding the near collapse of LTCM.^{136/} The Task Force formed to undertake the

^{132/} Working Group Report.

^{133/} March 3rd Hearing (Sachs statement).

^{134/} In his testimony before Congress in December 1998, CFTC Commissioner Newsome described what topics the Report would cover, and the Working Group delivered on its promise. See Dec. 16th Hearing (statement of James E. Newsome, Commissioner, CFTC) ("Newsome statement").

^{135/} General Accounting Office, *Long Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, October 1999 ("GAO Report").

^{136/} Technical Committee of the International Organization of Securities Commissions, *Hedge Funds and Other Highly Leveraged Institutions*, November 1999 ("IOSCO Report"), available at <[http:// www.iosco.org](http://www.iosco.org)>.

study, which was composed of regulators in 14 jurisdictions, was “instructed to determine what measures might be advisable to reduce the systemic risk and market stability concerns raised by the activities of HLIs.”^{137/} The IOSCO Report’s finding and conclusions are discussed below.

In July 1999, the **SEC**, **NYSE**, and **NASD** issued a joint statement relating to broker-dealer risk management practices based on examinations of these practices by a task force created several years ago.^{138/} The statement serves as a guide to broker-dealers by highlighting the weaknesses and strengths found in risk management practices. The statement commended the CRMPG for its initiatives in improving risk management practices.

The **OECD**^{139/} and **IMF**^{140/} have also completed various studies and the **European Council** has reached certain conclusions. The financial press has reported that certain foreign regulators and politicians are calling for various types of regulatory measures.^{141/}

In addition to specific guidance relating to highly leveraged institutions, the **Bank for International Settlements** has also issued proposed revisions to its current capital standards and guidance on credit risk with implications for banks’ interactions with highly leveraged institutions:

- The Basel Committee on Banking Supervision of the BIS issued a consultative paper proposing revisions to the 1998 Basel Capital Accord to “improve the way regulatory capital requirements reflect underlying risks.”^{142/} The new framework rests on three pillars: minimum capital requirements, supervisory review of a bank’s capital adequacy, and market discipline. The Basel Committee has also issued related papers (i) providing guidance on what disclosures should be made in order to advance the role of market discipline in promoting bank capital adequacy;^{143/} and (ii) providing information related to the study of how credit risk

^{137/} IOSCO, Press Release, Hedge Funds and Other Highly Leveraged Institutions, November 5, 1999 (“IOSCO Press Release”), available at <[http:// www.iosco.org](http://www.iosco.org)>.

^{138/} Office of Compliance Inspections and Examinations, Securities and Exchange Commission; New York Stock Exchange, NASD Regulation, Inc., *Joint Statement: Broker-Dealer Risk Management Practices*, July 29, 1999, available at <[http:// www.sec.gov](http://www.sec.gov)>.

^{139/} OECD Study.

^{140/} IMF Survey; IMF International Capital Markets Report.

^{141/} See Testimony of Brooksley Born, Chairperson Commodity Futures Trading Commission before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the House Committee on Banking and Financial Services, Mar. 25, 1999.

^{142/} Basel Committee on Banking Supervision, *A New Capital Adequacy Framework*, June 1999 (Consultative Paper), available at <[http:// www.bis.org](http://www.bis.org)>.

^{143/} Basel Committee on Banking Supervision, *A New Capital Adequacy Framework: Pillar 3 Market Discipline*, January 2000 (Consultative Paper), available at <[http:// www.bis.org](http://www.bis.org)>.

mitigation techniques should factor into capital standards.^{144/} Comments on the proposed revisions are due by March 31, 2000.

- In October 1999, the Basel Committee and the IOSCO jointly issued guidance to banks and securities firms on public disclosure of trading and derivatives activities.^{145/} The Report notes that “transparency of banks’ and securities firms’ activities and risks” are “a key element of an effectively supervised system.”
- The Basel Committee on Banking Supervision of the BIS released four papers in June 1999 providing guidance to banks and banking supervisors on credit risk generally (as opposed to credit risk relating specifically to HLIs) in an effort to strengthen bank risk management procedures. These papers relate to accounting for loans and loan losses,^{146/} principles for the management of credit risk,^{147/} best practices for credit risk disclosure,^{148/} and management of FX settlement risk.^{149/}

c. *Legislation and Rule-Making.* In response to suggestions in the President’s Working Group Report, **Rep. Richard H. Baker (R-La.)** introduced legislation to require hedge funds to increase the amount of information they disclose to the public. The **SEC** and **CFTC** have indicated that they are working on proposed rule changes recommended in the Working Group Report.

Senator Byron L. Dorgan (D-N.D.) and **Rep. Ed Markey (D-Mass.)** have introduced legislation entitled the “Derivatives Market Reform Act of 1999” to address concerns raised in the GAO Report. The bill would grant additional authority to the SEC and require reporting by financial regulators and hedge funds.

^{144/} Basel Committee on Banking Supervision, *Industry Views on Credit Risk Mitigation*, January 2000, available at <[http:// www.bis.org](http://www.bis.org)>.

^{145/} Basel Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions, *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*, October 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

^{146/} Basel Committee on Banking Supervision, *Sound Practices for Loan Accounting and Disclosure*, July 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

^{147/} Basel Committee on Banking Supervision, *Principles for the Management of Credit Risk*, July 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

^{148/} Basel Committee on Banking Supervision, *Best Practices for Credit Risk Disclosure*, July 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

^{149/} Basel Committee on Banking Supervision, *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*, July 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

d. *Ongoing Efforts and Current Studies.* Various domestic and international organizations are currently studying questions relating to hedge funds:

- **U.S. Treasury Department.** The Treasury Department is studying various tax issues relating to hedge funds, which were outside the scope of the President's Working Group's study on hedge funds. The Working Group Report stated 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."
- **President's Working Group on Financial Markets.** The President's Working Group, although it has issued its Report on hedge funds with specific recommendations for their direct and indirect regulation, will continue "monitoring the credit risk management policies of large commercial and investment banks and assessing the effectiveness of the measures outlined [in its Report] as a means of addressing concerns about excessive leverage on the part of hedge funds and other highly leveraged market participants." As such, its study of hedge funds is ongoing.
- **International Organization of Securities Commissions ("IOSCO").** The IOSCO formed a task force in February 1999 to focus on securities firms' relationships with hedge funds.^{150/} Although the Task Force issued its Report in November 1999, it is continuing to "assess the progress of the on-going international initiatives on public disclosure by market participants [including the work of the Fisher II Group and the Financial Stability Forum]."
- **Basel Committee on Banking Supervision.** The Basel Committee noted in its recent Anniversary Review of banks' interactions with HLIs that it "will continue to serve as a platform for the coordination of the approaches taken by G10 supervisors to strengthen banks' risk management practices vis-a-vis HLIs and counterparties more generally." Moreover, the Committee will continue its work with respect to proposed revisions to the Capital Accord which are designed to establish a stronger link between capital requirements and risk categories. In recognition of the need for consistency of sound practices among different sectors of the financial industry "to avoid slippage of prudent practices due to competitive pressures," the Basel Committee has proposed that members of the Basel Committee and the IOSCO Task Force on HLIs (along with persons from the International Association of Insurance Supervisors) meet

^{150/} March 24th Hearing (McDonough statement).

to establish common areas of interest relating to risk management practices with respect to HLIs.^{151/}

- **Multidisciplinary Working Group on Enhanced Disclosure (also known as the Fisher II Group).** The Multidisciplinary Working Group, chaired by Peter Fisher of the New York Federal Reserve Bank, is made up of representatives of the Basel Committee, IOSCO, the International Association of Insurance Supervisors and the Committee on the Global Financial System. One of the recommendations of the President's Working Group is that regulated firms provide public disclosure relating to their credit exposures to HLIs. The Fisher II Group is currently considering what information should be publicly disclosed by financial intermediaries to provide a clear view of their exposures to market and credit risks. In connection with this endeavor, the Group is developing a model risk information disclosure template in cooperation with industry participants and intends to conduct a pilot study with such industry participants. The intent is to use the results of the pilot study to assess the utility and feasibility of enhanced public disclosure by financial intermediaries.^{152/}
- **Group of Seven Countries ("G-7")** (consisting of the United States, Japan, Germany, France, Britain, Italy and Canada). The G-7 issued a statement endorsing both the Basel Committee and IOSCO efforts and intends to continue to review the topic of highly leveraged institutions,^{153/} including the need for increased regulation of hedge funds.^{154/} In this regard, the **Financial Stability Forum**^{155/} (composed of financial officials from the G-7 nations and several other nations^{156/} as well as

^{151/} Basel Committee on Banking Supervision, *Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practices Paper* (Jan. 2000), available at <[http:// www.bis.org/publ](http://www.bis.org/publ)>; Basel Committee on Banking Supervision, Press Release, *HLI Report -- Anniversary Review*, January 25, 2000, available at <<http://www.bis.org>>.

^{152/} See IOSCO Report for description of the Fisher II Group's activities. Materials prepared by the Fisher II Group are not publicly disseminated.

^{153/} March 24th Hearing (McDonough statement); see also, March 3rd Hearing (Born statement).

^{154/} *G-7 Nations Pledge Global Money Watch*, Greensboro News & Record, Feb. 21, 1999.

^{155/} See web site for Financial Stability Forum, located at <[http:// www.fsforum.org](http://www.fsforum.org)>.

^{156/} In addition to the G-7 nations, the following nations are members of the Financial Stability Forum: Australia, Hong Kong, Netherlands, and Singapore.

officials from a number of international agencies) determined at its first meeting on April 14, 1999, to establish a working group to study highly leveraged institutions. The Chairman of the Financial Services Authority, the British banking regulator, is the chair of this working group. The working group is studying both systemic risk and market integrity questions associated with hedge funds. It is focussing on “the potential risk to the financial system presented by the failure of large HLIs and the effects of the activities of HLIs on the dynamics and integrity of financial markets in small and medium-sized economies.” It is expected that the working group’s findings will be announced in April 2000.

At its meeting in Cologne, Germany, in mid-June 1999, the Finance Ministers of the G-7 nations released a statement which proposed a number of reforms to the architecture of the international financial system.^{157/} The statement recommended that “steps should be taken to improve transparency by all market participants, including steps to improve the quality and timeliness of public disclosure of direct material exposure to highly leveraged financial institutions, and of relevant information by highly leveraged institutions.” The statement noted the Finance Ministers “look forward to the work of the Financial Stability Forum on this issue.”

- **G-22** (consisting of the G-7 countries and developing nations including Malaysia, Indonesia, Thailand, Singapore, India, China, South Africa, Brazil, South Korea and Russia). The G-22 is focusing on regulatory issues raised by LTCM and other highly leveraged institutions.^{158/}
- **Asia-Pacific Central Bankers**. The Malaysia central bank stated in its annual report that the 12 central banks and monetary authorities from the Asia-Pacific region have upgraded their study group on banking supervision to a working group and are assessing the supervisory approach for monitoring hedge funds.^{159/}
- **Asia-Pacific Economic Cooperation (“APEC”)**. The APEC, an organization of 21 countries in the Asia-Pacific region, is studying the

^{157/} Report of the G7 Finance Ministers to the Koln Economic Summit, *Strengthening the International Financial Architecture*, Cologne, Germany, June 18-20, 1999, available at <<http://www.g8cologne.de>>.

^{158/} March 3rd Hearing (Born statement); *see also*, March 25th Hearing (Born statement).

^{159/} *Asia-Pacific Central Banks Intensify Joint Supervisory Activities*, Agence France- Presse, Apr. 1, 1999.

need for the regulation of hedge funds. The APEC finance ministers met in Malaysia in mid-May 1999 to discuss the issue.^{160/}

The types of regulatory measures being considered, recommended and implemented are discussed below.

5. **Regulatory Responses.** Potential regulatory responses being debated include the following: 1) no additional regulation of hedge funds or related parties and continued reliance on market discipline and the current regulatory structure; 2) indirect regulation of hedge funds through enhanced supervision and/or regulation of hedge fund counterparties and lenders; or 3) direct regulation of hedge funds through various means including reporting and disclosure requirements. One topic on which there is a broad consensus is the need for creditors and lenders to hedge funds to more carefully scrutinize their lending decisions.^{161/} Another common mantra is the need for increased transparency.

Julie L. Williams, Acting Comptroller of the Currency, testified before the House Committee on Banking and Financial Services on October 1, 1998, that “the LTCM case underscores the need for banks to understand the full extent of their credit and trading exposure to leveraged customers, including hedge funds. As creditors, banks need to get as much information as possible about the fund’s investment strategy and the exposure of other financial institutions to the fund.”^{162/} The President’s Working Group found that the “opaqueness of LTCM’s risk profile is an important part of the LTCM story and raises a number of concerns regarding credit-risk management and counterparty trading relationships.”^{163/} One factor weighing against full disclosure is hedge funds’ “proprietary information.” Laurence Meyer of the Federal Reserve testified before the House Subcommittee on Financial Institutions and Consumer Credit on March 24, 1999, that the private sector is grappling with the question of how hedge funds can provide the necessary disclosure without compromising the integrity of their proprietary investment strategies.^{164/} Both the CRMPG Report and the Hedge Fund Manager Report address means through which such proprietary information can be safeguarded.

Thus far, some have argued that no additional supervision or regulation is called for in light of the LTCM incident. Many have recognized that market discipline generally serves to prevent these types of episodes and that market participants will adjust their risk management practices in the face of the lessons learned. Others have pointed out, however, that market discipline has been undermined because the Federal Reserve’s involvement in the episode has

^{160/} Martin Abbugao, *APEC Finance Ministers Grapple with Hedge Fund Issue*, Agence France Presse, May 14, 1999.

^{161/} Dec. 16th Hearing (Anderson statement).

^{162/} Oct. 1st Hearing (statement of Julie L. Williams, Acting Comptroller of the Currency) (“Williams statement”).

^{163/} Working Group Report.

^{164/} March 24th Hearing (Meyer statement).

implicated moral hazard concerns. A preference for indirect regulation through the regulation of counterparties and lenders has been voiced by members of both the public and private sector on both ease and efficiency grounds and in recognition that the direct regulation of hedge funds might drive them overseas where the U.S. regulators would have even less ability to influence their conduct. As Representative Spencer Bachus stated on October 1, 1998:

I would say the focus does not need to be on hedge funds, because I don't think we are ever going to be able to regulate hedge funds. They are going to go overseas. In fact, Mr. Ely on CNBC last night said trying to regulate a hedge fund is like trying to nail a jellyfish to a wall and I would agree with that.

But we do have regulatory oversight and responsibility for regulating lending practices and our banking institutions, and so part of this hearing ought to be to ask the questions, did our institutions loan too much? Were these prudent and reasonable loans? Did the Federal banking regulators fail to monitor the situation?^{165/}

Despite the risks attendant to direct regulation, various forms of direct regulation (namely, reporting and disclosure requirements) are being considered and have been recommended. Legislation to require periodic reporting has been introduced.

The viewpoints being expressed by members of both the public and private sectors relating to potential regulatory responses are highlighted below. The recent recommendations by the President's Working Group, which constitute actual regulatory responses (albeit ones which are in need of further definition and in need of implementation by either the regulators themselves or by Congress), are discussed in depth given their significance to the likely course of action at both home and abroad. The debate that has begun over these specific recommendations and the steps that have been taken in light of these recommendations are also discussed. The Working Group adopted a measured, market-oriented approach which pulls from all three types of regulation -- market discipline, indirect, and direct regulation. The Report focuses on enhancing market discipline in constraining excessive leverage through increased transparency via reporting requirements and through enhancements to indirect regulation via public and private sector actions. The recent recommendations by the GAO, IOSCO, the Counterparty Risk Management Policy Group and the Hedge Fund Manager Group are also discussed in detail.

a. Background -- Market Discipline and Current Forms of Regulation.

The debate over what, if any, regulatory actions should be taken must be framed by the current restraints in the system against major market failures.

(i) Market Discipline and the Debate over the Federal Reserve's Intervention in LTCM. One of the primary concerns being raised relating to hedge funds is excessive leverage. Market discipline generally serves to prevent undue risk-taking. Patrick M. Parkinson, an Associate Director of the Division of Research and Statistics of the Board of Governors of the Federal Reserve System, explained to the Senate Committee:

^{165/} Oct. 1st Hearing (statement of Rep. Spencer Bachus, R-AL *See* Pg 51) ("Bachus statement").

In our market-based economy, the primary mechanism that regulates firms' risk-taking is the discipline provided by creditors and counterparties. If a firm seeks to achieve greater leverage, its creditors and counterparties will ordinarily respond by increasing the cost or reducing the availability of credit to the firm. The rising cost or reduced availability of funds provides a powerful economic incentive for firms to restrain their risk-taking.^{166/}

A firm's fear of failure also serves to limit its risk-taking.

Controversy surrounds the Federal Reserve's involvement in the LTCM incident. Some have argued that the Federal Reserve's involvement has undermined market discipline. Burton G. Malkiel and J.P. Mei, professors at Princeton University and New York University's Stern School of Business, respectively, summarize the "moral hazard problem" which they believe is created by such intervention:

If unsuccessful hedge funds are not allowed to fail, if brokerage firms believe they will somehow be protected from the effects of far too liberal margin requirements, if banks believe help will be forthcoming should loans go sour during unsettled market conditions, how will we discipline future decisions of investors and lenders? Will such intervention make our financial system even more fragile later? By offering a helpful hand to hedge funds, will their activities in speculating against certain currencies, such as the Brazilian real, make the international financial system even more fragile?

Anything that weakens the effect of market discipline and that lessens the punishment the market affords speculators when they have made incorrect decisions is likely in the long run to lead to more instability.^{167/}

Congressman Spencer Bachus shares Malkiel and Mei's moral hazard concern. He stated during the October 1, 1998 hearing before the House Committee on Banking and Financial Services:

Rescuing firms is always tempting because it helps to avoid short-term economic and political pain. But, when we start bailing out well-connected firms, we interfere with how markets work and we will pay the price down the road -- in a weaker economy and in greater economic pain for our citizens. To use a metaphor, I am afraid that the Fed has embarked on a policy of slapping a new coat of paint on a termite infested house. In the short run things look great, but, in the long run the house is in trouble.^{168/}

^{166/} Dec. 16th Hearing (statement of Patrick M. Parkinson, Associate Director, Board of Governors of the Federal Reserve System) ("Parkinson statement").

^{167/} Burton G. Malkiel & J.P. Mei, Editorial, *Hedge Funds: The New Barbarians at the Gate*, Wall St. J., Sept. 29, 1998, at A22.

^{168/} Oct. 1st Hearing (Bachus statement).

