1-1-2000

THE LEGAL REGULATION OF HEDGE FUNDS IN THE UNITED STATES LONG-TERM CAPITAL MANAGEMENT EPISODE

JONG CHEOL PARK
University of Georgia School of Law

THE LEGAL REGULATION OF HEDGE FUNDS

IN THE UNITED STATES

– LONG-TERM CAPITAL MANAGEMENT EPISODE –

by

JONG CHEOL PARK

LL.B., HANYANG UNIVERSITY, KOREA, 1987

LL.M., HANYANG UNIVERSITY, KOREA, 1989

A Thesis Submitted to the Graduate Faculty

of The University of Georgia in Partial Fulfillment

of the

Requirements of the Degree

MASTER OF LAWS

ATHENS, GEORGIA

2000

THE LEGAL REGULATION OF HEDGE FUNDS

IN THE UNITED STATES

– LONG-TERM CAPITAL MANAGEMENT EPISODE –

by

JONG CHEOL PARK

Approved:

Major Professor — Date: 4/17/00

Chair, Reading Committee — Date: 4/17/00

Approved:

Graduate Dean

April 21, 2000

Date

DEDICATION

This paper is dedicated to my wife who, even in a difficult situation, has tried her best to support me.

ACKNOWLEDGMENTS

I would like to thank Professor Netter, Professor Huszagh, and Professor Wilner for their care and support.

Also, I would like to thank Ms. Braxley, Mr. Kennedy, Ms. Oh, and the Neumeisters for their help during my studying in the United States.

TABLE OF CONTENTS

Page

ACKNOWLEGMENTS v

CHAPTER

I INTRODUCTION 1

II THE HEDGE FUND INDUSTRY 5

Origin and Development 5

Activities and Influence 7

Performance 9

III THE LEGAL CHARACTERISTICS OF HEDGE FUNDS 10

Mutual Funds Structure 10

Hedge Funds Structure 11

IV THE REGULATIONS OF HEDGE FUNDS AND MUTUAL FUNDS..16

Securities Regulation of Mutual Funds 16

Securities Regulation of Hedge Funds 17

V DIFFERENCES BETWEEN MUTUAL FUNDS AND HEDGE FUNDS 21

Regulation 21

Investors and Minimum Investment 21

Fees 21

Leverage 22

Liquidity 22

VI HEDGE FUND FRAUD AND DEBACLES 24

Manhattan Investment Fund Fraud Case 24

Hedge Funds Debacles 28

Comments 35

VII LONG-TERM CAPITAL MANAGEMENT EPISODE 37

Review 37

The Failure of Economic Genius 42

The UBS Fiasco 42

Other Losers 44

Problems 45

VIII THE ACTIVITIES OF FINANCIAL COMMUNITY 54

The President's Working Group on Financial Markets

(President's Working Group) 54

The Counterparty Risk Management Policy Group (CRMPG)........55

The Basle Committee on Banking Supervision

(Basle Committee) 56

The Financial Stability Forum (Forum) 57

The Basle Committee and the Technical Committee of International

Organization of Securities Commissions (IOSCO) 57

The Committee on the Global Financial System (CGFS) 58

IOSCO 58

VIX BENEFITS AND COSTS OF REGULATION 60

Law Professors' Opinions 60

The Hedge Funds Disclosure Act 60

Benefits and Costs in Regulation of Hedge Funds 61

Discussion 63

VX CONCLUSION 68

BIBLIOGRAPHY 70

CHAPTER I

INTRODUCTION

Mutual funds and hedge funds are popular forms of investment in the United States and throughout the world. Mutual funds are regulated by securities' regulators in the United States. Hedge funds, however, are not regulated because of their operational flexibility in investment.