James A. Leach, the Chairman of the House Banking and Financial Services Committee, also questions the Federal Reserve's involvement:

[T]he principal lesson would appear to be that the Fed should rely more extensively on market mechanisms and America's sophisticated bankruptcy laws. Above all, the public should be assured that the government won't subsidize insider bailouts or protect those who make investment errors.^{169/}

He issued a press release in February 1999 stating that "if intrusive regulation of hedge funds is to be avoided, they must be subject to market forces -- which should mean no collusion, no misapplication of federally-insured deposits and no public bail-outs."^{170/} 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."^{171/} Similarly, Rep. Ken Bensten (D-Texas) called the failure of the Working Group Report to address the bailout issue a "glaring omission."^{172/}

^{169/} 144 Cong. Rec. H10652: *The Failure of Long-Term Capital Management: A Preliminary Assessment Before U.S. House of Representatives, 105th Cong.* Oct. 12, 1998 ("Oct. 12th Hearing"), (statement of Rep. James A. Leach, (R-IA) Chairman House Banking and Financial Services Committee) ("Leach statement").

^{170/} U.S. House of Representatives Press Release: "Leach Urges President's Working Group to Address Hedge Fund Issues" by Rep. James A. Leach, (Feb. 25, 1999). Leach also has raised concerns that the LTCM rescue effort has potential anti-trust implications. *Id.* He has urged the Department of Justice to conduct an anti-trust review of the consortium operating LTCM. U.S. House of Representatives Press Release: "Leach Urges DOJ Review of Long-Term Capital Management Consortium" by Rep James A. Leach (Oct. 1, 1998). In his opening statement during the May 6, 1999, hearing on the President's Working Group Report, Leach again reiterated his anti-trust concerns: "It would seem that an anti-trust umbrage has been precipitated and that from a competitive perspective the result of government intervention in the Long-Term Capital management situation has been the creation of a more difficult situation than that which confronted the markets last fall when LTCM appeared to be insolvent." U.S. House of Representatives Press Release: "Opening Statement of Rep. James A. Leach, Chairman, House Banking and Financial Services Committee, Hearing on President's Working Group Report on Hedge Funds" by Rep. James A. Leach (May 6, 1999).

^{171/} U.S. House of Representatives Press Release: "Opening Statement of Rep. James A. Leach, Chairman, House Banking and Financial Services Committee, Hearing on President's Working Group Report on Hedge Funds" by Rep. James A. Leach (May 6, 1999).

^{172/} BNA Securities Law Daily, *Hedge Funds: Leach Says Hedge Fund Report Should Have Taken Stand on Public Bailouts*, May 7, 1999.

Chairman Greenspan recognizes that the Federal Reserve's involvement raises moral hazard concerns, but argues that these concerns are minimal and are certainly outweighed by broader market concerns:

Of course, any time that there is public involvement that softens the blow of private-sector losses -- even as obliquely as in this episode -- the issue of moral hazard arises. . . .

But is much moral hazard created by aborting fire sales? To be sure, investors wiped out in a fire sale will clearly be less risk prone than if their mistakes were more orderly unwound. But is the broader market well served if the resulting fear and other irrational judgments govern the degree of risk participants are subsequently willing to incur? Risk taking is a necessary condition for wealth creation. The optimum degree of risk aversion should be governed by rational judgments about the market place, not the fear flowing from fire sales.^{173/}

The IMF concluded that "[i]t is not possible to evaluate objectively the potential costs of these signals [the moral hazard problem caused by the Federal Reserve's involvement] against the benefits of the Federal Reserve's involvement."^{174/}

Others in academia have argued that the moral hazard concern raised by the LTCM incident is mitigated by "the likelihood that market participants often will not care one whit about helping a failed competitor. This is insurance of a very uncertain sort: no assurance that it will be there when you need it, and the premium -- here [the LTCM situation], 90% of the equity of the firm and loss of control -- is negotiated when the insurance is needed the most."^{175/}

Professor Coffee commends the Federal Reserve for its role as a "coordinating body," a role which he believes is a "practical and efficient substitute for a bankruptcy proceeding," despite economists claims that such involvement raises "moral hazard" problems. He testified before the House Banking Committee on May 6, 1999, that "[t]he irony is that the more we exempt creditors from the bankruptcy stay [a proposal set forth in the President's Working Group Report], the more they need a substitute coordinating mechanism, which the Fed provided. In the LTCM debacle, the Fed properly acted as the coordinating body that creditors needed to minimize the losses that can result under a 'run on the bank' scenario."^{176/}

^{173/} Oct. 1st Hearing (Greenspan statement).

^{174/} IMF Survey at 56.

^{175/} Daniel R. Fischel & Randal C. Picker, Editorial, *Manager's Journal: A Firm that Failed Well*, Wall St. J., Oct. 12, 1998, at A18. Mr. Fischel and Mr. Picker are professors at the University of Chicago Law School.

^{176/} May 6th Hearing, (John C. Coffee, Professor, Columbia University School of Law) ("Coffee statement").

(ii) **Current Regulatory Framework.** As discussed in detail in section II.A. above, it is a “misnomer” to say that hedge funds are unregulated.^{177/} Although most hedge funds are designed to avoid the registration requirements of the federal securities laws, such funds are generally subject to the broad anti-fraud provisions of the various securities laws and are subject to various reporting requirements imposed by these laws. In addition, some hedge funds are subject to regulation by the Commodity Futures Trading Commission (“CFTC”). Hedge funds are subject to “indirect regulation” through the regulation of financial institutions that act as creditors of, or counterparties, to these funds. The enhancement of indirect regulation has been one of the primary focusses in the aftermath of the LTCM incident.

b. No Additional Direct Regulation Required of Hedge Funds or Any Market Participants. Various public sector participants, academics and industry participants have expressed the view that the LTCM episode does not suggest the need for additional direct regulation of hedge funds. Others have argued that there is no need for additional regulation of any market participants, including hedge funds and their counterparties and lenders. Several persons have suggested that the direct regulation of hedge funds is either impractical or impossible because they will simply migrate to countries where such regulations are not imposed. Of particular importance, a number of banking regulators have expressed the view that the direct regulation of hedge funds is not likely to be a successful endeavor; and the President’s Working Group has only recommended one form of direct regulation, that of public disclosure, unless its recommendations for various forms of “indirect regulation” prove not to work effectively in constraining excessive leverage. In the following pages, the viewpoints of these various persons are described:

(i). *The President’s Working Group* recognized 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:

For highly leveraged hedge funds, regulatory restraints such as capital requirements, could serve to constrain more effectively their degree of leverage and the probability of a failure with systemic implications. It is possible, however, that directly regulating these institutions could drive some of them offshore, which could make regulation less effective. In addition, direct regulation of hedge funds could present formidable challenges in terms of cost and effectiveness.^{178/}

Because of the attendant costs of direct regulation of hedge funds, the Working Group believes that indirect measures to address concerns relating to systemic risk should be given a chance to work before direct measures are imposed (although the Working Group does endorse one form of direct regulation, that of disclosure requirements). These indirect measures involve enhancements to market discipline.

^{177/} Warburg Dillon Read Study at 28.

^{178/} Working Group Report.

(ii). The *Counterparty Risk Management Policy Group*, not surprisingly, does not endorse any additional regulation of hedge fund counterparties.^{179/} The Group notes that its suggestions on enhanced counterparty risk management practices should “not be viewed as a roadmap for new regulation or even a mandated checklist for supervision.” Moreover, the Group proposes a voluntary framework for enhanced reporting to regulators rather than a mandatory framework and argues against public disclosure of exposure information. Given the complex definitional and aggregation issues raised by disclosures surrounding exposure information and the difficulties in interpretation arising from these complexities, the Group believes such information is “much more suitable for supervisory purposes rather than for public disclosure” as had been recommended by the President’s Working Group. The Group emphasizes the power of private sector solutions. According to Gerald Corrigan, the co-chairman of the Group, it is very unlikely that the LTCM situation would have “reached the proportions it did” if the Group’s private sector recommendations had been implemented prior to the late summer and fall of 1998.^{180/}

(iii). The consortium of hedge fund managers (*Caxton Corp.*, *Kingdon Capital Management*, *Moore Capital*, *Soros Fund Management* and *Tudor Investment Corp.*), which issued their sound practices report in February 2000, highlighted the integral importance of self-regulation. Without specifically arguing against additional regulation of hedge funds, the report focused on improvements to self-regulation, concluding that “the most effective form of oversight is self-evaluation combined with self-discipline.”^{181/}

(iv). *Rep. Ron Paul* expressed the view on October 1, 1998, in the hearing before the House Banking and Financial Services Committee, that market discipline is the best means to prevent future episodes like that of LTCM and that hedge funds cannot be regulated because their operations are international in scope:

Allowing the market to operate, even under today’s dangerous conditions, is still the best option for dealing with hedge funds’ gambling mistakes -- both current and future.^{182/}

(v). *Rep. Ken Bensten (D-Tx)* expressed the view at the June 24, 1999 hearing on the CRMPG Report that the President’s Working Group recommendation for new public disclosure requirements has “real problems” and may result in information being “unnecessarily disclosed.”^{183/}

^{179/} CRMPG Report.

^{180/} *Hearing of the House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services on the Counterparty Risk Management Policy Group Report*, 106th Cong. (1999) (“June 24th Hearing”).

^{181/} Hedge Fund Manager Report at 28.

^{182/} Oct. 1st Hearing (statement of Rep. Ron Paul (R-TX)).

^{183/} June 24th Hearing.

(vi). *Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System*, testified before the House Committee on Banking and Financial Services on October 1, 1998, that the direct regulation of hedge funds is not practical:

[M]ost hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do in my judgment is what we do today: Regulate them indirectly through the regulation of the sources of their funds. We are thus able to monitor far better hedge funds' activity, especially as they influence U.S. financial markets. If the funds move abroad, our oversight will diminish.^{184/}

(vii). *William J. McDonough, President of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision*, expressed the same view as Chairman Greenspan with respect to the direct regulation of hedge funds in his testimony before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services on March 24, 1999:

I do not believe that it would be easy to develop a workable approach to the direct oversight of hedge funds. The reality is that imposing direct regulation on hedge fund entities that are chartered in the major industrialized countries would likely result in the movement of all operations to sites offshore. Direct regulation of hedge funds would require a high level of coordination involving the political, legislative, and judicial bodies of many countries.^{185/}

(viii). *James E. Newsome, Commissioner of the Commodity Futures Trading Commission*, concurs with the view that direct regulation of hedge funds is not an appropriate response. He testified before the Senate Committee on Agriculture, Nutrition and Forestry on December 16, 1998:

There are many who doubt the utility of traditional, direct regulation of hedge funds. Indeed, as I have stated, I believe that heavy-handed regulation will certainly drive business off the shores of the United States.^{186/}

(ix). *Douglas E. Harris, Partner, Arthur Anderson LLP*, concurs with the conclusion of the President's Working Group that further regulation of hedge funds could drive them further offshore:

^{184/} Oct. 1st Hearing (Greenspan statement).

^{185/} March 24th Hearing (McDonough statement); *see also*, March 3rd Hearing (McDonough statement).

^{186/} Dec. 16th Hearing (Newsome statement).

I believe this argument has some merit. In the not too distant past, we have seen the regulatory pronouncements of the CFTC create uncertainty in the over-the-counter derivatives market, resulting in the migration of business (and, therefore, revenue and jobs) to European financial centers.

If the hedge fund industry were to move further offshore, we would have less knowledge about it than we already possess, a diminished ability to obtain information about it, and certainly less ability to control or take action against individual funds in the event of a severe market crisis or disruption. And yet, the funds would still possess the same degree of market power that they currently have and, presumably, have no less ability to pose a risk to our financial system.

He believes that market discipline is the most effective form of regulation and that the private sector initiatives currently being undertaken testify to the effectiveness of such discipline:

But there is real doubt as to whether any rule, regulation or guideline addressing these issues [fact that certain banks and securities firms did not possess the financial information necessary upon which to base prudent credit decisions and did not possess adequate collateral to cover fully their exposure to hedge funds] will be more effective in preventing these problems in the future than the private sector initiatives already being undertaken by the banks and securities firms and their memory of the consequences they have recently endured, including the financial losses suffered, the loss of shareholder confidence and in shareholder value, and the damage to their reputations. At this point, every bank that has or has had any dealings with hedge funds is reviewing its procedures for extending credit and controlling credit exposures and establishing trading relationships. It is quite likely that the discipline which market participants exert upon themselves will be the most effective form of regulation.^{187/}

(x). *Thomas A. Russo and Marlisa Vinciguerra, Managing Director of Lehman Brothers and Senior Vice President and Counsel at Lehman Brothers*, respectively, contend that additional regulations and laws (relating to hedge funds or specific products such as OTC derivatives) would be ill-advised. They argue that the enhancement of “self-regulation” is the best approach.^{188/}

Layering law upon law or rule upon rule to fix specific problems of today should be discarded in favor of a forward looking, flexible and voluntary

^{187/} May 6th Hearing (statement of Douglas E. Harris, Partner, Arthur Anderson LLP) (“Harris statement”).

^{188/} Thomas A. Russo & Marlisa Vinciguerra, *Regulation in the Wake of Long-Term Capital’s Rescue*, Futures and Derivatives Law Report, Vol. 18, No. 11 (Feb. 1999) at 1.

approach, along the lines of the new Policy Group proposed by Securities and Exchange Commission (“SEC”) Chairman Arthur Levitt.

According to Russo and Vinciguerra, the direct regulation of hedge funds would have detrimental consequences:

The call to regulate hedge funds carries the high price of driving this business even further offshore to the competitive detriment of the United States. Equally important, an exodus of U.S. hedge funds would mean the business would be transplanted in jurisdictions with weaker or nonexistent regulatory regimes and less developed legal and judicial systems, with the result of increasing systemic risk worldwide. These downside implications exist, albeit at a less acute level, for modified versions of hedge fund regulation, including imposing credit and position reporting requirements on hedge funds.

They also do not recommend the regulation of products, through the targeting OTC derivatives and their dealers:

[H]istory demonstrates that “blame-the-product” regulation proves futile at best and counterproductive at worst.

* * *

It is illogical to focus upon a category of instruments and base regulation upon it in a world of financial innovation in which new instruments outside the definitional boundaries of the law continually arise.

As such, the “optimal approach is a global voluntary initiative of ‘best practices’ that covers not only major commercial and investment banks, but also significant end users, including hedge funds such as LTCM and corporate treasuries.” This initiative should focus “upon the essential elements that contribute to systemic risk on a global basis and without regard to entity or instrument typecasting.” Independent outside auditors would verify adherence with the “best practices.”

(xi). *Daniel R. Fischel and Randal C. Picker, Professors at the University of Chicago Law School*, expressed the view that the LTCM incident should not result in new regulation and that its rescue was handled well.^{189/}

What now? There will be inevitable calls for increased regulation of hedge funds, but such a course would be misguided. Long-Term’s collapse was handled quickly and efficiently with no taxpayer funds at risk. The losses were borne entirely by the fund’s investors. The only complaint seems to be regret that these

^{189/} Daniel R. Fischel & Randal C. Picker, Editorial, *Manager’s Journal: A Firm that Failed Well*, Wall St. J., Oct. 12, 1998, at A18.

high-flying investors did not lose more as punishment for their sins. . . .

Sometimes, though, the point is just to fail well. So far Long-Term has done that, with the help of the Fed and its new owners.

(xii). *Bradley P. Ziff, Director and Principal, Global Derivatives and Treasury Risk Management Group, Arthur Andersen LLP*, testified before the House Committee on Banking and Financial Services on October 1, 1998 that the LTCM incident underscored that the system works:

LTC's investors are bearing the burden of the firm's losses. Its creditors have come together to protect their interests. No significant market disruptions have occurred. No significant default, settlement, legal or collateral issues have arisen. Dealers are continuing to increase their vigilance over a myriad of credit issues as they have been over the past year.

In sum, this is one instance where the system, despite enormous strains caused by highly extraordinary market disruptions, appears to be working. It has presented considerable challenges to the dealer community who thus far have demonstrated their ability to appropriately address the issues at hand.^{190/}

(xiii). *Leon Metzger, President of Paloma Partners Company, L.L.C.*, testified before the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises of the House Committee on Banking and Financial Services on March 3, 1999, that further regulation of hedge funds or limitations on leverage are not called for:

Market discipline and self-regulation are the best ways to reduce risks to the financial system in adverse market conditions. The hedge-fund industry is a dynamic one, producing, some say, the most financial innovation in the last twenty years. Further regulation of this industry only would result in less-efficient markets. Furthermore, regulation, which already exists over credit providers, can be supplemented by additional guidance to address areas of concern. The best possible solution, therefore, is for intra-industry discussion and vigilance combined with government guidance -- not further regulation of hedge funds, nor arbitrary limits on leverage.^{191/}

^{190/} Oct. 1st Hearing (Ziff statement).

^{191/} March 3rd Hearing (statement of Leon M. Metzger, President, Paloma Partners Co., LLC).

(xiv). *Stephen H. Axilrod, Global Economic Consultant, (formerly the Staff Director for Monetary and Financial Policy, Board of Governors of the Federal Reserve System)* testified before the House Committee on Banking and Financial Services on October 1, 1998 that hedge funds do not require regulation:

Hedge funds are not really in their nature institutions that require a substantial regulatory reach. They cater to very sophisticated investors. They do not operate with government guarantees of their deposits and are not integral to the payments mechanism, like banks do and are; nor are they central market-makers in the securities business, and custodians of much of the public's securities holdings, like broker/dealers. And from a business perspective, hedge funds have so many different approaches available to them for their market operations and have to shift so quickly among them as market conditions change, not to mention the problem of operating in markets that are evolving with new instruments and technology virtually minute by minute, that most any regulation governing their activities would probably be outdated almost instantly.^{192/}

He also testified that hedge funds raise business rather than regulatory issues:

If an institution that is specifically designed for risk, as I interpret hedge funds to be, wishes to take risk at the outer extreme of the curve, that does not strike me, in and of itself, as a regulatory issue but rather as a very serious business issue for lenders to the funds and investors in the funds.^{193/}

(xv). *Charles J. Gradante, Managing Principal, Hennessee Group LLC*, testified before the House Committee on Banking and Financial Services on October 1, 1998, that "current standards [of supervision and transparency] are adequate [to maintain bank safety and soundness] provided they are utilized by lenders" and that "hedge funds do not need more regulation" because "[e]xisting regulations and credit standards are adequate if properly implemented."^{194/}

(xvi). *Ernest T. Patrikis, Special Advisor to the Chairman, American International Group, Inc.*, testified before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the House Committee on Banking and

^{192/} Oct. 1st Hearing (statement of Stephen H. Axilrod, Global Economic Consultant).

^{193/} *Id.*

^{194/} Oct. 1st Hearing (statement of Charles J. Gradante, Managing Principal, Hennessee Group, LLC).