George Soros, manager of the famous Quantum Fund, is a successful case in the industry of hedge funds; his Quantum Fund recorded "41 percent net returns" per year between 1990 and 1994.[1] However, the near-bankruptcy of the Long–Term Capital Management Limited Partnership (LTCM), "the Cadillac of hedge funds"[2] with two Nobel prize winners among its partners,[3] demonstrates the negative side of hedge funds: this episode indicated even one hedge fund could threaten the world financial market. In addition, while common hedge fund failures followed the normal process in the financial market, only LTCM was uniquely rescued by a consortium of fourteen international institutions in September 1998. This "unprecedented" rescue underlined the "irony," or the "double standard" nature of the United States because America persuaded other countries including Asian countries which had economic crises to follow market

---

[1] M. Corey Goldman, *House Eyes Fund Rules Legislation Expected Thursday, though Experts Deem It Too Little Too Late*, CNNFN, Sept. 22, 1999. <http://cnnfn.com/1999/09/22/news/hedge>

[2] *Hedge Funds: Hearings Before the Subcomm. on Financial Institutions of the House Comm. on Banking and Financial Services*, 106th Cong. (1999) [hereinafter *Hearings 4*] (opening statement of Marge Roukema, Chairwoman) ; LTCM was the largest hedge fund by asset size in 1996. Beverly Chandler, INVESTING WITH THE HEDGE FUND GIANTS 3 (1998).

[3] Some famous partners are as follows: (1) John Meriwether who pioneered fixed-income arbitrage at Salomon Brothers and was Salomon vice chairman; (2) David W. Mullins Jr. who was vice chairman of the

discipline in dealing with defaulted companies,[4] yet it failed to use such discipline in dealing with LTCM.

The House banking committee discussed the risk of hedge funds on April 13, 1994.[5] During the committee meeting, it was mentioned that "highly leveraged hedge funds were cited as a source of market volatility in the 1987 market break,"[6] and "highly leveraged hedge funds appeared to have played a role in the 1992 European currency crisis."[7] Regulators, however, treated the risks of hedge funds to national banks very lightly and thought that banks could control those risks because their credit exposure was small.[8] In addition, after the European bond market turbulence, the central bankers of the Group of ten countries considered the regulation of hedge funds but did not decide upon immediate regulation.[9]

Since the Asian financial crises in the late 1997, there have been debates about the impact of the speculative activities of hedge funds on the Asian financial market and emerging markets.[10] However, most advanced countries and international financial communities had not concerned themselves with the activities of hedge funds.[11] Since the near-collapse of LTCM, most developed countries and the international financial

---

Federal Reserve Board; (3) Myron Scholes who was the 1997 Nobel economics prize winner; and (4) Robert Merton who was the 1997 Nobel economics prize winner.

[4] *See Risks that Hedge Funds pose to the Banking System: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 103rd Cong. (1994) [hereinafter *Hearings 1*] (written testimony of Henry T. C. Hu, Professor of Law, University of Texas).<http://www.house.gov/banking/10198wit.htm>

[5] Mark Jickling, *Hedge Funds*, 5, Congressional Research Service Report for Congress, (June 21, 1994).

[6] *Hearings 1*, *supra* note 4 (statement of Hon. James A. Leach).

[7] *Id.*

[8] The credit exposure of eight national banks was no more than $526 million at that time. *Id.* (testimony of Eugene A. Ludwig, Comptroller, OCC).

[9] *See* Mark Jickling, *supra* note 5, at 5.

[10] *See* Takehiko Nakao, *Hedge Funds and International Financial Markets* (July 1999). <http;//www.mof.go.jp/english/if/if006.htm>; *Hearings Before the Subcomm. on Capital Markets of the House Comm. on Banking and Financial Services*, 106th Cong. (1999)[hereinafter *Hearings 3*] (testimony of Leon M. Metzger, President, Paloma Partners Co., LLC). <http://www.house.gov/banking/3399wit.htm>

community have become concerned about the impact of hedge funds on the financial market.[12] In response to this, Congress had a hearing again on October 1, 1998 due to the near-failure of LTCM caused by high leverage. Consequently, "The Hedge Fund Disclosure Act" was introduced by a Congressman into the House of Representatives.[13] Regulation of hedge funds was considered on several occasions. No action, however, was taken because of the lack of "conclusive evidence" of "market volatility"[14]even though the impact of hedge funds on the financial market was very powerful[15]because of their aggressive trading strategies and leverage.[16]

U.S. regulators are concerned that if they regulate hedge funds, hedge funds will, along with their economic benefits, emigrate to offshore havens.[17] However, if we consider the importance of the American financial markets in the world, this idea can be dismissed. Due to globalization in the capital markets, small events in the United States can have large effects in the world market. In addition, the bankruptcy of hedge funds can have severe consequences as we can see why the Federal Reserve Bank of New York

---

[11] *See* Takehiko Nakao, *supra* note 10; *See World Economic Outlook*, IMF, I, 5, Box 1 (May 1998) [hereinafter *Outlook May 1998*].
[12] *See* Takehiko Nakao, *supra* note 10; ASEM (Asia-Europe Meeting) discussed ways to curb hedge fund activity, and Japan's ruling Liberal Democratic Party (LDP) will discuss the need to urge banks to restrict their lending to hedge funds. *Japan LDP to Debate Ways to Curb Hedge Funds,* REUTERS, Jan.26, 1999.<http://www. http://biz.yahoo.com/rf/990126/b4a.html>
[13] H.R.2924, 106th Cong. (1999).
[14] Mark Jickling, *supra* note 5, at 1.
[15] *See Hearings 3*, *supra* note 10 (testimony of Lewis A. Sachs, Deputy Assistant Secretary, U.S. Dept. of the Treasury).
[16] *See* Report of The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April, 1999)[hereinafter *The President's Working Group Report*]. <http://www.cftc.gov/tm/hedgefundreport.htm>
[17] *Hedge Fund Operations: Hearings Before the House Comm. on Banking and Financial Services*, 105th Cong. (1998) [hereinafter *Hearings 2*] (statement of Alan Greenspan, Chairman, FED), (testimony of Richard R. Lindsey, Director, SEC) <http://www.house.gov/banking/10198wit.htm>; The Managed Funds Association, a trade group that represents 700 hedge funds and managed futures funds, criticized the President's Working Group Report. Michael Schroeder, *Hedge Funds Blast Plan [for] Disclosure of Internal-Financial Data*, DOW JONES NEWSWIRES, May 7, 1999.

(FRBNY) intervened in LTCM's recapitalization.[18]In addition, there was a suggestion that the United States should be the first to enact legislation regulating hedge funds since most hedge funds are in America, and such regulation would be very effective.[19] Therefore, regulation of hedge funds by the United States is vital.

This paper will explain the hedge funds industry, explore the definition of hedge funds, their structure, their investors, and their effects on the financial market. It will also evaluate the difference in securities regulation between mutual funds and hedge funds. In particular, it will fully discuss some problems in the LTCM episode and other hedge fund debacles. In addition, it will explain the activities of the financial community. In conclusion, it will present my suggestions for regulation.

---

[18] *See World Economic Outlook and International Capital Markets Interim Assessment*, III, 54, Box 3.4, IMF (Dec.1998) [hereinafter *Outlook Dec.1998*]; There were concerns about possible disruptions in the U.S. and global marketplace if LTCM had failed. *Hearings 2*, *supra* note 17 (testimony of Richard R. Lindsey, Director, SEC); Recently, Tiger Management Funds (Tiger), one of the biggest hedge funds in the world, announced plans to liquidate all investment in the market. In fact, Tiger was an example of a successful hedge fund, and it has been in the spotlight since 1980. Because of Tiger's high returns, many hedg funds were incorporated in the financial market. It started with capital of $8.8 million in May of 1980, and its capital reached $21 billion in 1999. Its compound average return was 31.7 percent, but since August of 1998, its profit has declined. This episode indicates that there seem to be some warning signs in the hedge fund industry. Jennifer Karchmer, *Tiger Management Closes its doors,* CNNFN, March 30, 2000 <http://cnnfn/2000/03/30/mutualfunds/q_funds_tiger>

[19] Takehiko Nakao, *supra* note 10.