Financial Services on March 3, 1999, that the direct regulation of hedge funds would actually pose a risk to the financial system and is impractical. In terms of the risk of regulation, he stated:

Proposals for partial regulation or position reporting to an information clearinghouse will have little tangible effect and far too much moral hazard risk. It will be assumed that the agency acting as a clearinghouse will be able to bring pressure to bear on a hedge fund whose behavior it concludes is questionable. This could have the effect of taking some of the pressure off of private firms to conduct their necessary in-depth reviews and could well lead market participants to conclude that the government can be expected to have the situation well in hand. I believe that one of the worst situations an agency can find itself in is to have knowledge but not the power to act.

He also argues against formal capital rules for lenders and counterparties:

Until such models [stress testing models] exist and are combined with appropriate experience, and until both the models and their application are reasonably standardized, it is folly to undertake to embed the essence of such risk management in formal capital rules.

The question that should be asked is “not whether to regulate hedge funds, but whether existing supervision of commercial and investments [sic] banks which deal with hedge funds is adequate to the task, and, if not, how it should be improved.”^{195/}

(xvii). *John C. Coffee, Professor, Columbia University School of Law*, testified before the House Banking Committee on May 6, 1999, that the LTCM episode does not demonstrate the need for the direct regulation of hedge funds because such direct regulation is unnecessary from an investor protection standpoint and would simply drive such funds offshore:

Although I believe the LTCM debacle exposes serious and systemic problems in creditor monitoring of large institutional borrowers, I do not believe that it supplies any persuasive justification for direct regulation of hedge funds. In overview, the problem with direct regulation of hedge funds is two fold: (1) Investor protection -- the traditional primary goal of SEC regulation -- does not supply a coherent justification for regulation of hedge funds; and (2) Regulation is likely to drive hedge funds offshore.^{196/}

^{195/} March 3rd Hearing (Patrikis statement).

^{196/} May 6th Hearing (Coffee statement).

(xviii). *Managed Funds Association's Hedge Fund Review*. The Managed Funds Association warns that direct regulation of hedge funds would be both difficult and dangerous:

Such [direct] measures would require sophisticated analysis and monitoring to be targeted meaningfully, are unlikely to be effective in reducing risk and may in fact be counterproductive by creating static rules that do not adequately address dynamic market risks and will tend to encourage movement of hedge funds to offshore locations in which they may operate under significantly less regulatory scrutiny than in the U.S.^{197/}

c. **Indirect Regulation.** The President's Working Group has endorsed indirect regulation as the basic appropriate approach for regulating hedge funds at this point in time and has made specific recommendations relating to such indirect regulation, including enhancements to credit risk management at the counterparty level and hedge fund level; public disclosure by public companies of their exposure to counterparties; changes to capital requirements at the counterparty level; and reporting by unregulated affiliated entities of broker-dealers and futures commission merchants. The GAO Report, IOSCO Report, CRMPG Report and Hedge Fund Manager Report have also endorsed various forms of indirect regulation (although there is disagreement among them regarding the most appropriate means of indirect regulation). Rep. Ken Bensten (D-Texas) suggested the possibility of creating a self-regulatory body to oversee hedge funds.^{198/} The banking regulators, securities regulators, and the private sector have already taken actions to enhance risk management at the counterparty level and hedge fund level. Moreover, banking and securities regulators have recommended that banks and securities firms make public disclosures of their trading and derivatives activities as a means to enhance market discipline. Prior to the Release of the Working Group Report, the Chairman of the Federal Reserve and the President of the Federal Reserve Bank of New York (who is also the Chairman of the Basel Committee) indicated that they believe that indirect regulation of hedge funds through their counterparties and lenders is an adequate and appropriate response. Various other persons from the public and private sector have also suggested that the focus should be on methods of enhancing market discipline through the supervision and regulation of hedge fund lenders and counterparties. The recommendations made by the President's Working Group, the guidance provided by the banking regulators, securities regulators and private sector, and the viewpoints expressed in the public and private sectors in favor of and against various forms of indirect regulation (or the enhancement thereto) are discussed below.

(i) President's Working Group Recommendations on Indirect Regulation and Reactions Thereto by Public and Private Sectors. The President's Working Group (consisting of the Secretary of the Treasury, and the Chairs of the Federal Reserve, the SEC and the CFTC) released a report on April 29, 1999, entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," based on its study of the lessons

^{197/} Managed Funds Association, *Hedge Funds: Issues for Public Policy Makers*, April 1999 at 2.

^{198/} June 24 Hearing.

to be learned from the LTCM incident.^{199/} The Report's primary finding is that it is excessive leverage that poses unacceptably high levels of systemic risk, an issue that is not limited to hedge funds that generally employ less leverage than other financial institutions, including some banks and securities firms. Hedge funds and leverage are not the problem.^{200/} 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 regulation of hedge funds and other financial institutions, with an emphasis on indirect regulation. House Banking Committee Chairman James A. Leach has called the Report's recommendations "thoughtful and appropriately moderate."^{201/} 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.^{202/}

The Report focusses on public disclosure of risk by 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, as discussed below), the Report represents a warning to the

^{199/} 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.

^{200/} While the Managed Funds Association agrees that hedge funds are not the problem, it does not cite "excessive leverage" as the sole culprit in the LTCM episode. It points out that leverage is just one factor in a comprehensive risk profile. Other factors include size, liquidity, and position concentrations. Managed Funds Association, *Hedge Funds: Issues for Public Policy Makers*, April 1999 at 16.

^{201/} U.S. House of Representatives Press Release: "Opening Statement of Rep. James A. Leach, Chairman, House Banking and Financial Services Committee, Hearing on President's Working Group Report on Hedge Funds" by Rep. James A. Leach (May 6, 1999).

^{202/} BNA Securities Law Daily, *Hedge Funds: Leach Says Hedge Fund Report Should Have Taken Stand on Public Bailouts*, May 7, 1999.

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’s various recommendations relating to indirect regulation call for action by regulators, Congress and the private sector. These recommendations, which include both enhancements to, and changes in, the indirect regulation of hedge funds, are discussed below.

- **Constraining Excessive Leverage through Reporting Requirements for Public Companies.**

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.” The enhanced transparency would take two forms -- (i) specific reporting requirements for hedge funds (a form of direct regulation as discussed below); and (ii) additional reporting requirements for public companies, which are counterparties or lenders to hedge funds.

With respect to the method of indirect regulation, the Report recommends that public companies, including financial institutions, publicly report their direct material exposures to significantly leveraged financial 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 **G-7 Finance Ministers**^{203/} and the **IOSCO** endorse the Working Group’s recommendation. The IOSCO recently noted: “[R]equiring public companies, which are already subject to the discipline of public disclosure, to disclose additional information about their direct exposures to HLIs should merely supplement good business practices.”^{204/} Similarly, the **Basel Committee** recognizes the “beneficial role of public disclosure by all leveraged institutions”^{205/} **Rep. Richard Baker’s** recent bill, H.R. 2924 (the “Hedge Fund

^{203/} Report of the G7 Finance Ministers to the Koln Economic Summit, *Strengthening the International Financial Architecture*, Cologne, Germany, June 18-20, 1999, available at <<http://www.g8cologne.de>>.

^{204/} IOSCO Report at 41.

^{205/} Basel Committee on Banking Supervision, *Banks’ Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee’s Sound Practices Paper*, January 2000 at 2, available at <<http://www.bis.org>>.

Disclosure Act”) contains a provision supporting this recommendation. Section 6 establishes the “sense of the Congress” that “each public company, including financial institutions, should regularly and publicly disclose a summary of direct material exposures of the company” and directs the SEC, the CFTC, and Federal banking agencies to prescribe the appropriate regulations. In late January 2000, Baker indicated that he plans to hold hearings on his hedge fund bill in the near future and plans to have the House capital markets subcommittee vote on amendments to the bill in mid-March 2000.^{206/}

The implementation of this requirement would involve rule-making by the SEC, which includes a public comment process. The SEC staff has indicated that it intends to develop proposed rule changes for comment this Spring. Belinda Blaine, an associate director of the SEC’s Division of Market Regulation, is reported to have stated that a measure to implement this recommendation is current being drafted by the SEC’s Office of the Chief Accountant and likely to be formally proposed this Spring.^{207/}

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.” The **Fisher II Group** is currently studying the feasibility and utility of public disclosure of risk information with the participation of market participants in a pilot study.

Douglas E. Harris, a partner at Arthur Anderson, testified before the House Banking Committee with respect to this proposal that the measuring of risk is problematic: “[D]ifferent institutions, using different risk models and different assumptions, compute risk in various ways. Therefore, there 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.”^{208/}

The **Counterparty Risk Management Policy Group** argues against such public disclosure of risk and exposures. Such information is subject to complex definitional and aggregation issues, which results in difficulties of interpretation. As such, this information is “much more suitable for supervisory purposes rather than for public disclosure.” Moreover, complexities surrounding aggregation call into question the usefulness of the information. According to the Policy Group, “it is very unlikely that aggregate information on exposures to broad classes of

^{206/} Will Acworth, *US Rep Baker Plans Hearings Soon on Hedge Fund Bill*, Bridge News, January 25, 2000.

^{207/} *SEC May Propose New Disclosure Rule For Companies with Hedge Fund Exposure*, BNA, Inc., Securities Law Daily, January 18, 2000.

^{208/} May 6th Hearing (Harris statement).

financial counterparties would prove at all useful to investors in trying to monitor independently the counterparty risk profile of the disclosing institutions.” Given the complexities involved in this type of disclosure, the Group has emphasized the importance of industry involvement in any rule-making process.

Rather than public disclosure, the Group recommends a voluntary reporting framework in which firms would meet informally with a small number of senior officials with their primary regulator to discuss risks and exposures. Not surprisingly, the banking and securities regulators do not agree with the voluntary reporting framework advocated by the CRMPG. The **Basel Committee** stated in its Anniversary Review that it is “of the opinion that regulators should have access to all relevant information in possession of firms as and when required.”^{209/} The **IOSCO Report**, in a critique of the CRMPG Report’s voluntary framework proposal, notes that “regulators may wish to implement more rigorous, mandatory methods of obtaining relevant exposure and risk management information from regulated firms.”^{210/}

- **Constraining Excessive Leverage through Enhanced Risk Management at the Counterparty Level and 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. This form of self-regulation can be thought of as another form of indirect regulation in the sense that it is not direct regulation by the government. One commentator noted that “[t]he primary uncertainty as to the Report’s eventual usefulness lies in whether or not the private sector will adequately police itself.”^{211/} Not surprisingly, the notion that self-policing by hedge funds and their counterparties should be enhanced is not controversial in either the public or private sectors.

Private Sector -- Risk Management at the Counterparty Level

^{209/} Basel Committee on Banking Supervision, *Banks’ Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee’s Sound Practices Paper*, January 2000 at 4, available at <[http:// www.bis.org](http://www.bis.org)>.

^{210/} IOSCO Report at 41.

^{211/} *Van’s Chairman on Proposed New Hedge Fund Regulation*, *Business Wire*, May 18, 1999.

Acting in its own self-interest, the private sector (banks and securities firms) has already taken significant steps to improve its systems and to study means through which the systems can be improved. These steps are discussed in section (iv) below. The Report commended the private sector for the actions that have been taken by the private sector and recommended 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 cited the efforts of the Counterparty Risk Management Policy Group, the International Swaps and Derivatives Association (for its study of collateral management practices which recommended 22 methods of enhancing such practices), and the Institute of International Finance (for its report on Risk Assessment). 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 commended the actions taken by the public sector and recommended 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 cited to the guidance already provided by various banking regulators (the Basel Committee on Banking Supervision; the Federal Reserve; the Office of the Comptroller of the Currency; and the New York State Banking Department) and noted the efforts of the International Organization of Securities Commissions on risk management, internal controls, and disclosure issues as they relate to securities firms' interactions with HLIs. Supervision over risk management programs is a dynamic, ongoing undertaking. The Report noted 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." The guidance provided by the banking and securities regulators is discussed in sections (ii) and (iii) below.

Private Sector -- Risk Management at Hedge Fund Level

The Report recommended 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. Five of the largest hedge funds formed a group to develop such standards, no doubt based on the view that the development of such best practices is in the industry's self-interest from both a business and legal perspective. The "Sound Practices" report issued by the hedge funds is discussed in section (v) below.

- **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 recommended 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.

As discussed above, the **Basel Committee** is currently proposing revisions to its Capital Accord to “improve the way regulatory capital requirements reflect underlying risks.”^{212/} The GAO Report noted that the **SEC** has also announced initiatives to make capital standards of broker-dealers more risk-based.^{213/}

- **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.

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. The

^{212/} Basel Committee on Banking Supervision, *A New Capital Adequacy Framework*, June 1999 (Consultative Paper), available at <[http:// www.bis.org](http://www.bis.org)>.

^{213/} GAO Report at 29.

Working Group's November 1999 Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act reiterates this recommendation.^{214/}

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.

The **GAO's Report** concludes that the Working Group's recommendation "may not go far enough." Reporting authority alone does not sufficiently cover the regulatory gap. The SEC and CFTC should have full regulatory authority over the unregistered affiliates of broker-dealers and FCMs, similar to the Federal Reserve's authority over bank holding companies. The authority should include the ability to both identify weaknesses in risk management practices and address such weaknesses. The GAO Report recommends that Congress consider legislation to expand the SEC and CFTC's authority over such affiliates to include "the ability to examine, set capital standards, and take enforcement actions." The GAO does not believe that these expanded authorities would "lessen the role of effective market discipline."

The bills introduced by **Senator Dorgan and Rep. Markey**, H.R. 3483 and S. 1968, contain a section implementing the GAO Report's and Working Group's recommendations relative to the SEC. The bills grant the SEC authority to regulate non-bank derivatives dealers (including the power to establish capital standards, recordkeeping and reporting requirements, anti-fraud and sales practice rules). In addition, the bills amend the Market Report Act of 1990 to enhance the SEC's ability to obtain information from derivative dealers or other affiliates of a registered broker-dealer regarding their derivatives or other financial activities. According to Rep. Markey, "[a]doption of this bill would close the regulatory black hole that has allowed derivatives dealers affiliated with securities or insurance firms to escape virtually any regulatory scrutiny. It will give the SEC the tools needed to monitor the activities of these firms, assess their impact on the financial markets, and assure appropriate protections are provided to their customers against any fraudulent or abusive activities."^{215/}

- **Protecting the Financial System through Changes to the Bankruptcy Code**

^{214/} Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act, November 1999 ("OTC Derivatives Report"), at 34-35.

^{215/} Statement of Representative Edward J. Markey (D-MA), Introduction of "Derivatives Market Report Act," November 18, 1999.

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. Through such protections to the system, the need for the direct regulation of hedge funds is reduced. The Report recommends the adoption of improvements to the netting regime under the Bankruptcy Code. This netting 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 was located in the U.S. or the principal place of business of the entity was the U.S. In its **OTC Derivatives Report**, the Working Group reiterates "its strong support" for these recommended changes which are currently under consideration by Congress.^{216/}

The suggested netting regime improvements are the subject of a legislative proposal entitled the "Financial Contract Netting Improvement Act," which has been incorporated as Title X of **H.R. 833** and has been introduced as a separate measure by Rep. James Leach (R-Iowa) and Rep. John J. La Falce (D-N.Y.) as H.R. 1161. H.R. 833, introduced by Sen. George Gekas (R-Pa.), was approved by the House in May 1999. A companion bill introduced by Sen. Charles Grassley (R-Iowa), **S. 625**, updates the treatment of certain new and complex financial products under the bankruptcy laws. **The Bond Market Association** recently wrote a letter to Senate Majority Leader Trent Lott in support of the bill, noting that the amendments are "vital to reducing systemic risk in the financial markets and ensuring continued market efficiency."^{217/}

(ii) Banking Regulators' Guidance to Enhance Bank Risk Management Practices. As noted above, guidance has been provided by the Federal Reserve, the OCC, the Basel Committee and the State of New York Department of Banking in recognition that recent global crises demonstrate certain weaknesses in bank risk management systems. In its 69th Annual Report, the Bank for International Settlements found that "the turmoil of last autumn stemmed primarily from the build-up of excessively large and concentrated exposures to customers who proved to be more vulnerable to market, credit and liquidity risks than had been supposed."^{218/} The Federal Reserve, OCC and Basel Committee reports are "consistent in how

^{216/} OTC Derivatives Report at 32.

^{217/} *Bond Market Group Urges Senate to Update Bankruptcy Law for New Types of Securities*, Securities Law Daily, BNA, Inc., January 31, 2000.

^{218/} Bank for International Settlements, 69th Annual Report 1998/1999, at 139 ("69th Annual Report").

they address the issue of credit risk as it relates to hedge fund counterparties.”^{219/} In fact, the OCC and the Federal Reserve played major roles in the preparation of the Basel Committee guidance.^{220/} The differences among the guidance are in scope.^{221/} The OCC guidance is the broadest, covering credit risk in addition to market, compliance and transaction risk management issues. The Basel Committee guidance is the narrowest, focusing specifically on counterparty risk management practices for banks relating to highly leveraged institutions.^{222/} The Federal Reserve guidance focusses generally on counterparty credit risk management, beyond simply highly leveraged institutions. One common theme is the need for *increased transparency* of hedge fund operations and risk levels. As the Bank for International Settlements noted, “[t]he crisis [in the fall of 1998] . . . revealed the inadequacy of information supplied by leveraged investors on the extent of their market risk exposures, the nature of their trading strategies and the validity of their risk management methodologies.”^{223/} The actions and guidance of the various regulators is summarized below:

- **Office of Comptroller of the Currency.** The OCC issued supplemental guidance regarding the risk management of financial derivatives and trading activities, including counterparty credit risk, in January 1999.^{224/} Credit risk management includes management of a bank’s direct lending and counterparty activities. The OCC provided guidance that issuer and counterparty credit decisions should be consistent with the overall credit standards of the bank. It also emphasized the need for banks to obtain sufficiently comprehensive financial and other information to provide a clear understanding of the “obligor’s risk profile;” and that banks should recognize that collateral cannot always mitigate weaknesses in credit approval and exposure monitoring processes. Moreover, the OCC stressed that risk managers need to consider the interconnection between, and across, material risks; that banks should develop methodologies to stress test their counterparty credit exposures; and that credit limits should be based on risk appetite.

^{219/} March 24th Hearing (Brosnan and Meyer statements).

^{220/} *Id.*

^{221/} March 24th Hearing (Brosnan statement).

^{222/} The New York State Banking Department contributed its findings to the Basel Committee and fully endorses the Committee’s recommendations. Press Release, *Banking Department Report on Hedge Funds Shows Industry and Examination Concerns*, Mar. 8, 1999, available at <<http://www.banking.state.ny.us/pr990308.htm>>.

^{223/} 69th Annual Report.

^{224/} Office of Comptroller of the Currency, *Risk Management of Financial Derivatives and Bank Trading Activities*, Bulletin 99-2 (Jan. 25, 1999), available at <<http://www.occ.treas.gov/ftp/bulletin/99%2D2.txt>>.