CHAPTER II

THE HEDGE FUND INDUSTRY

Origin and Development

Even though hedge funds have only come into the spotlight recently, their history is not short. Alfred W. Jones made the first hedge fund as a general partnership on Jan. 1, 1949.[20] In fact, he was a sociologist, then a journalist, and at last became a fund manager. While he was preparing for his article "Fashions in Forecasting" in Fortune in March 1949, he found new investment skills in the financial market.[21] He planned to reduce some market risks produced by holding "a long stock position" with "market-neutral" strategy.[22] He changed his investment method "from market timing to stock picking."[23] He used unique systems, i.e., short sales, leverage, and incentive fees, for the first time in the financial market.[24] In the beginning, he used a limited partnership which invested with several independent portfolio managers. After that, he changed his hedge fund from a general partnership to "a multi-manager hedge fund" in 1952.[25]

Carol J. Loomis used publicly the name "hedge funds" for the first time in her Fortune magazine article, "The Jones Nobody Keeps Up With," in April 1966.[26] The article introduced a "hedge fund" managed by Alfred W. Jones; the fund's performance

---

[20] Matthias Bekier, MARKETING OF HEDGE FUNDS 73 (1996).
[21] Stephen J. Brown et al., *Offshore Hedge Funds: Survival & Performance 1989-1995*, 3 (Jan. 2, 1998); William N. Goetzmann, *Hedge Funds*, Yale School of Management BZW Presentation (1997) <http://viking.som.yale.edu/will/presentations/hedge/scd003.htm>; Franklin R. Edwards, *Hedge Funds and the Collapse of Long -Term Capital Management*, 189, 13 J. ECON. PERSPECTIVES 2, (1999).
[22] Phillipp Cottier, HEDGE FUNDS AND MANAGED FUTURES 13 (1997).
[23] *Id.*
[24] Beverly Chandler, *supra* note 2, at 3.
[25] *Id.*

after the 20 percent incentive fee was better than most mutual funds' performance, which surprised the financial community.[27]

After that, many hedge funds appeared: a hundred hedge funds were operating within a few years.[28] Many fund managers, however, were confronted with high losses and bankruptcy during 1969 and 1970.[29] Hedge funds had a hard time again during 1973 and 1974.[30] Moreover, many hedge funds had problems in 1994 because of "the strong increase of American interest rates," but the hedge fund industry recovered in 1995 and 1996.[31]

The 1968 survey of the Securities and Exchange Commission (SEC) found approximately 140 hedge funds in operation among 215 partnerships, but the hedge fund industry has developed enormously since the late 1960's[32]: due to global financial liberalization, hedge funds have increased and could have "internationally diversified portfolios."[33]

Nowadays, estimates for the number of hedge funds operating and for the amount of assets they manage vary. For example, the Report of President's Working Group on Financial Markets (hereinafter President's Working Group report) indicated that about 2,500 to 3,500 hedge funds were managing $200 to $300 billion in capital as of mid-1998[34] and handled about $800 billion to $1 trillion in total assets.[35] On the other hand,

---

[26] Stephen J. Brown et al., *supra* note 21, at 4.
[27] Barry Eichengreen et al., HEDGE FUNDS AND FINANCIAL MARKET DYNAMICS 27, Occasional Paper No.166, IMF (May 1998).
[28] Stephen J. Brown et al., *supra* note 21, at 4.
[29] Phillipp Cottier, *supra* note 22, at 13.
[30] *Id.*
[31] *Id.* at 14.
[32] *The President's Working Group Report*, *supra* note 16; Stephen J. Brown et al., *Offshore Hedge Funds: Survival & Performance 1989-1995* 4 (Jan. 1998).
[33] Barry Eichengreen et al., *supra* note 27, at 5.
[34] *Id.*

the estimate of Mar/Hedge, a major source database on hedge fund performance, showed that 1,100 hedge funds were managing $92.2 billion in assets in 1997.[36] Van Hedge Fund Advisors, a Nashville, Tennessee-based investment advisory firm, estimated that there were about 5,830 hedge funds worldwide.[37]