- **Basel Committee on Banking Supervision of the Bank for International Settlements.** The Basel Committee issued a report analyzing banks' interactions with highly leveraged institutions together with guidance on sound practices in such dealings in January 1999.^{225/} The report highlights several deficiencies in some banks' risk management practices with respect to highly leveraged institutions ("HLIs"). In particular, the report indicated that banks were placing too much reliance upon collateral to protect against credit losses. The report emphasized the need for banks to obtain comprehensive and timely information about HLIs and to update the credit analysis on an ongoing basis. The Committee also concluded that banks must develop more effective measures of "potential future exposure" and must develop better "stress testing" methodologies for credit risk under extreme market conditions. The recommended sound practices for banks include: (1) establishing clear policies governing their involvement with HLIs; (2) adopting credit standards addressing the specific risks associated with HLIs; (3) establishing meaningful measures of potential future exposure; (4) establishing meaningful credit limits, incorporating the results of stress testing; and (5) monitoring exposure on a frequent basis.

In January 2000, the Basel Committee issued a follow-up report on the implementation of its recommendations in its January 1999 Sound Practices paper based on a survey carried out by banking supervisors in the G10 countries.^{226/} The Committee noted the importance of this continued monitoring of banks' interactions with HLIs "because HLIs can be expected to continue to expand their activities and to remain important players in the financial markets." According to the report, banks "appear to have considerably reduced their exposures to HLIs" and "overall" progress has been made in the banks' risk management practices vis-a-vis HLIs. As a general matter, banks have been reviewing and codifying their strategies with respect to HLIs, have been less inclined to take information submitted by HLIs at face value, have been setting credit limits for exposures to HLIs, and have improved day-to-day collateral management for their transactions with HLIs. However, "[t]here are some indications . . . that competitive and business pressures are starting to re-assert

^{225/} Basel Committee on Banking Supervision, *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (Jan. 1999), available at <[http:// www.bis.org/publ](http://www.bis.org/publ)>; Basel Committee on Banking Supervision, *Banks' Interactions with Highly Leverage Institutions* (Jan. 1999), available at <<http:// www.bis.org/publ>>; see also, March 24th Hearing (McDonough statement).

^{226/} Basel Committee on Banking Supervision, *Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practices Paper* (Jan. 2000), available at <<http:// www.bis.org/publ>>; Basel Committee on Banking Supervision, Press Release, *HLI Report -- Anniversary Review*, January 25, 2000, available at <<http:// www.bis.org>>.

themselves and may be influencing credit standards imposed by banks in their dealings with HLIs.” The report notes that further work by banks and their supervisors is necessary on several fronts. With respect to banks, the report notes that banks need to improve their efforts to obtain adequate information from HLIs and need to focus on improving exposure measurement techniques and on using stress tests. Supervisors are urged to continue monitoring banks’ interactions with HLIs and to coordinate with their counterparts in other sectors (i.e., coordination among securities, insurance and banking regulators) to “avoid slippage of prudent practices due to competitive pressures.”

- **Board of Governors of the Federal Reserve System.** The Federal Reserve issued supervisory guidance regarding counterparty credit risk management on February 1, 1999.^{227/} This guidance relates to banks’ relationships with all types of counterparties, including hedge funds. The guidance both reiterates and supplements the principles of counterparty risk management that are covered in existing Federal Reserve supervisory materials and the materials of other regulators. According to Laurence Meyer, a member of the Federal Reserve Board of Governors, the guidance “emphasizes areas that, while generally understood for years, have become increasingly important given the global linkages of financial markets” and discusses at length the “important interrelationships between market and credit risks and their effect on the magnitude of derivative counterparty exposures, especially in times of stress.”^{228/} Banking institutions are advised to focus sufficient resources on all elements of counterparty credit risk management systems, “especially for activities, business lines, and products experiencing significant growth, above normal profitability or risk profiles, and large potential future exposures” and to avoid general policies and procedures that are not tailored to specific situations.^{229/} The guidance specifically addresses four basic elements of counterparty credit risk management systems: the assessment of counterparty creditworthiness; credit risk exposure measurement; the use of credit enhancements and contractual covenants; and credit risk exposure limit-setting and monitoring systems.^{230/}

^{227/} Board of Governors of the Federal Reserve System, *Supervisory Guidance Regarding Counterparty Credit Risk Management*, S.R. 99-3 (Feb. 1, 1999), available at <<http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9903.HTM>>.

^{228/} March 24th Hearing (Meyer statement).

^{229/} *Id.*

^{230/} *Id.*

In June 1999, Meyer continued to urge banks to improve their credit risk management, “citing a ‘disappointing’ recent visit by Fed officials to inspect the risk models used by a large number of banks.”^{231/}

- **State of New York Banking Department.** The New York Banking Department issued a report on major New York banks’ hedge fund activities.^{232/} The report indicated the need for banks to improve due diligence and risk management practices. The report found that banks “may have placed excessive reliance on the reputation of fund managers” and urges banks “to demand greater disclosure of financial information and risk management practices from hedge funds and other similar counterparties as a condition of doing business.”^{233/}

(iii) **Securities Regulators’ Guidance to Enhance Broker-Dealer Risk Management Practices.** U.S. securities regulators as well as international securities regulators have provided guidance on enhancements to securities firms’ risk management practices. In its November 1999 report on HLIs, the IOSCO concluded that “the first line of defence against systemic risk in the market is strong and prudent management processes at the regulated firms with which the HLIs trade.”^{234/} The Basel Committee welcomed the IOSCO report, noting that the IOSCO’s recommendations “correspond with its own recommendations.”^{235/}

- **IOSCO.** In November 1999, the Technical Committee of IOSCO issued a report entitled “Hedge Funds and Other Highly Leveraged Institutions.”^{236/} The Report contains a section on strengthening risk management at securities firms, concluding that many of the concerns raised by HLIs may be addressed by improvements in this regard. The Report emphasizes that a key aspect of effective risk management is “obtaining, understanding and verifying information about counterparties” on an ongoing basis, a

^{231/} Richard Wolffe and John Authers, *Fed Boosts Watch on Big Banks*, The Financial Times, June 4, 1999.

^{232/} State of New York Banking Department, *Review of Hedge Fund Activities* (March 4, 1999), available at <http://www.banking.state.ny.us/hfreport.htm>.

^{233/} Press Release, *Banking Department Report on Hedge Funds Shows Industry and Examination Concerns*, Mar. 8, 1999, available at <<http://www.banking.state.ny.us/pr990308.htm>>.

^{234/} IOSCO Press Release.

^{235/} Basel Committee on Banking Supervision, *Banks’ Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee’s Sound Practices Paper*, January 2000 at 2, available at <<http://www.bis.org>>.

^{236/} IOSCO Report.

task which is more difficult with HLIs because their operations are typically opaque. Firms are urged to gain an adequate understanding of the HLI's organization, management and performance; financial condition (including the HLI's exposures to other counterparties); and relationships with other HLIs. At this point, the IOSCO believes that it is not appropriate to recommend that a standardized template be used by regulated firms to gather information from HLIs because, among other reasons, such a template "could tempt regulated firms to follow the specified format blindly and fail to apply the skill and common sense that regulators expect of firms in their risk management processes."

In addition to gathering adequate information, a firm should have well-developed risk management processes which include: 1) specifications of risk appetite and desired balance of risk and return; 2) an adequate internal control structure, including an independent credit evaluation function; 3) credit limits for each HLI counterparty and for HLI counterparties as a group as well as policies regarding credit concentration or diversification by geographical area, industry, type of investment, type of collateral and credit rating; 4) procedures requiring risk reduction instruments, such as collateral and initial margin; 5) exposure monitoring and stress testing; and 6) contingency plans.

Regulated firms must also be cognizant of potentially heightened legal risks associated with HLIs arising from their frequent organization in offshore centers, their multi-jurisdictional activities, and the legal uncertainties surrounding the transactions in which they engage. To help minimize legal risks, regulated firms should take steps to ensure a full understanding of the legal status of the HLI and to ensure that legal documentation supporting transactions with HLI counterparties is clear and complete.

Recognizing that "[s]ound practices at regulated firms are vulnerable to erosion by competitive and other pressures," especially with respect to HLIs "which may be seen as desirable and profitable counterparties and which have considerable bargaining power," the IOSCO Report stresses that regulators and market authorities have a role to play in preventing the erosion of such practices. The IOSCO has concluded that "[c]lear regulatory expectations, diligently enforced by appropriate oversight mechanisms, coupled with regulatory incentives to maintain or improve risk management may serve to lock in the improvements at the regulated firms."^{237/} Supervisors are urged to (1) obtain information from regulated entities as to their exposures to HLIs; (2) assess the adequacy of risk management practices of regulated firms with material exposures to HLIs; and 3) determine appropriate regulatory responses to identified risk management inadequacies. Such regulatory responses might include the following: 1) more frequent or detailed reporting from a regulated firm on its HLI activities; 2) more frequent or detailed examinations of the regulated firm; 3) penalties, fines or

^{237/}

IOSCO Press Release.

disciplinary orders; 4) higher capital requirements; or 5) limitations on the regulated firm's business with HLIs.

- **SEC, NYSE and NASD.** In July 1999, the SEC, NYSE, and NASD issued a joint statement regarding broker-dealer risk management practices.^{238/} The statement provides guidance on sound practices and weaknesses in broker-dealers' risk management practices that were noted during a task force examination sweep focused on this issue conducted over the previous two years. In the wake of the LTCM episode, the SEC's Office of Compliance Inspections and Examinations conducted a series of examinations specifically focussed on broker-dealer credit policies with respect to hedge funds.^{239/} Given the increased importance of risk management in light of the increasingly complex nature of the securities business, the SEC, NYSE, and NASDR indicated that they "will increase their emphasis on the review of risk management controls during regulatory examinations." Such prudential supervision over broker-dealer risk management practices serves to enhance the indirect regulation of hedge funds.

The guidance contained in the joint statement, while not limited to credit risk management practices, provides a roadmap of do's and don't for broker-dealers relating to such practices. Weaknesses include the failure to (i) set credit limits; (ii) conduct credit reviews on approved counterparties in the prescribed time frame; (iii) document credit reviews adequately; (iv) accurately monitor credit exposure; and (v) conduct adequate internal audits of credit risk management. Sound practices include (i) the involvement of the firm's Board of Directors in risk management; (ii) the maintenance of an independent credit risk function; (iii) the establishment and documentation of credit lines; (iv) adoption of a system of internal credit ratings of counterparties; and (v) the creation of credit monitoring systems which monitor credit risk over all products and operations of the firm and consider future potential exposure in monitoring credit utilization.

(iv) Private Sector Guidance on Methods of Enhancing Risk Management at the Counterparty Level. Acting in its own self-interest, the private sector has taken steps to improve its credit risk management practices, which serves to enhance the indirect regulation of counterparties such as HLIs. Recently, several industry groups have engaged in studies and provided specific guidance on methods of enhancing such practices, a fact which the President's Working Group commends in its recent report. When the Counterparty Risk

^{238/} Office of Compliance Inspections and Examinations, Securities and Exchange Commission; New York Stock Exchange, NASD Regulation, Inc., *Joint Statement: Broker-Dealer Risk Management Practices*, July 29, 1999, available at <[http:// www.sec.gov](http://www.sec.gov)>.

^{239/} Remarks by Lori Richards, Director, Office of Compliance Inspections and Examinations, before the Securities Industry Association Compliance and Legal Division, SEC Broker-Dealer Examination Priorities for the Year 2000, October 19, 1999.

Management Policy Group issued its report in June 1999, the SEC issued a press release welcoming the report. Chairman Levitt stated that “I expect CRMPG’s recommendations to contribute significantly to our continuing dialogue on ways to better understand, manage, and contain risks faced by regulated entities and ultimately our nation’s financial markets.”^{240/}

- **Counterparty Risk Management Policy Group.** The CRMPG, a group of 12 of the world’s largest commercial and investment banks, issued a report in June 1999 entitled “Improving Counterparty Risk Management Practices” which sets forth 20 recommendations to enhance strong practices in counterparty credit and market risk management. The Report sets forth a private sector solution to risk management, questioning the need for and utility of mandatory reporting and public disclosure by hedge fund counterparties. Emphasizing the “constructive role that the private sector can play” in helping to ensure the efficiency and stability of the markets, Gerald Corrigan, co-chairman of the Policy Group, testified before Congress that if the recommendations had been in place well in advance of August and September 1998, it is “very unlikely the Long-Term Capital situation would have ever reached the proportions that it did.”^{241/} He further stated that “we do not think that legislation is needed, except, as I said, possibly in some technical areas having to do with bankruptcy.”^{242/}

In setting forth the recommendations, the Group emphasized that it is not appropriate to view the recommendations as either “static” or “one size fits all.” Nor should the practices be used as a “roadmap for new regulation” since such practices should not be codified -- the practices must constantly be monitored and improved to take into account evolutions in the market and lessons learned and to take advantage of new technologies and ideas. Moreover, the recommendations should be viewed in their totality and with the understanding that risk management is “much more an art than it is a science.”^{243/} It is clear that the purpose of the report is not only to proactively set forth private sector solutions, but is also to react to public sector recommendations and to educate the public sector as to the complexities and nuances of risk management, the marketplace, the risks faced by financial institutions and the role of leverage as it relates market, credit and liquidity risk.

^{240/} SEC Welcomes Counterparty Risk Management Policy Group Report, Press Release 99-68, June 21, 1999, available at <[http:// www.sec.gov](http://www.sec.gov)>.

^{241/} June 24th Hearing.

^{242/} June 24th Hearing.

^{243/} June 24th Hearing (comment by Corrigan).

The Report's recommendations fall into four basic areas: 1) improving the effectiveness, transparency and quality of counterparty credit evaluations; 2) evaluating techniques for improved risk measurement, risk awareness and decision-making within firms; 3) focussing on methods of reducing legal risks associated with interactions with counterparties through documentation policies and practices and the content of documentation; and 4) exploring methods for improving information flows between major market participants and their primary regulators besides mandatory reporting and public disclosure. The building blocks upon which the recommendations are structured are as follows: 1) the need for transparency among counterparties, including the need for protections for confidential information; 2) application of an integrated analytical framework to evaluate the effects of leverage, not as an independent risk factor, but in relation to its effects on market risk and liquidity risk; 3) implementation of a series of steps to improve counterparty credit risk estimation techniques, including stress testing; 4) implementation of credit risk management practices which focus on limit setting, collateral margin practices, exposure management and valuation techniques; 5) enhancements in the quality of risk information for a firm's senior management and Board of Directors as well as for regulators; and 6) improvements to standard industry documents, harmonization of standard documentation across products and jurisdictions, and improvements to document control policies to mitigate against legal risks and promote certainty in outcomes.

According to Stephen Thieke, co-chairman of the Group, in his testimony before Congress regarding the Report, "implementation efforts are in fact already well underway" by the leading firms in the market.^{244/}

At a hearing on the Report, Chairman Richard Baker (R-La.) and Rep. Marge Roukema (R-N.J.) both expressed concern over the voluntary nature of the Report's recommendations. Roukema said that she does not believe that the "'you are on your honor' approach is satisfactory from a policy perspective."^{245/}

- **International Swaps and Derivatives Association.**^{246/} The ISDA, a global trade association representing participants in the privately negotiated derivatives industry, organized a special meeting of senior collateral practitioners to assess the effectiveness of collateral management processes and procedures during recent periods of market stress in 1997 and 1998, including the LTCM episode, and to make recommendations for improvements to these processes and procedures. In general, the practitioners agreed that collateralization was a "highly successful credit risk management tool during the market stress of 1997

^{244/} June 24th Hearing.

^{245/} June 24th Hearing (comments by Roukema and Baker).

^{246/} ISDA Study.

and 1998.” Nonetheless, the ISDA provided a series of 22 recommendations for improving collateral management practices aimed at individual institutions, the ISDA itself, and legislators and regulators, falling into the following nine categories: 1) credit analysis and collateralization; 2) managing the risks of collateralization; 3) dispute resolution; 4) shortening the collateral cycle to reduce exposures; 5) expansion of collateral types; 6) initial margin; 7) legal and documentation issues; 8) cross-product netting and collateralization; and 9) substitutions and liquidity. The ISDA also set forth an action plan for implementing its recommendations. These recommendations were endorsed by the CRMPG in its June 1999 Report.

- **Institute for International Finance.**^{247/} The IIF, a global association of financial institutions, formed a special Task Force on Risk Assessment in 1998, to examine the lessons learned from the emerging markets crises of 1997 and 1998 with respect to risk management assumptions and practices. The goal of the study was “to determine whether best risk management practices in emerging markets finance could be identified that would bolster crisis avoidance efforts and encourage implementation of those practices.” The Task Force’s March 1999 Report noted that credit risk management would be enhanced by increased transparency from both counterparty firms and governments as well as from improvements in collateral management. It also suggested 6 general best risk management practices for the private sector to follow, some of which directly relate to credit risk management and others of which apply more generally:

- (1) Comprehensive stress testing and scenario analysis programs should be performed regularly to examine the potential impact of extreme values on the firm’s portfolio and risk structure;
- (2) Economic country analysis and risk measurement systems should be more closely integrated, especially when devising stress tests and scenario analysis and when assessing potential correlations so that critical information is utilized in the risk management process;
- (3) Firmwide portfolio strategies should be communicated more clearly and more frequently to line managers in order to facilitate the process of both initiating transactional relationships and then determining how best to manage those positions during times of stress;
- (4) Strong, independent risk control units should be in place and should themselves be accountable to another group or entity within the firm;

^{247/}

Risk Assessment Report.

(5) The relationship among broad market movements, liquidity risk, and obligor credit quality needs to be better understood, and methods need to be devised to integrate more closely market risk and credit risk measurement processes; and

(6) Renewed emphasis on the strict observance of “know your customer” and collateral policies are needed to ensure that lending standards do not slip during boom periods.

- **The Bond Market Association.** In response to the financial crisis in 1998 related to Russia and the LTCM incident, The Bond Market Association (“TBMA”) and an international consortium of global financial industry associations^{248/} released a Cross-Product Master Agreement (“CPMA”) on February 16, 2000.^{249/} The CPMA is an effort to “help curtail systemic risk in the marketplace” through the reduction in legal risk when a defaulting firm has a range of financial contracts with another firm. The CPMA represents an umbrella netting agreement, covering the variety of financial contracts one firm has with another, and will enable firms to better manage counterparty risk. The CRMPG, in its June 1999 report, expressly supported the release of such a cross-product netting agreement.

(v) Private Sector Guidance on Methods of Enhancing Risk

Management at the Hedge Fund Level. Hedge funds’ willingness to police themselves may help to stave off additional regulation. In response to the President’s Working Group’s suggestion that hedge funds develop a “set of sound practices for their risk management and internal controls,” five of the largest hedge fund managers (Caxton Corporation, Kingdon Capital Management, Moore Capital Management, Soros Fund Management and Tudor Investment Corporation) established a working group to carry out the recommendation. The Group’s February 2000 Report, “Sound Practices for Hedge Fund Managers,” contains 34 recommendations, designed to “provide a framework of internal policies and controls that will enhance the ability of Hedge Fund Managers to prudently address unexpected market events or

^{248/} This consortium includes the British Bankers’ Association, the Emerging Markets Traders Association, the Foreign Exchange Committee, the International Primary Market Association, the International Swaps and Derivatives Association, the Investment Dealers Association of Canada, the Japan Securities Dealers Association and the London Investment Banking Association.

^{249/} Cross-Product Master Agreement, February 2000, available at <<http://www.bondmarkets.com>>; Cross-Product Master Agreement Guidance Notes, February 2000, available at <<http://www.bondmarkets.com>>; The Bond Market Association Press Release, “The Bond Market Association and an International Consortium of Global Financial Industry Associations Release Cross-Product Master Agreement to Help Curtail Systemic Risk in the Marketplace,” February 16, 2000, available at <<http://www.bondmarkets.com>>.

losses.”^{250/} Many of the recommendations dovetail with those made by the CRMPG. While the Report does not directly oppose calls for additional regulation, the Report clearly does not endorse the need for such additional regulation, emphasizing that “the most effective form of oversight is self-evaluation combined with self-discipline” and that the “first line of defense to market stress will always be the Hedge Fund Manager itself.”

The recommended practices, which the Group states are not necessarily appropriate for all hedge funds depending on their size and objectives, fall into four basic categories, the first two of which hedge fund managers can unilaterally implement, and the second two of which require coordination among other market participants and regulators. The first set of recommendations addresses the responsibilities of senior management at the hedge fund manager for setting risk parameters and ensuring risk monitoring. The second set addresses the means through which various forms of risk should be monitored (including market, funding liquidity, counterparty credit risk) and describes the impact of leverage on market, credit and liquidity risk. The third set addresses hedge fund disclosure practices in connection with investors, management, counterparties and credit providers, regulators and the public. The final set discusses sound documentation practices and means to reduce legal and compliance risk. Together, the recommendations set forth a common sense set of practices to govern risk management at hedge funds, including the need for the involvement of top management in setting risk appetite and policy and in monitoring the implementation of those policies; the need for independent controls over the risk function; the need for appropriate risk measurements and stress testing; the need to adapt risk management practices to evolving circumstances; and the need to reduce legal, compliance and operational risks where possible.

As did the CRMPG Report, this Report is careful to note that the recommendations should not be used as a “weapon.” The Report notes that the recommendations should not be viewed as definitive requirements that “could serve as a basis for either auditing hedge fund managers or assessing their financial stability” given (i) the heterogeneity within the hedge fund industry (as far as size, structure, strategies, and investment approaches) which means “one size does not fit all;” (ii) the fact that as markets continue to evolve the practices need to be refined and adapted; and (iii) some of the practices are aspirational in nature. Nor should the recommendations be viewed as the only means through which sound risk management can be achieved.

While highlighting the need to protect proprietary information, the Report jumps on the transparency bandwagon to a certain extent, endorsing the benefits of various levels of disclosure to investors, counterparties and regulators. The Report endorses the view that investors should receive periodic performance and risk information. Counterparties and credit providers should receive varying amounts of financial and risk information depending on the nature of their relationship to the fund, provided that appropriate agreements to safeguard proprietary information are in place. With respect to regulators, the Report does not suggest the need for any new types of reporting, but does indicate that hedge funds should work with regulators to ensure compliance with applicable large position reporting requirements.

^{250/} Hedge Fund Manager Report.

But, the Report stops short of endorsing public disclosure by hedge funds. Rather, the Report notes that hedge fund managers should work with other market participants and regulators to ensure that both the costs and benefits of any such disclosure are fully understood in the context of the purpose of such public disclosure.

(vi) **Banking and Securities Regulator Guidance on Enhancing Market Discipline at Counterparty Level through Public Disclosure of Trading and Derivatives Activities.** In October 1999, the Basel Committee and the IOSCO issued guidance to banks and securities firms on public disclosure of trading and derivatives activities.^{251/} Although the Report goes beyond disclosure of counterparty risk, the Paper's recommendations dovetail with the Working Group Report's recommendation for constraining excessive leverage indirectly through public reporting of counterparty risk by public companies. The Report notes that "transparency of banks' and securities firms' activities and risks" are "a key element of an effectively supervised system."

The Paper represents an effort by the regulators "to encourage banks and securities firms to provide market participants with sufficient information to understand the risks inherent in their trading and derivatives activities." The regulators consider transparency to reinforce self-regulation and supervisory oversight of financial intermediaries:

Meaningful and accurate information reported in a timely manner provides an important foundation for the decisions of market participants. Well-informed investors, depositors, customers and creditors can impose strong market discipline on an institution to manage its activities and risk exposures in a manner that is both prudent and consistent with its stated business objectives.

The Paper includes two types of recommendations. First, it recommends that financial institutions disclose a meaningful summary on the scope and nature of their trading and derivatives activities. Second, it recommends that institutions disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing such exposures.

^{251/} Basel Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions, *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*, October 1999, available at <<http://www.bis.org>>. The October 1999 recommendations were issued after comments were received from financial analysts and industry practitioners on the February 1999 consultative paper that was issued on the topic. Basel Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions, *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*, February 1999, available at <<http://www.iosco.org>>.

In December 1999, the Basel Committee and IOSCO published a survey report on the trading and derivatives disclosures of major G10 banks and securities firms.^{252/} An important objective of the survey was to determine the extent to which the October 1999 recommendations were being met (although these recommendations had not yet been issued as of the time period covered by the survey). The survey found that virtually all surveyed banks and securities firms disclosed information on market risk and the management of such risk and that the majority of surveyed institutions disclosed information on the management of liquidity and operational risk. When compared to the level of disclosure in the past, the survey revealed that “many leading institutions continued to expand their disclosure of qualitative and quantitative information about market risk.

(vii) GAO Guidance on Enhancements to Regulatory

Oversight. In addition to recommending that the SEC and CFTC receive enhancements to their authority over unregulated entities which serve as counterparties to hedge funds, the GAO also found that better coordination among regulators in their oversight of these counterparties would help to mitigate systemic risk. After studying the LTCM incident at the request of Sen. Byron Dorgan and Rep. Ed Markey, the GAO concluded that “[f]ederal financial regulators did not identify the extent of weaknesses in banks’ and securities and futures firms’ risk management practices until after LTCM’s near-collapse.”^{253/} Given the “blurring in recent years of traditional lines that separate the businesses of banks and securities and futures firms,” regulators “would have needed to coordinate their activities to have had a chance of identifying” the risks posed by LTCM.^{254/} Accordingly, the GAO recommended that “federal financial regulators develop ways to better coordinate oversight activities that cross traditional regulatory and industry boundaries.”^{255/} Responding to this recommendation, Dorgan and Markey included a provision in their bills that would require an annual report by financial regulators on their coordination activities.

In response to the financial crises in recent years, regulators and governments have improved cooperation and coordination amongst themselves. The joint work of the Basel Committee and the IOSCO and the work by the President’s Working Group and the Financial Stability Forum are all prime examples. In its recent report, the European Council^{256/} noted the

^{252/} Basel Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions, *Trading and Derivatives Disclosures of Banks and Securities Firms*, December 1999, available at <[http:// www.bis.org](http://www.bis.org)>.

^{253/} GAO Report at 2.

^{254/} GAO Report at 3.

^{255/} GAO Report at 3.

^{256/} The European Council consists of the Heads of State or Government of the fifteen member states of the European Union and the President of the European Commission.

need for such improved coordination and welcomed the establishment of the Financial Stability Forum.^{257/}

(viii) **Additional Endorsements of Indirect Regulation.** In addition to all of the viewpoints expressed above endorsing various forms of indirect regulation, certain public and private sector participants have endorsed indirect regulation as the most efficient and effective means of regulating hedge funds. The viewpoints of these participants are discussed below.

- **Basel Committee.** The Basel Committee concluded:

[M]any of the systemic risks associated with the activities of HLIs can be addressed through better risk management at the counterparty level. Prudent internal risk management can have the additional benefit of limiting or reducing leverage of HLIs, and limiting the riskiness of HLI portfolios. As such, it may also reduce the potential for systemic disruptions resulting from a rapid deleveraging or liquidation of positions, and may contribute to greater stability in the financial system as a whole.^{258/}
- **The Federal Reserve.** Both Chairman Greenspan and William McDonough, the President of the N.Y. Federal Reserve Bank, have endorsed indirect regulation in testimony before Congress. Chairman Greenspan stated as follows: “The best we can do in my judgment is what we do today: Regulate them [hedge funds] indirectly through the regulation of the sources of their funds.” Similarly, President McDonough testified that the “most practical” policy response to the potential risks to the financial system posed by HLIs is “to focus on financial institutions’ lending activities, because such an approach offers a near-term and cost-effective remedy”^{259/} and is likely to succeed.^{260/} According to Chairman Greenspan, hedge funds’ lenders and counterparties are the “first line of risk defense,” and banking supervisors are the “second line of risk defense.”^{261/}

^{257/} European Council, *Report to the European Council on Improvements in the Functioning of the International Financial System*, June 1999 (“European Council Report”).

^{258/} See Press Release, *Banks’ Interaction with Highly Leveraged Institutions*, Jan. 28, 1999, available at <http://www.bis.org/press/p990128.htm>.

^{259/} March 3rd Hearing (McDonough statement).

^{260/} March 24th Hearing (McDonough statement).

^{261/} Oct. 1st Hearing (Greenspan statement).

- **CFTC Commissioner James E. Newsome.** Commissioner Newsome testified before the Senate that he believes that indirect rather than direct regulation may be the most appropriate:

I would agree that indirect methods, through the funding sources of hedge funds, may be more appropriate [than direct regulation]. Therefore, I think that resolutions to the concerns stated may include improved disclosure of credit concentration, improved credit analyses, and enhanced prudential oversight by lenders. Let me add that, in order to be effective, I think that these efforts should be made internationally, and that globalized resolutions are befitting the nature of the markets and market concerns.^{262/}
- **OECD.** The OECD found that the “main lesson to be learnt from the LTCM episode is that banks must be more vigilant about the quality of their borrowers and counterparties.”^{263/}
- **Hon. Spencer Bachus.** Congressman Bachus stated on October 1, 1998, that he did not believe that the direct regulation of hedge funds was possible. But, he thought it was important to determine if indirect regulation was working properly: “[W]e do have regulatory oversight and responsibility for regulating lending practices and our banking institutions, and so part of this hearing ought to be to ask the questions, did our institutions loan too much? Were these prudent and reasonable loans? Did the Federal banking regulators fail to monitor the situation?”^{264/}
- **Hon. James Leach, Chairman of the House Banking Committee.** The financial press reported that Leach said in an interview that “the only truly credible way of looking at the whole hedge fund issue from a regulatory perspective is clearly on the banking side.”^{265/}
- **Burton G. Malkiel and J.P. Mei, professors at Princeton University and the New York University’s Stern School of Business.** Malkiel and Mei argue that the most effective strategy to minimize the threat caused by hedge funds and to constrain their activities is to let them fail and that regulators can play a role through indirect regulation:

^{262/} Dec. 16th Hearing (Newsome statement).

^{263/} Economic Survey of the United States, OECD Economic Surveys, May 1999.

^{264/} Oct. 1st Hearing (Bachus statement).

^{265/} Richard Wolffe & Tracy Corrigan, *Congress Plans Crackdown on Hedge Funds*, National Post, Mar. 2, 1999, at C12.

What regulators can do is to ensure that U.S. banks and brokerage firms set clear risk guidelines concerning hedge-fund lending and encourage better risk management through full disclosure of risky positions. The key is to ensure that the risks taken by hedge funds are not shared by government-guaranteed deposit institutions.^{266/}

- **Milken Institute Report.** The Milken Institute issued a report entitled, *Hedge Funds and Systemic Risk Demystified*, in December 1998, in which it concluded that “it is most appropriate for public policy to focus on *banks* and their considerable investment in hedge funds rather than on hedge funds themselves.” The report also recognized that “[a] policy consensus appears to have emerged between central banks and bank regulators that transparency issues are best addressed by regulating hedge funds indirectly through the source of their funds, since direct regulation would simply drive them offshore.”^{267/}

Singapore’s Finance Minister Richard Hu. Hu was reported to have said that the preferred way of regulating hedge funds is through the banks which lend them money.^{268/}

Although not specifically endorsing indirect regulation as the only method of regulation, these members of Congress as well as other international entities suggested the such regulation should be part of the equation:

- **Hon. Margaret Roukema, Chairwoman of the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services.** In her opening statement in connection with the March 24, 1999, hearing before the Subcommittee, Congresswoman Roukema expressed a willingness to try indirect regulation:

Quite frankly, I think indirect regulation, through regulation of the banks and securities firms, should be given an opportunity to work. I am somewhat worried that direct regulation will lead to hedge funds going offshore. I want to make it clear, however, that if indirect regulation does not

^{266/} Burton G. Malkiel & J.P. Mei, Editorial, *Hedge Funds: The New Barbarians at the Gate*, Wall St. J., Sept. 29, 1998, at A22.

^{267/} Glenn Yago, Lalita Ramesh, & Noah E. Hochman, *Hedge Funds and Systemic Risk Demystified*, Milken Institute Policy Briefs, December 1998 at 2 (“Milken Institute Report”).

^{268/} Ravi Velloor, *Should Hedge Funds Be Regulated*, The Strait Times (Singapore), Jan. 24, 1999.

work I am willing to look at direct regulation of hedge funds.^{269/}

- **Hon. Richard E. Neal.** Congressman Neal suggested that indirect regulation is at least one of the keys to avoidance of another LTCM situation. He stated before the House on October 2, 1998 that “[t]he financial service industry bears the overwhelming portion of the blame. Lenders extended enormous amounts of credit without adequate supervision or knowledge of the activities of the fund.”^{270/}
- **European Council.** In its recent report, the Council concluded that “[i]nternational financial stability can be enhanced by making private sector participants in international financial markets adhere to certain minimum standards of openness, accounting, decision making and risk management.” Not only should the direct regulation of HLIs be investigated, but also banks’ lending and investing in HLIs “should be more tightly supervised.”^{271/}

d. Direct Regulation. The direct regulation of hedge funds could take a variety of forms from recordkeeping, reporting, disclosure and capital requirements to registration requirements. The most commonly discussed form of “direct” regulation is enhanced disclosure and reporting (although even that may be able to be obtained “indirectly” through hedge fund counterparties and lenders). As part of its study, the President’s Working Group explored “what additional disclosure is needed, to whom such disclosures should be made (some or all counterparties, creditors, investors, regulators, and the public), and whether the government needs to do more to require disclosure.”^{272/} The Group concluded that hedge funds should be required to make quarterly public reports on their risk profiles and has requested Congressional action to accomplish this recommendation. It is this recommendation by the Working Group that has engendered the most controversy and discussion.

The Working Group’s recommendations relating to hedge fund disclosure and reporting and the controversy surrounding such recommendations as well as the views expressed by the various members of the public and private sector relating to hedge fund transparency are explored below. The CFTC has indicated that it is working on a rule amendment to carry out the Working Group’s recommendations. Moreover, two bills have been introduced in Congress to

^{269/} March 24th Hearing (Roukema statement).

^{270/} 144 Cong. Rec. E1889: *Did Tax Avoidance Play A Role in the Fall of Long-Term Capital? Before U.S. House of Representatives, 105th Cong.*, Oct. 2, 1998 (statement by Rep. Richard E. Neal (D-MA)).

^{271/} European Council Report.

^{272/} Dec. 16th Hearing (Anderson statement).

carry out the Group's disclosure recommendations. Other methods of direct regulation explored by the Working Group, but rejected by the Group at least for the time being, are also discussed.

(i) President's Working Group Report -- Hedge Fund

Disclosure and Reporting. As discussed above, 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." One of the two primary methods that the Report recommends for increasing transparency is to require specific reporting requirements for hedge funds, a form of direct regulation which would require Congressional action (with the exception that such direct regulation can be accomplished through amendments to CFTC reporting rules for those hedge funds which are CPOs). 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, on a public basis could well drive hedge funds offshore. The Report provides no other detail relating to its recommendation.

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. Several commentators on the Report who testified before Congress on May 6, 1999, have recommended that such reporting be made available to all the regulators that are members of the President's Working Group:

- **John C. Coffee, Jr., Professor, Columbia University Law School.** Professor Coffee recommends that hedge fund reporting (which should be private as opposed to public and which should include positions and exposures) should be available to "[b]odies such as the Federal Reserve, the Treasury, the SEC and the CFTC."^{273/}
- **Robert Todd Lang, Partner, Weil, Gotshal & Manges LLP.** Mr. Lang recommends that the hedge fund reporting (which should be confidential) should be made "in a special repository with access by each of the agencies which comprise the Working Group. In this manner, all of the relevant government authorities will have access to the information which would facilitate a response to an emerging problem."^{274/}

Both the Baker bill and the Dorgan/Markey bill require that all financial regulators be given access to the reports, but the primary agency with whom the reports are to be filed differs between the bills, with Baker calling for such reports to be filed with the Federal Reserve Board and Dorgan and Markey calling for such reports to be filed with the SEC.

^{273/} May 6th Hearing (Coffee statement).

^{274/} May 6th Hearing (statement of Robert Todd Lang, Partner, Weil, Gotshal & Manges L.L.P.) ("Lang statement").

A second question which the Report does not address is how the term hedge fund would be defined for these reporting purposes. As discussed below, the choice of definitions is likely to be the subject of intense debate.

A third set of questions which the Report does not address in any detail is the type of information to be provided and the form that provision of information would take. These questions are currently under consideration by the **Fisher II Group**.

(ii) **Controversy Surrounding Working Group Report's Recommendation.** The Report's recommendation for public reporting by hedge funds has engendered controversy on two fronts. First, commentators have argued that the public nature of the reporting serves no purpose and is, in fact, detrimental. Second, commentators have criticized the recommendation for being overbroad, which is where the debate over the definition of hedge funds is likely to center.

a. *Debate over Public Nature of Reporting.* 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."^{275/}

The **IOSCO Report** found that additional transparency regarding HLI activities is necessary because "not all the information needed to monitor and mitigate these risks [systemic risks] is generated by the bilateral information flows between a regulated firm and its HLI counterparties."^{276/} On balance, the IOSCO has concluded that some level of public disclosure, rather than merely requiring reporting to regulators, is "necessary to materially reduce systemic risk." In its report, the IOSCO notes that public disclosure has "significant advantages." It allows market participants and all other interested parties to better assess risks; helps to counteract the "halo effect" that may surround certain HLIs; may help to reduce panic in the event of market disruption; may help to strengthen market discipline; and may expose significant trends. The IOSCO recognizes, however, that the usefulness of such public disclosure may be affected by the need to protect proprietary information; the periodic nature of such disclosure; and difficulties in comparing disclosure by different HLIs.^{277/}

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 on May 6, 1999, 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

^{275/} May 6th Hearing (statement of Patrick M. Parkinson, Associate Director of the Division of Research and Statistics of the Board of Governors of the Federal Reserve) ("Parkinson statement").

^{276/} IOSCO Press Release.

^{277/} IOSCO Report at 24-26, 29.

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 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.^{278/}

Several editors of the Futures & Derivatives Law Report, **Richard Miller and Donald L. Horwitz**, support public reporting of earnings and balance sheet information by hedge funds. The editors argue that because highly leveraged institutions can have public consequences, their financial status should not remain “cloaked from public inspection.” According to the editors, “daylight helps keep things in perspective”-- it reinforces market discipline of hedge funds and their counterparties. The editors discount the risk that such financial disclosure requirements will cause hedge funds to “flee overseas” because “[t]he hedge funds that are large enough to pose a public risk are deeply invested in U.S. operations and personnel.”^{279/}

Many arguments have been advanced on the other side of the debate. These arguments emphasize that such public reporting is unnecessary, unlikely to be useful for its intended purpose, or counterproductive.

- **Counterparty Risk Management Policy Group.**^{280/} The CRMPG has concerns about the usefulness, fairness and potential detrimental effects of such public disclosure:

In the Policy Group’s view, there are major questions as to the likely usefulness of this information for its presumed intended purpose [namely, to better inform markets.] There are also questions of uneven application of such a rule, since other forms of regulated active institutional asset managers would presumably have no such disclosure requirement, yet manage positions which could also pose market disruption potential. There is also some concern that the funds in question would regard any such disclosure requirement as a substitute for the more robust and customized creditor information sharing proposals contained in this report. Thus, it may well be that the combination of improved creditor information sharing, along with the improved risk analysis and senior management and regulatory reporting contemplated in

^{278/} May 6th Hearing (Parkinson statement).

^{279/} Richard A. Miller and Donald L. Horwitz, *Letter from the Editors*, Futures and Derivatives Law Report, Vol. 19, No. 2 (April 1999).

^{280/} CRMPG Report at 55.

this report, would provide more effective risk control mechanisms than new public disclosure rules.

- **Thomas Russo, Chief Legal Office for Lehman Brothers, and member of the CRMPG.** Mr. Russo, in monitoring a panel held by The Bond Market Association, is reported to have stated that “disclosure could be totally misleading and do more harm than good” and that the information would likely be “stale” by the time it was made public.^{281/}
- Robert Todd Lang, Partner at Weil, Gotshal and Manges and Chair of the Subcommittee on Private Investment Entities of the Federal Regulation of Securities Committee. In testimony before the House Banking Committee on the Working Group Report, Mr. Lang 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.^{282/}

- **Douglas E. Harris, Partner, Arthur Anderson LLP.** In testimony before the House Banking Committee on the Working Group Report, Mr. Harris 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

^{281/} Hedge World Daily News, *Bond Market Hosts Seminar on Last Year's Global Crisis, LTCM Bailout*, October 28, 1999.

^{282/} May 6th Hearing (Lang statement).

problems with this suggestion. First, different institutions, using different risk models and different assumptions, compute risk in various ways. Therefore, there 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?^{283/}

- **George Crapple, Chairman of Managed Funds Association.** In testimony before the House Banking Committee on the Working Group Report, Mr. Crapple 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-

^{283/} May 6th Hearing (Harris statement).

related data -- more comprehensive and timely data than any public reporting system is or should be calculated to produce.^{284/}

- **John C. Gaine, President of the Managed Funds Association.** In his testimony before the House Agriculture Committee's Subcommittee on Risk Management, Research and Specialty Crops, Mr. Gaine testified that the proposed hedge fund reporting requirement set forth by the Working Group does not benefit either regulators or the public. The proposed reports would provide a "snapshot of stale data which would, not in our view, provide any antidote to LTCM-type events and or provide meaningful insights to regulators or the investing public concerning the operations of the reporting fund." He also noted that this type of "administrative burden and selective public dissemination of fund data" gives "incentives to funds to avoid operating in the U.S."^{285/}
- **John C. Coffee, Professor, Columbia University Law School.** In testimony before the House Banking Committee on the Working Group Report, Professor Coffee 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."^{286/}
- **George Soros, President of Soros Fund Management and Chief Investment Advisor to the Quantum Group.** Soros testified before Congress in 1994 that regulators need more information than the general public and that public disclosure can have unintended consequences:

I should like to draw a distinction between information gathering and disclosure. I think the authorities need a lot more information than the general public. In fact,

^{284/} May 6th Hearing (Crapple statement).

^{285/} Hearing before the House Committee on Agriculture, Subcommittee on Risk Management, Research and Specialty Crops, 106th Cong. (June 8, 1999) (statement of John G. Gaine, Managed Funds Association President).

^{286/} May 6th Hearing (Coffee statement).

information we are legally obliged to disclose has, on occasion, caused unwarranted price movements.^{287/}

- David S. Ruder, a Professor at Northwestern University School of Law (and former Chairman of the Securities and Exchange Commission). Ruder argued that the necessary disclosure information “need not be made public” and that its confidentiality should be preserved by regulators. He noted that precedent exists for limiting disclosure to regulators -- “Banks are required to reveal their capital positions to bank regulators. Brokerage firms must reveal their risk positions to the SEC and to overseeing self-regulatory bodies. Commodity firms’ risk positions are well known to the various commodities exchanges.”^{288/}

b. Debate over Definition. As noted above, the Working Group Report does not address how the term hedge fund would be defined for purposes of its proposed reporting requirement. 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. Both legislators and members of the private sector have argued that the reporting requirement should not be applied to all hedge funds. As discussed in section (iii) below, the legislation that has been introduced by Baker, Dorgan and Markey only requires hedge funds of a certain size to make public disclosures.

- **Rep. Marge Roukema (R-NY)**, in her remarks before the House Banking Committee on May 6, 1999, 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.
- **George P. Van, Chairman of Van Hedge Fund Advisors International, Inc.**, stated that the reporting requirements “should be limited to the largest hedge funds which can measurably impact the markets.”^{289/}

^{287/} April 13th Hearing (statement of George Soros, Fund Management) (“Soros statement”).

^{288/} Oct. 1st Hearing (Ruder statement).

^{289/} *Van’s Chairman On Proposed New Hedge Fund Regulation*, Business Wire, May 18, 1999.

- **Robert Todd Lang, a partner at Weil, Gotshal and Manges, who is the Chair of the Subcommittee on Private Investment Entities of the Federal Regulation of Securities Committee**, testified before House Banking Committee on May 6, 1999, 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 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.”^{290/}

(iii) Implementation of President’s Working Group

Report’s Recommendations. The CFTC and various legislators have taken steps to implement the Working Group’s recommendations.

- **CFTC.** The Working Group recommended that for hedge funds that are CPOs, the CFTC amend its rules to provide for the additional disclosure called for by the Report. Brooksley Born, the former Chairperson of the CFTC, testified on May 18, 1999 before the Subcommittee on Risk Management and Specialty Crops of the U.S House of Representatives Committee on Agriculture that the CFTC staff is preparing recommendations for such rule amendments.
- **Baker Bill.** The Baker bill represents a “minimalist approach” to the regulation of hedge funds.^{291/} The bill provides for quarterly public reporting to the Federal Reserve Board by a very narrow class of large hedge funds, namely, hedge funds with capital of \$3 billion or more or with total assets under management of \$20 billion or more. Baker’s office is reported to have stated that the bill would only capture 20 hedge funds

^{290/} May 6th Hearing (Lang statement).

^{291/} Mitchell Pacelle, *Hedge Funds Would Have to Disclose Risk Data Under Bill Set to Go to House*, Wall St. J., September 23, 1999.

within its reporting requirements.^{292/} Sensitive to proprietary information concerns, the bill provides that the Board may prevent proprietary information from being disclosed to the public. Under the bill, the narrow class of hedge funds must report: (i) total assets; (ii) total derivatives positions; (iii) balance sheet leverage; (iv) a meaningful and comprehensive report of measures of market risks, including VAR or stress tests; and (v) such other information as required by the Federal Reserve Board after consultation with other regulators. Although the reports are filed with the Federal Reserve Board, the Board must transmit them to other financial regulators.

- **Dorgan/Markey Bills.** In response to the Working Group's recommendation, the bills establish quarterly public SEC reporting requirements for hedge funds. The reports are required to include financial information (i.e., a statement of financial condition, a statement of income, a statement of cash flow, and a statement of changes in equity) and market risk information (i.e., a description of the models and methodologies used to calculate, assess, and evaluate market risk) as well as such other information that the SEC, in consultation with other regulators, may require. Although the reports are filed with the SEC, the SEC is required to transmit copies of the reports to the other financial regulators and the public. The SEC is given discretion to promulgate rules and regulations to govern the "form" of the reports.

Like the Baker bill, the Dorgan/Markey bills recognize that size matters and take into account proprietary information concerns. The bills only require quarterly reports for "unregistered hedge funds" with total assets under management of \$1 billion or more. Proprietary information concerning investment strategies and provisions could be segregated in a confidential section of the report in conformity with SEC regulations.

(iv) **Additional Calls for Enhanced Disclosure and**

Reporting. In addition to the President's Working Group, the following persons/groups (including legislators and regulators, some of whom are members of the Working Group)^{293/} have called for (or are reported to have called for) additional disclosure and reporting of various information about hedge funds (although the exact method of enhancing disclosure is always not discussed):

^{292/} Hedge World Daily News, *US Hedge Fund Bill Would Affect Just 20 of 3500 Funds*, September 23, 1999.

^{293/} The views of the individual regulators comprising the Working Group are significant to an appreciation of the debate surrounding the recommendation for hedge fund reporting requirements. It is likely that certain recommendations by the Working Group were the result of compromise among the various regulators.

- **Dorgan/Markey Bills -- Large Trader Reporting.** In addition to imposing direct reporting requirements on certain large hedge funds as described above, the Dorgan/Markey bills also include a provision that would capture additional information about large hedge funds through a large trader reporting system. The bills require the SEC within one year after the enactment of the legislation to impose additional reporting requirements on market participants, including hedge funds, falling into the “large trader” category. In the Market Reform Act of 1990, the SEC was given authority to issue such rules, but to date the SEC has not issued a final rule. In Markey’s statement regarding the proposed legislation, he criticizes the SEC for this long delay.^{294/}

Richard Lindsey, the now-former Director of the Division of Market Regulation, testified in October 1998 that the authority provided to the SEC under the Market Reform Act of 1990 would only allow the SEC to collect information about large traders’ completed transactions in the U.S. equity markets. According to Lindsey, the securities industry has complained that the limited purpose for such reporting does not justify the costs involved. Lindsey emphasized that the Commission has been working with the industry in developing the rules, but that even if such a system had been in place in the fall of 1998, it would have “had little relevance to LTCM’s activities, few of which involved equity transactions.”^{295/}

- **IOSCO.**^{296/} As mentioned above, the IOSCO, in its recent report, concluded that transparency regarding HLI activities is necessary to reduce systemic risk and that, on balance, public disclosure at some level is warranted. The IOSCO has also concluded that regulators need access to information about HLI exposures and that additional regulatory reporting and public disclosure are not mutually exclusive options. One benefit of regulatory reporting, as opposed to public disclosure, is that an HLI may be “less reluctant to report certain sensitive competitive information . . . to a regulator.” Disclosure of both routine and event-driven information should be considered.
- **G-7 Finance Ministers.** At its meeting in Cologne, Germany, in mid-June 1999, the Finance Ministers of the G-7 nations released a statement which proposed a number of reforms to the architecture of the

^{294/} Statement of Representative Edward J. Markey (D-Ma.), Press Conference on GAO Report on Long-Term Capital Management, November 19, 1999.

^{295/} October 1st Hearing (Lindsey Statement).

^{296/} IOSCO Report; IOSCO Press Release.

international financial system.^{297/} The statement recommended that “steps should be taken to improve transparency by all market participants, including steps to improve the quality and timeliness of public disclosure of direct material exposure to highly leveraged financial institutions, and of relevant information by highly leveraged institutions.”

- **European Council.** The European Council, in its recent report on strengthening the international financial system, recommended that HLIs should be more closely regulated: “Just like any other financial institution, also highly leveraged institutions should comply with minimal transparency, disclosure, and regulation requirements, and overall leverages should be monitored to avoid risks of systemic crisis or major misalignments in the international markets.”^{298/}
- **APEC.** APEC has “urged prompt action to improve transparency of highly- leveraged institutions.”^{299/}
- **Senator Richard Lugar, Chairman of the Senate Agriculture, Nutrition and Forestry Committee.** Senator Lugar, during his opening statement for the December 16, 1998, hearing before his Committee, stated that the LTCM affair may call for a regulatory response which encompasses direct regulation through disclosure and indirect regulation through the regulation of lenders:

The LTCM affair may suggest the need for a regulatory response. Additional disclosure of information to regulators may be appropriate. More prudent practices on the part of lenders may also need to be encouraged or even required.^{300/}

- **Securities and Exchange Commission.** Business Week reported on March 29, 1999, that SEC Chairman Levitt “insists that tougher regulation of hedge funds is needed to prevent a repeat of the financial-system risks exposed when LTCM’s \$125 billion portfolio tottered on the brink.” Apparently, Treasury Secretary Rubin sympathizes with Levitt and “has

^{297/} Report of the G7 Finance Ministers to the Koln Economic Summit, *Strengthening the International Financial Architecture*, Cologne, Germany, June 18-20, 1999, available at <<http://www.g8cologne.de>>.

^{298/} European Council Report.

^{299/} See Asia-Pacific Economic Cooperation web site at <<http://www.apecsec.org>>.

^{300/} Dec. 16th Hearing (statement of Rep. Richard G. Lugar, (R-IN)).

put out word that it might be a good idea to make hedge funds report their complex currency and interest-rate trades to the authorities.”^{301/}

- **Commodity Futures Trading Commission.** Brooksley Born, Chairman of the CFTC, testified to the lack of transparency to regulators in the OTC market, in which LTCM dealt. Born noted that transparency significantly contributes to the “futures markets” being the “most trusted in the world,” and that the CFTC has previously raised the need for recordkeeping and reporting requirements and for disclosure by OTC derivatives dealers to their customers.^{302/}
- **Foreign Regulators and Politicians.** The financial press has reported that various foreign regulators (including those in Japan, Hong Kong and Australia) are urging greater disclosure of information by hedge funds or, more generally, greater regulation over hedge funds:

(i) *Japanese Ministry of Finance Official, Junichi Maruyama:*

Maruyama is reported to have said that “[m]ore disclosure of information about hedge funds would mean the market and the public could monitor their activities and thereby institute check and balance mechanisms.”^{303/} It was also reported in March 1999 that Japan’s Financial Supervisory Agency was planning to press the G7 for disclosure rules.^{304/}

(ii) *Hong Kong Chief Executive Tung Chee Hwa and Financial Secretary Donald Tsang:*

Tung is reported to have said that he wanted to see greater transparency in hedge fund operations.^{305/}

Tsang is reported to be supporting Rep. Baker’s bill imposing disclosure requirements on hedge funds.^{306/}

^{301/} Mike McNamee, *Reining in Hedge Funds: How to Break the Impasse*, Business Week, No. 3622 (Mar. 29, 1999).

^{302/} March 3rd Hearing (Born statement).

^{303/} *Japan MOF Official Maruyama Urges More Hedge Fund Disclosure*, Knight-Ridder, Nov. 28, 1998.

^{304/} *Japan to Press G7 for Radical Hedge Fund Disclosure*, Derivative Week, Vol. VIII, No. 11, Mar. 15, 1999; *Japan to Propose Tighter Hedge Fund Rules at G-7 Meeting*, Agence France-Presse, Mar. 8, 1999.

^{305/} *Hong Kong’s Tung Says Wants Greater Transparency*, Knight-Ridder, Oct. 30, 1998.

(iii) *Australian Treasurer Peter Costello:*

Costello is reported to have said that there had not been a sufficient level of disclosure from hedge funds about their activities.^{307/}

(iv) *President of France, Jacques Chirac:*

In an piece in the Wall Street Journal, President Chirac made the general statement in connection with his discussion of global economic crises that “[w]e must ensure that states and international financial institutions become as transparent as possible.”^{308/}

He is also reported to have stated that reforms to the global financial system should include “the imposition of controls on hedge funds.”^{309/}

(v) *South Korean President, Kim Dae-Jung:*

The President is reported to be calling for “stringent regulation of hedge funds”^{310/} and is urging APEC to effect this tighter regulation.^{311/}

- **International Monetary Fund.** In a December 1998 survey, the IMF concluded that “[i]t is a necessary first step [to avoid the difficulties encountered in September and October 1998] to enhance disclosure of the financial activities of financial institutions, particularly the least regulated among them. This can enhance the ability of both private and public stakeholders to assess financial risks and to understand where the risks reside.”^{312/}

^{306/} *HK Welcomes Hedge Funds Disclosure Move*, Asia Pulse, September 30, 1999.

^{307/} *Aus’ Costello Backs Calls for Global Hedge Fund Supervision*, Knight-Ridder, Oct. 20, 1998.

^{308/} Jacques Chirac, Editorial, *Global Economic Crisis Requires a Global Response*, Wall St. J., Feb. 17, 1999.

^{309/} *LatAm/EU Summit: Chirac Urges Global Economic Reforms to Boost Growth*, AFX News, June 29, 1999.

^{310/} *Kim Dae-Jung Backs Regulation of Hedge Funds/Speculative Inflows*, AFX News, November 28, 1999.

^{311/} *Controls on Hedge Funds Sought*, South China Morning Post, September 14, 1999.

^{312/} IMF Survey at 64.

- **David S. Ruder, a Professor at Northwestern University School of Law (and former Chairman of the Securities and Exchange Commission).** Ruder argues for greater transparency for all participants in hedging and derivatives transactions, not just hedge funds:

I also believe that, either through legislation or the use of available powers, efforts should be made to determine the risk positions being taken by the various participants in hedging and derivative trading activities. At all times, and particularly in times of stress and possible panic of the type that seemed to emanate from the Long-Term Capital Management crisis, regulators should be in a position to determine the magnitude of possible risk problems. Our capital markets should not be held hostage to the activities of a group of risk takers who can operate in secrecy without regard to possible systemic effects. It may be that banking authorities, the SEC, and the CFTC together can require those whom they regulate to obtain risk information from their debtors and contracting parties. If so, an orderly process for accumulation of this information and transmission to regulatory authorities should be developed. If not, legislation is needed.^{313/}

- **Roger Altman, founder of Evercore Partners, Inc. and former Deputy Treasury Secretary.** Altman argues that “a new system of financial regulation is necessary” and that “[i]f the public ultimately is going to be responsible for institutions such as this [LTCM], they must be regulated. Presumably this would involve regular financial reporting . . .”^{314/}

(v) **Other Forms of Direct Regulation beyond Disclosure and Reporting.** As discussed above, the Working Group proposes a moderate approach to the regulation of hedge funds that is designed to enhance market discipline primarily through improvements to indirect regulation and disclosure requirements for hedge funds. However, the Report cautions that the Working Group will be monitoring the effectiveness of these proposals and that direct regulation will be considered if the “indirect regulation of currently unregulated market participants is not working effectively to constrain leverage.” One such method of direct regulation that the Report specifically indicated it would consider is capital requirements for

^{313/} Oct. 1st Hearing (statement of David S. Ruder, Professor of Law, Northwestern Univ.) (“Ruder statement”).

^{314/} Roger C. Altman, *Dangerous Bailout*, Washington Post, Oct. 1, 1998. Altman also opined that such regulation would presumably also involve minimum levels of capital adequacy.

hedge funds. At the present time, the IOSCO is in agreement that direct regulation beyond disclosure and reporting is not indicated.^{315/}

* * * * *

Having examined the parameters of the debate relating to systemic risk, the discussion will now turn to the second type of attack upon hedge funds -- their ability to cause market volatility and their threat to market integrity.

B. Hedge Funds -- Market Volatility and Integrity.

Financial markets have a range of functions. As the OECD points out, these functions include: the efficient allocation of capital; the development of efficient prices, which fully reflect all information about the fundamental value of a security traded on the market; the availability of sufficient liquidity, characterized by the ability to accommodate incoming orders in a timely manner (immediacy) and the ability to satisfy new orders with minimal effect on prices; and the taking and transforming of risks.^{316/} The role of hedge funds in financial markets is the subject of intense debate. Rep. Leach, Chairman of the House Banking Committee, summarized the debate as follows:

In one view, hedge funds provide liquidity and stability in financial markets, allowing economies to finance the infrastructure and enterprises necessary to modernize. In another view, hedge funds have a narrower rationale: they're seen to be run-amok casino-like enterprises, driven by greed with leveraged bets of such huge proportions they can influence global capital markets and even jeopardize the economic viability of individual sovereign states.^{317/}

Several emerging countries have blamed hedge funds for their currency crises and turbulence in their securities markets, with Malaysia taking the lead.^{318/} The Chief Executive of

^{315/} IOSCO Report at 37 (noting that it is not at the present time recommending direct regulation of HLIs through "licensing or the imposition of capital and margin requirements, concentration limits or other regulatory restraints").

^{316/} OECD Study at 12.

^{317/} Press Release: "The Dilemma of Public Policy in an Era of Kleptocratic Greed" by Rep Leach. December 9, 1998.

^{318/} See, e.g., March 3rd Hearing (Born statement). The financial press reported that the G15 developing nations in addition to Malaysia (Algeria, Argentina, Brazil, Chile, Egypt, India, Indonesia, Jamaica, Kenya, Mexico, Nigeria, Peru, Senegal, Sri Lanka, Venezuela and Zimbabwe) are in general agreement with Malaysia that the East Asian financial crisis was caused by currency speculators and hedge funds. Zainul Ariffin, *G15 Warming Up to Need for Revamp of Financial System*, The New Strait Times, Feb. 9, 1999.

Interestingly, in its 1998 Annual Report, the **Malaysian Securities Commission** did not join the bandwagon of blaming hedge funds for its financial crisis. Rather, in its chapter relating

Hong Kong has accused hedge funds of being in the forefront in creating havoc in the Asian market places in most cases.^{319/} In a recent report, the Reserve Bank of Australia concluded that highly leveraged hedge funds have had success in moving market prices in currency markets in Australia, South Africa, and Hong Kong in the past year. One commentator summarized the attack: “hedge funds ha[ve] made billions of dollars in profits by forcing the devaluation of not only the Malaysian currency but also the baht, rupiah, peso and won as well as the Singapore dollar. . . . Because of their activities, thousands of genuine investments and businesses went bankrupt and millions of workers lost their jobs.”^{320/} In response to its currency crisis, Malaysia has imposed currency exchange rate controls.^{321/} As a recent IMF Report aptly stated, the “concern here is that hedge funds can dominate or manipulate markets,” which is a question of “market integrity.”^{322/}

This section of the outline will explore the attack upon hedge funds (or at least upon some “large” hedge funds) that they are responsible for, or capable of, moving markets to the detriment of other market participants and countries. It will also describe the viewpoints of those who would argue that hedge funds play a generally positive role in global financial markets, including the economic theory that underpins these viewpoints. The outline will also explore the empirical evidence and academic studies (albeit limited) relating to this type of attack upon hedge funds and the debate surrounding the market integrity concerns raised by hedge funds.

1. **The Attack -- Market Movers and Manipulators.** Hedge funds’ size and leverage have been blamed for moving markets.^{323/} The size and influence of such funds may be magnified by their use of leverage (which, as discussed above, varies widely among funds) and by the alleged “herding” dynamic in which hedge funds act together and/or lead other market participants.^{324/} Concerns have also been raised that hedge funds contribute to declining markets

to hedge funds, the Report simply discussed “current issues and concerns” relating to hedge funds (namely, market integrity, lack of transparency, excessive leverage, and systemic risk) without reaching any conclusions. Malaysian Securities Commission, 1998 Annual Report, April 1999.

^{319/} *Hong Kong’s Tung Says Wants Greater Hedge Fund Transparency*, Knight- Ridder, Oct. 30, 1998.

^{320/} *See, e.g., Currency Controls Win the Day*, Business Times (Malaysia), Apr. 8, 1999.

^{321/} *Id.*

^{322/} IMF Report at 3.

^{323/} *See, e.g., Celarier* at 52.

^{324/} *See, e.g.,* IMF Report at 2-3 (describing the popular argument of how hedge funds move markets). Hong Kong’s Chief Executive subscribes to the point of view that hedge funds create herding problems. He is reported to have said: “But the fact is that they can create this herd instinct mentally [sic] and that that herd instinct, and the activities of hedge funds, do give lead

through destabilizing strategies, such as dynamic hedging,^{325/} and through the sales of securities and other assets to meet margin calls.^{326/} Hedge funds have also been attacked for intentionally moving markets for their own benefit -- in other words, for manipulating markets. This is the mantra of the emerging market countries who blame hedge funds for their currency crises. In the past, federal officials have filed complaints against hedge funds for manipulative activity through the use of the anti-fraud provisions of the federal securities laws.^{327/}

2. **Defenders -- The Positive Role Played by Hedge Funds.** Although hedge funds have been demonized by many, they also have their defenders who argue that hedge funds play a positive role (at least in most cases) in global financial markets by increasing efficiency and adding to liquidity. Such defenders include regulators. Their viewpoints and statements in support of hedge funds are described below:

- **The President's Working Group Report** on hedge funds recognizes the positive role played by hedge funds in financial markets through providing liquidity and reallocating financial risk.
- **The Hedge Fund Manager Report** outlines the various means through which hedge funds play a positive role in financial markets:^{328/}

By participating in the market as risk seekers, Hedge Fund Managers play a unique and critical role in financial markets by providing needed liquidity and reducing systemic risk. In this sense Hedge Funds often act as "risk absorbers" in markets by serving as ready counterparties to those wishing to hedge risk, even when markets are volatile, and, in doing so, reduce pressure on market prices while increasing liquidity. In addition Hedge Fund

to many, many other international financial institutions to follow, to act together, and they together create havoc in many financial markets around the world, including Hong Kong." *Hong Kong's Tung Says Wants Greater Hedge Fund Transparency*, Knight-Ridder, Oct. 30, 1998.

^{325/} Dynamic hedging results in "positive feedback trading" -- trading in the direction that the market is moving, which can lead to price destabilization. Dynamic hedging is complex. See IMF Report at 56 for a full description of this strategy.

^{326/} Susan C. Ervin, *The Perils of Success: Public Policy Issues Presented by Hedge Funds*, Futures and Derivatives Law Report, Vol 16, Nos. 1 and 2, Mar./Apr. 1996 (describing this declining market concern).

^{327/} The SEC and the Department of Justice filed complaints against two hedge fund managers for manipulating the markets for two-year Treasury notes in 1991. The cases were settled.

^{328/} Hedge Fund Manager Report at 3.

Managers, through their trading based on extensive research, bring price information to the markets which translates into market price efficiencies. Without Hedge Fund Managers' research and commitment of capital, the markets would have potentially wider price spreads, pricing inefficiencies and illiquidity. Perhaps most importantly, by standing ready to lose capital, Hedge Funds act as a buffer for other market participants in absorbing "shocks."

- **Treasury Deputy Assistant Secretary Lee Sachs** testified before the House that *generally* hedge funds like other active market participants "can provide benefits to financial markets by enhancing liquidity and efficiency" and can "play a role in financial innovation and the reallocation of financial risk."^{329/}

- **CFTC Commissioner Newsome** testified before the Senate as follows:

Hedge funds can and do provide positive benefits to financial markets. Their trading can increase market efficiency, in that positions taken to profit from temporary price discrepancies can reduce such gaps. Indeed, the risk-taking engaged in by hedge funds and major market participants can serve to correct incongruities in market valuations.

I believe that attempts to eliminate or stifle this market activity will result in less efficiency and liquidity in the marketplace.^{330/}

- Stephen H. Axilrod, former Staff Director for Monetary and Financial Policy for the Federal Reserve, testified before the House that hedge funds have a special, positive role to play:

Markets function best when they have participants who will take on a broad spectrum of risk from low to high. Hedge funds . . . are an outlet for those investors willing to take sizable risks in markets In doing so, these funds through arbitrage operations help connect market sectors one to another, or the funds through sizable directional bets in one market or another add to the activity and liquidity of a particular market. Sometimes bets are right and

^{329/} March 3rd Hearing (Sachs statement). Sachs did note that some hedge funds, as was demonstrated by LTCM, have "the potential to disrupt the functioning of financial markets."

^{330/} Dec. 16th Hearing (Newsome statement).

sometimes wrong, but the liquidity added tends to make the market broader and more fluid.^{331/}

- **Steven A. Lonsdorf, President, Van Hedge Fund Advisors International, Inc.**, testified before the House that “[i]t is probably true, however, that hedge funds make the global markets more efficient and help to establish the true market value of currencies, interest rates, and stock markets.”^{332/}
- **Leon Metzger, President of Paloma Partners Company, LLC**, testified before the House that “hedge funds play a uniquely beneficial role in the financial markets” by engaging in “‘risk absorbing’ financial speculation necessary to keep our markets efficient.” He argues that if the government imposes further regulations on hedge funds, then it “will be regulating the flow of liquidity and, hence, may interfere with the efficiency of markets, causing the public and investors, in particular, to be worse off.”^{333/}
- **Managed Funds Association’s Hedge Fund Review.**^{334/} The review notes that hedge funds provide important benefits to both investors and markets. Hedge funds provide investors with “attractive mechanisms for portfolio diversification.” They “enhance market liquidity, helping to absorb shocks in volatile markets, reducing the severity of price fluctuations and fostering smaller bid-ask spreads and lower transaction costs.”

3. **The Debate -- Economic Theory and Empirical Evidence.** Despite the attacks on hedge funds, much has been said to support the view that hedge funds do not have a unique ability to move markets and were not the source of the various financial crises ascribed to them. As the IMF Report notes, “while hedge funds sometimes take sizable positions, so do banks, corporations [sic], and institutional investors, all of whom manage assets many times larger than those of the hedge funds,”^{335/} and “[t]his creates doubt that hedge funds can dominate, or corner, particular markets under most circumstances.”^{336/} The Federal Reserve Governor John

^{331/} Oct. 1st Hearing (Axilrod statement).

^{332/} Oct. 1st Hearing (statement of Steven A. Lonsdorf, President, Van Hedge Fund Advisors International, Inc.).

^{333/} March 3rd Hearing (Metzger statement).

^{334/} Managed Funds Association, *Hedge Funds: Issues for Public Policy Makers*, April 1999 at 11.

^{335/} IMF Report at 16.

^{336/} IMF Report at 6.

P. LaWare testified before the House Banking Committee in 1994 that “[it] would be wrong to single out hedge funds as being responsible for moving global prices of financial assets or as being a major source of risk in financial markets.”^{337/} In terms of the blame placed on hedge funds for recent currency crises, only a subset of hedge funds even take positions in currencies.^{338/} This section explores the economic theory and empirical evidence available relating to hedge funds and market volatility as well as the debate surrounding such theory and evidence.

a. Market Influence. Hedge funds have been accused of dominating and cornering markets. The recent IMF Report indicates that there are several reasons to be skeptical that hedge funds can generally wield such influence.^{339/} First, “hedge fund capital pales in comparison with the capital of other institutional investors.”^{340/} Second, “these other institutional investors engage in many of the same practices as hedge funds.”^{341/} Moreover, these “[o]ther institutional investors . . . -- in particular the proprietary trading desks of commercial and investment banks -- use leverage in investment activities, much as hedge funds do,”^{342/} suggesting that hedge funds are not the only ones whose size is magnified by leverage.

However, a recent Reserve Bank of Australia Report counters that hedge funds do have the ability to wield such influence and are quite different from commercial banks and investment banks in ways that are important to market integrity concerns. The Report notes that it does not follow from the fact that hedge funds’ assets are smaller than those of banks that their impact on markets is any less:

For one thing, the extensive use by hedge funds of off-balance sheet instruments gives them more influence than their asset size would suggest. Perhaps more importantly, it is changes in positions that influence market prices, and in this respect hedge funds are much more active than banks. . . or mutual funds, pension funds or life offices.^{343/}

The Reserve Bank of Australia Report also notes that hedge funds are more likely to raise market integrity concerns because they are less constrained in their activities than banks which

^{337/} April 13th Hearing (statement of John P. LaWare, Board of Governors of the Federal Reserve System).

^{338/} See Section II.C.2.a above for a description of the range of investment strategies followed by hedge funds.

^{339/} IMF Report at 6.

^{340/} *Id.*

^{341/} *Id.*

^{342/} *Id.* at 36.

^{343/} June 1999 Reserve Bank of Australia Report.

“are mindful of their wide-ranging relationships with governments and businesses in individual countries, and therefore less inclined to pursue trading strategies which could disrupt a country’s markets and harm the bank’s reputation.”^{344/} Moreover, hedge funds’ positions are more concentrated and centrally controlled than a banks. Accordingly, banks’ positions “tend to be smaller and less strongly held, and therefore less likely to have effects on markets.”^{345/}

b. Market Stability. Although hedge funds have been accused of being destabilizing speculators, various commentators have argued that there are reasons to believe that hedge funds serve as a more stabilizing influence than other market participants. George Soros testified before Congress in 1994 with respect to his funds: “Our activities are trend bucking rather than trend following. We try to catch new trends early and in later stages we try to catch trend reversals. Therefore, we tend to stabilize rather than destabilize the market. We are not doing this as public service. It is our style of making money.”^{346/}

A recent IMF Report provides an in depth discussion of the economic theory and empirical evidence relating to hedge funds and market stability.^{347/} The recent Deutsche Bundesbank and Reserve Bank of Australia reports also speak to these issues.

(i) Feedback Trading. Feedback trading refers to a market participant’s trading relative to market prices. A market participant engages in negative feedback trading when it buys when prices fall and sells when prices rise. Conversely, a market participant engages in positive feedback trading when it trades in the direction of the market. Positive feedback trading amplifies market moves and adds to price volatility.

Positive feedback trading can arise through various market mechanisms -- dynamic hedging, stop loss orders and collateral or margin calls.^{348/} As the IMF Report notes, stop loss orders and collateral or margin calls are “not specific to hedge funds” and “[h]edge funds are typically buyers of options and do not need to hedge using dynamic hedging techniques.”^{349/}

The IMF Report sets forth the economic reasoning that hedge funds may be less inclined than other market participants to engage in positive feedback trading. First, hedge funds have more freedom in investment strategy than, for example, mutual funds:

[H]edge funds, unlike mutual funds, are not bound by their prospectuses to invest inflows of funds in the same manner as existing capital. A mutual fund that

^{344/} *Id.*

^{345/} *Id.*

^{346/} April 13th Hearing (Soros statement).

^{347/} IMF Report; *see also*, Milken Institute Report.

^{348/} IMF Report at 56.

^{349/} IMF Report at 56.

enjoys high returns may attract new investors and be bound by its prospectus to buy more of the recently appreciated assets; hedge funds have more flexibility.^{350/}

Second, hedge funds have a longer term investment horizon than, for example, mutual funds because of lock-in periods:

The predictability of purchases and redemptions by small retail investors in mutual funds depending on market conditions makes their managers particularly prone to “momentum trading,” that is, buying into a rising market and selling into a falling market, increasing market volatility. Consider a mutual fund manager in a bull market, for example. He is aware that funds will be flowing in at a robust pace. It is, therefore, in his interest to reduce his average holding of cash balances, and increase, for example, the proportion of his portfolio devoted to equities. The opposite is true in a falling market when the manager is aware that there will be substantial outflow. It is then in his interest to increase holdings of cash balances, that is, sell in a falling market. Hedge funds, with longer redemption horizons, have fewer incentives to engage in such momentum selling.^{351/}

A mutual fund manager “who allows losses to mount in anticipation of a subsequent reversal may find himself a former mutual fund manager before that reversal takes place,” as investors withdraw their money.^{352/}

One recent study provides some evidence that hedge funds engage in negative feedback trading. In this study (which examined the herding behavior by large futures participants), the authors were surprised to find “the relatively large number of times negative feedback trading was statistically detected among institutional participants, especially hedge funds.”^{353/} In addition, hedge funds were reported to have engaged in negative feedback trading in the market for the Indonesian rupiah in the 1997 crisis.^{354/}

The Deutsche Bundesbank Report cautions that a precondition for the “long-termist” approach by hedge funds is adequate liquidity in the marketplace.^{355/} The Report explains:

^{350/} IMF Report at 11 (footnote omitted).

^{351/} IMF Report at 34.

^{352/} IMF Report at 11-12.

^{353/} Laura E. Kodres & Matthew Pritsker, *Directionally Similar Position Taking and Herding by Large Futures Market Participants*, Risk Measurement and Systemic Risk, Proceedings of a Joint Central Bank Research Conference (Nov. 1995) at 271 (“Kodres and Pritsker”) (cited by IMF Report at 11 and Milken Institute Report at 14).

^{354/} IMF Report at 18.

^{355/} Deutsche Bundesbank Report.

Some hedge funds assume selected unsystematic risks; that tends to make them more vulnerable to shocks than other investors who have diversified portfolios. In these circumstances, unexpected, sharp movements of asset prices may lead to such funds having to close out positions on a large scale in order to meet additional margin requirements in derivatives markets. Similar effects are likely to arise whenever hedge funds have to reduce short-term loans due to the falling value of the securities normally used as collateral. This would tend to reinforce price movements in the financial markets.

(ii) **Herding.** Herding, which refers to market participants taking positions similar to those of other market participants, can be another destabilizing market phenomenon in addition to positive feedback trading. There are two relevant types of herding: (i) herding among hedge funds; and (ii) herding by other investors who follow the lead of hedge funds.^{356/}

Recent Reserve Bank of Australia reports conclude that hedge funds are in fact “market leaders.”^{357/} Their strong reputations, combined with their willingness to use leverage to build large positions, gives hedge funds the ability to influence the behavior of other market participants. Banks and investment banks regularly inform their better clients of hedge funds’ strategies in foreign exchange markets. Armed with such information, some market participants copy the positions of the hedge funds and others, who would have been on the other side, withdraw.

As for herding among themselves, the IMF Report suggests that hedge funds are less likely than other institutional investors to herd among themselves because of the compensation structure:

It is far from clear that hedge fund managers have the same incentive to mimic each other as, say, mutual fund or pension managers, since hedge fund managers have their own wealth invested in the fund and are not compensated relative to a benchmark but on total return.^{358/}

The Report does recognize, however, that hedge funds may create the impression that they herd:

[M]any hedge funds probably have access to the same information, and one could imagine, especially for macro hedge funds, that hedge funds could arrive at a

^{356/} IMF Report at 57.

^{357/} Reserve Bank of Australia, *Hedge Funds, Financial Stability and Market Integrity*, March 1999 (“March 1999 Reserve Bank of Australia Report”); June 1999 Reserve Bank of Australia Report.

^{358/} IMF Report at 57.

similar assessment at approximately the same time, creating the illusion that they collude and purposely execute similar positions.^{359/}

A recent study by Kodres and Prisker, who analyzed data reported to the CFTC on futures trading, found that hedge funds herd among themselves in the S&P 500 index contract and the three-month Eurodollar contract. The study also found that smaller funds herded with larger funds in the Japanese yen contract and the S&P 500 index contract.^{360/} As noted above, however, the study also detected negative feedback trading among hedge funds. The authors note in their conclusion that “[t]he negative feedback trading found in conjunction with herding in this paper raises doubts as to the destabilizing effects of herding, but further work is required to substantiate this link.”^{361/}

On the question of whether hedge funds lead other investors (which is the more important question “given that hedge funds are small relative to other investors”),^{362/} the IMF Report notes that there is “reason to be skeptical.”^{363/} The Report noted as follows:

Hedge funds have low overhead; a small staff can mean that they have limited capacity to monitor conditions simultaneously in many markets. Many are consumers rather than producers of information Insofar as other institutional investors have better access to information and more extensive research capability, hedge funds may in turn follow their lead.^{364/}

The authors of the IMF Report extended the analysis in Kodres and Pritsker of futures markets to investigate whether other market participants’ position changes were positively correlated with those of hedge funds.^{365/} The IMF Report reported that the evidence of this study of futures markets is “mixed or actually negative,”^{366/} and concluded that “[t]here is little evidence here, in other words, that hedge funds play a singular role in herding in financial markets.”^{367/}

^{359/} IMF Report at 57.

^{360/} IMF Report at 11 (citing Kodres and Pritsker).

^{361/} Kodres and Pritsker.

^{362/} IMF Report at 11.

^{363/} IMF Report at 10.

^{364/} IMF Report at 10.

^{365/} IMF Report at 58.

^{366/} IMF Report at 11.

^{367/} IMF Report at 11.

c. **Financial Crises.** As noted above, hedge funds have been blamed for various currency crises over the past decade. Opinion is divided and much work remains to be done in assessing whether HLIs have manipulated, or have the ability to manipulate, small and medium-sized markets. Treasury Secretary Rubin is reported to have said that he does not believe that hedge funds have been a significant factor in financial crises,^{368/} and that it is capital flight from within countries that starts such crises.^{369/} Only a subset of hedge funds are even engaged in currency trading. Various recent studies suggest hedge funds are not to blame. Although the President's Working Group did not undertake to study the role that hedge funds may have played in financial market crises, the Group did note in its Report that several independent studies (namely, the IMF study and the Brown, Goetzmann and Park studies discussed below) suggest hedge funds are not at fault. The recent Reserve Bank of Australia Report, however, concludes that the role of hedge funds in the events of 1997 and 1998 has been dismissed too readily and that the impact of hedge funds on medium-sized economies is of particular concern.^{370/} The Reserve Bank Report also notes the limitations of the Brown, et al., and IMF studies, which the Bank believes have influenced the viewpoints of major countries.

The role of hedge funds in these crises is currently the subject of studies. A working group of the **Financial Stability Forum** recently established by the G-7 countries (the United States, Japan, Germany, France, Britain, Italy and Canada) is studying "the effects of the activities of HLIs on the dynamics and integrity of financial markets in small and medium-sized economies."^{371/} The **Manila Framework Group**, formed in the wake of the Asian financial crises in 1997 by 14 Asia-Pacific nations,^{372/} is also exploring the role of hedge funds in these crises.^{373/}

(i) **IMF Report.** In its recent report, the IMF studied the various financial crises, including the 1992 ERM crisis, the 1994 Bond Market Turbulence, the 1994-1995 Mexican Crisis and the 1997 Emerging Markets Crisis in Asia.^{374/} The report

^{368/} Alan Friedman & Jonathan Gage, *A Proposal to Monitor World Finance System*, International Herald Tribune, Feb. 1, 1999.

^{369/} Bruce Nussbaum, *Letter from Davos*, Business Week, No. 3616, Feb. 15, 1999.

^{370/} June 1999 Reserve Bank of Australia Report.

^{371/} See web site of Financial Stability Forum, located at <<http://www.fsforum.org>>.

^{372/} These nations include Australia, Brunei, Canada, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the United States.

^{373/} *Banning Hedge Funds Ruled Out at Singapore Conference*, Deutsche Presses- Agentur, August 30, 1999; *Lee Says Global Market Regulator Not Workable*, Japan Economic Newswire, August 29, 1999.

^{374/} IMF Report. See Chapter 1, "Hedge Funds and Recent Crises," for an in depth discussion of the role of hedge funds in each crisis.

concluded that the analysis “does not suggest a strong case for supervisory and regulatory measures . . . targeted specifically at hedge funds.”^{375/} According to the Report, “[h]edge funds . . . are only one part of the constellation of institutional investors active in international financial markets.”^{376/} The IMF’s study of the crises “suggests that the most important action policymakers can take to protect their economies against uncomfortable market movements is to avoid offering one-way bets in the form of inconsistent policies and indefensible currency pegs.”^{377/}

The Reserve Bank of Australia criticizes the conclusions reached in the IMF Report, noting that the evidence supporting the conclusions drawn are “not very strong.”^{378/} In reference to the IMF’s conclusions relating to the Thai baht, the Reserve Bank states:

The report downplayed the role of hedge funds in the Thai crisis on the grounds that they “. . . were at the rear, not the front, of the herd . . .”. Data on the timing of hedge funds [sic] sales of Thai baht do not exist but, even if the IMF claim is correct, it is difficult to dismiss the role of hedge funds given that they had a short position in Thai baht equal to almost 5 per cent of Thailand’s GDP.^{379/}

In the recent IMF International Capital Markets Report, which postdates the IMF Report, the IMF concluded that “it remains unclear to what degree certain HLIs have from time to time colluded in effort to try to manipulate foreign exchange markets and whether such efforts can be a major systematic source of volatility and inefficiency.”^{380/} As such, according to this report, it is necessary to do further analytical and empirical work.

(ii) **Brown, Goetzman and Park Study.** In a recent academic study of the 1997 Asian currency crisis by Brown, Goetzman and Park, the authors found “no empirical evidence to support the hypothesis that George Soros, or any other hedge fund manager was responsible for the crisis.”^{381/} With respect to the Malaysian ringgit, the authors stated that “[i]f anything, it appears that the top ten hedge funds were buying into the ringgit as it fell in the late summer and early fall of 1997.” The “story is essentially the same” for the “Asian currency basket,” consisting of the currencies of the Philippines, Taiwan, Thailand, Japan,

^{375/} IMF Report at 4.

^{376/} *Id.*

^{377/} *Id.*

^{378/} June 1999 Reserve Bank of Australia Report.

^{379/} *Id.*

^{380/} IMF International Capital Markets Report at 164.

^{381/} Stephen J. Brown, William N. Goetzman & James Park, *Hedge Funds and the Asian Currency Crisis of 1997*, National Bureau of Economic Research, Working Paper No. 6427 at Abstract, Feb. 1998.

Malaysia, Singapore, China and India. The authors conclude, “There have been periods when hedge funds have huge positive and negative exposures to Asian currencies, but these bear no relation to current, past or future moves in exchange rates.”

According the Reserve Bank of Australia, the methodology supporting these conclusions is flawed, which “calls into question the findings of the paper.” Because data on the short positions in Asian currencies was not available, the authors “constructed their own estimates using a methodology initially developed to analyse returns of mutual funds [sic] managers.” Such a methodology cannot be readily transferred to hedge funds due to the difference between hedge funds and mutual funds in terms of trading strategies.^{382/}

(iii) Reserve Bank of Australia. In its recent reports, the Reserve Bank of Australia concluded that a “strong ‘in principle’ argument exists for the regulation of some types of hedge funds on the grounds that they pose a risk to the stability of the financial system and to the integrity of financial markets.”^{383/} While noting that the “abuse of market power by hedge funds occurs only periodically” and is limited to a small subset of large hedge funds, “some large hedge funds have been able to affect the market price, either through the sheer size of their positions, or by employing trading strategies that affect the behaviour of other market participants.”^{384/} According to the Bank, hedge funds were “major players in the ERM crisis in the early 1990s and in the US dollar/yen exchange rate last year” and are of particular concern in “medium-sized economies, where markets are generally liquid but participants can build positions which are large relative to the size of markets.”^{385/} Such medium-sized markets provide the “right combination of liquidity and opportunity.”^{386/} The Bank found that Australia’s experience in 1998 “illustrates the destabilising impact which hedge funds can have.”^{387/} South Africa and Hong Kong, which like Australia fall into the “medium-sized liquid category,” have also “seen highly leveraged hedge funds have some success in moving market prices” in the past year.^{388/}

The Reserve Bank argues for indirect regulation of hedge funds to combat both financial stability and market integrity concerns, concluding that “hedge fund-specific regulation is weakened by the likelihood of other institutions, with similar risk profiles, developing outside an expanded regulatory framework.”^{389/} Such indirect regulation would include: (i) improved

^{382/} June 1999 Reserve Bank of Australia Report.

^{383/} March 1999 Reserve Bank of Australia Report.

^{384/} March 1999 Reserve Bank of Australia Report.

^{385/} June 1999 Reserve Bank of Australia Report.

^{386/} March 1999 Reserve Bank of Australia Report.

^{387/} June 1999 Reserve Bank of Australia Report.

^{388/} March 1999 Reserve Bank of Australia Report.

^{389/} March 1999 Reserve Bank of Australia Report.

standards of disclosure; (ii) improved risk monitoring by hedge fund counterparties and lenders, which provide hedge funds “with the ability to generate large positions;” (iii) the removal of distortions in the Basel capital framework; and (iv) capital charge penalties for banks when the institutions with whom they interact do not meet minimum disclosure standards. Disclosure on an aggregate basis, as opposed to an individual institution basis, could be facilitated by the formation of an international credit registry.^{390/} While the Bank recommends that a coordinated international approach be used, it concludes that there is room for unilateral action by countries such as the United States.^{391/}

(iv) **Institute of International Finance Report.** The Institute of International Finance, a global association of financial institutions, recently issued a report (prepared by a Working Group comprised of 25 of its members) based on its review of the recent financial crises in East Asia and Russia and made concrete recommendations on ways to prevent, mitigate and resolve such crises.^{392/} Notably, it did not ascribe blame to hedge funds for the crises nor did it recommend the direct regulation of hedge funds. It found that the most fundamental step to be taken to reduce the likelihood of crisis is to ensure “sound economic policies in emerging market economies.”^{393/} In this regard, the Report emphasized the need for domestic economic policies to be aimed at avoiding an excessive build-up of short-term debt, which “played a key role in the East Asian crises and in Russia, as it did in the earlier Mexican peso crisis of 1995.”^{394/}

The Report also stressed the need for the pursuit of consistent monetary and exchange rate policies. According to the report, “[i]n Mexico in 1994 and again in East Asia in 1997 rigid regimes of fixed exchange rates led to growing real overvaluation and external deficits while contributing to excessive short-term borrowing as a consequence of the stimulus to short-term capital inflows taking advantage of relatively high domestic interest rates with seemingly minimal exchange rate risk.”^{395/} A “country cannot have all three of the following at the same time: a fixed exchange rate, an independent monetary policy, and complete capital mobility.”^{396/} The Report noted that currency boards or floating rates could help to ensure consistency between monetary and exchange rate policies.^{397/} As an example, the Report noted that the “Argentine

^{390/} Deutsche Bundesbank also suggests the formation of such a registry as a possibility for enhanced disclosure. See Deutsche Bundesbank Report.

^{391/} March 1999 Reserve Bank of Australia Report.

^{392/} *Report of the Working Group on Financial Crises in Emerging Markets*, Institute of International Finance, Inc. (January 1999) (“IIF Report”).

^{393/} *Id.* at 1.

^{394/} *Id.* at 1-2.

^{395/} *Id.* at 2.

^{396/} *Id.* at 21.

^{397/} *Id.* at 20.

and Hong Kong currency boards appear to have contributed to these economies' ability to weather spillover from their respective regional crises, and Mexico's floating rate in the past four years appears to have provided a stabilizing influence for that economy."^{398/} Peru is reported to be considering a switch to "dollarization," which can be achieved, among other ways, through a currency board where a country pegs its currency at a fixed rate to the dollar.^{399/} The Report did note that some countries may be able to utilize crawling pegs and exchange rate bands provided they carefully coordinate fiscal and monetary policies.^{400/}

The Report made several other recommendations for avoiding financial crises. It proposed a new country-based dialogue between the private sector and country officials; supported the Basel Committee "Core Principles" for banking system operation, supervision and regulation; recommended increased international surveillance by the IMF; and recommended better risk management by lending institutions. Moreover, the report emphasized the need for improved transparency by governments, domestic corporations and banks.^{401/}

(v) International Organisation of Securities Commissions.

In September 1998, the IOSCO issued an interim report of the Emerging Markets Committee entitled "Cause, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets." The Committee studied the crises from January 1997 through July 1998 by surveying 17 Emerging Markets Committee members. The Report concluded that "there has been no conclusive evidence, so far, of the exact role played by hedge funds in the East Asian crisis." However, "allegations that hedge funds triggered the crisis resulted in greater scrutiny of how the activities of such funds could be made more transparent" and has caused "regulators in certain jurisdictions" to "perceive a need to re-examine the manner in which these funds are regulated."^{402/}

IV. CONCLUSION.

^{398/} *Id.*

^{399/} *Dollarization Gains Currency*, The Peru Report, March 19, 1999. The Subcommittee on Economic Policy and the Subcommittee on International Trade and Finance of the Senate Banking Committee held a hearing on "Official Dollarization in Emerging-Market Countries" on April 22, 1999.

^{400/} IFF Report.

^{401/} *Id.* at 2-6.

^{402/} International Organisation of Securities Commissions, *An Interim Report of the Emerging Markets Committee, Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets* (Sept. 1998), available at <http://www.iosco.org/docs-public/1998-causes_and_effects-document01.html>.

The “mature market turbulence” in 1998, during which, among other things, “liquidity almost dried up in some of the deepest capital markets in the world following the near-collapse of Long-Term Capital Management,” has caused both the private and public sector to focus renewed attention on ways to reduce systemic risk.^{403/} The role of hedge funds in the systemic risk equation has received particular scrutiny and continues to be the subject of studies among various domestic and international groups, both public and private as well as combined.

As discussed in this outline, the focus on hedge funds has also included market integrity concerns. Although treated separately for purposes of emphasis in this outline, market integrity and systemic risk issues are interrelated, and recommendations to mitigate systemic risk may also help to bolster market integrity (and vice-versa). As Deutsche Bundesbank recently noted, “if hedge funds initiated massive price movements in what are already tight markets,” then “the liquidation of large positions could lead -- via widely dispersed ‘domino effects’, the reciprocal spiralling of credit and market price risk and loss of confidence - to disruptions of market integrity, thereby triggering or reinforcing system-wide crisis.”^{404/} The recent reports by the Reserve Bank of Australia underscore that a hedge fund’s size and leverage can implicate both market integrity and financial stability concerns.^{405/} A hedge fund that is large relative to the market in which it is operating (whose size may be magnified through the use of leverage) may have the requisite market power to manipulate a market. Moreover, such a large hedge fund may also raise systemic risk concerns if its default could cause ripple effects throughout the financial system. The recommendations being made to enhance financial stability should also contribute to market integrity. For example, enhanced disclosure relating to hedge funds serves to enhance market discipline and to expose large positions being taken. Moreover, both prudential risk assessment by hedge fund counterparties and capital requirements for regulated entities serve to constrain excessive leverage, thereby reducing systemic risk and market power concerns.

The global financial system is constantly evolving and changing. As the IMF aptly noted, the changes in the system mean that the nature of systemic risk is also changing.^{406/} Mechanisms to defend against systemic risk (such as modern private risk management systems) also carry risks of their own. Although “many of the features of modern finance are efficiency enhancing when used in moderation,” such “potential improvements in efficiency” have also come with “more frequent changes in asset prices and financial flows, and possibly more rapid and complicated market dynamics.”^{407/} Because market-makers that “provide critical market liquidity are often also traders and investors, large price shocks can be associated with the withdrawal of market makers, a decline in market liquidity, and sharp and disruptive price

^{403/} IMF International Capital Markets Report at 1.

^{404/} Deutsche Bundesbank Report.

^{405/} March 1999 Reserve Bank of Australia Report; June 1999 Reserve Bank of Australia Report.

^{406/} IMF International Capital Markets Report at 136.

^{407/} IMF International Capital Markets Report at 127.

declines.”^{408/} In short, changes to the system have “created a more market-oriented form of systemic risk, involving an array of markets and their underlying infrastructures.”^{409/}

The changing nature of systemic risk challenges both the public and private sectors to keep pace in their efforts to mitigate such risk. Mechanisms must be developed that “are effective in encouraging prudent behavior and management but that do not inhibit efficiency-enhancing activities.”^{410/} Given the interconnections among markets throughout the world, a “global approach” is necessary.^{411/}

^{408/} *Id.*

^{409/} IMF International Capital Markets Report at 136.

^{410/} IMF International Capital Markets Report at 137.

^{411/} IMF International Capital Markets Report at 136.