The position of the hedge funds industry is small relative to other investment vehicles in the U.S. financial markets.[38] For example, the volume of other investment sectors in total assets as of the end of 1998 was as follows: " (1) commercial banks had $4.1 trillion, (2) mutual funds had $5 trillion, (3) private pension funds had 4.3 trillion, (4) State and local retirement funds had $2.3 trillion, and (5) insurance companies had $ 3.7 trillion." [39]

According to data of the President's Working Group report, most hedge funds control less than $100 million in capital.[40] In addition, the number of hedge funds that have capital with more than $ 1 billion is very small, and just a few exceed $ 5 billion.[41] In the 1994 Hedge/Mar ranking, there were 57 hedge funds which had over $100 million under management.[42]

Activities and Influence

Even though hedge funds occupy only a small portion of the financial market, their impact is severe due to their leverage and highly aggressive trading strategies.[43]

---

[35] *Id.*
[36] Beverly Chandler, *supra* note 2, at 23.
[37] M. Corey Goldman, *supra* note 1.
[38] *The President's Working Group Report*, *supra* note 16.
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] Matthias Bekier, *supra* note 20, at 523-24.
[43] *See The President's Working Group Report*, *supra* note 16.

Hedge funds use various investment methods including highly quantitative techniques or more subjective factors. Usually, hedge funds use more aggressive derivatives and short positions than mutual funds. In particular, hedge fund managers want to get "absolute returns" because of their performance fee system.[44]

There are different theories regarding the impact of hedge funds on the world financial market. Some argue that hedge funds make markets efficient because they provide liquidity and stability and assert that hedge funds can affect the "financial innovation and the reallocation of financial risk."[45] In contrast, others claim that "hedge funds jeopardize the viability of sovereign states."[46] For example, the Prime Minister of Malaysia criticized the actions of hedge funds for causing his country's financial crisis.[47] Hedge funds, however, only had "short positions" in the Thailand baht during the Asian economic crises: they had "long positions" in Indonesia, "modest positions" in Malaysia, and "no significant positions" in the Philippines.[48] Recent research has also shown that hedge funds have not played an important role in the financial market crises of the past few years.[49]

---

[44] *See* Beverly Chandler, *supra* note 2, at 3.
[45] *The President's Working Group Report*, *supra* note 16.
[46] *Hearings 2, supra* note 17 (opening statement of James A. Leach, Chairman).
[47] He accused Soros [hedge funds] of speculating in the Malaysian ringgit in the summer of 1997. Beverly Chandler, *supra* note 2, at xiii.
[48] Even though hedge funds had approximately $7 billion transactions in Thailand, hedge funds did not play important role in the crisis. Barry Eichengreen and Donald Mathieson, *Hedge Funds: What Do We Really Knows?* Economic Issue 19, IMF (Sept. 1999) <http://www.imf.org/external/pubs/ft/issues19/index.htm>
[49] Stephen J. Brown et al., *Hedge Funds and the Asian Currency Crisis of 1997*, 13, NBER Working Paper No. 6427 (Feb. 1998); *Hearings 3*, *supra* note 10 (testimony of Leon M. Metzger); *Hearings 2*, *supra* note 17 (opening statement of James A. Leach, Chairman): A study on foreign investors' herding effect before the period of Korea's economic crisis found no evidence that foreign investors had negative effect on Korea's stock market. Hyuk Choe, et al., *Do Foreign Investors Destabilize Stock Markets? The Korean Experience in 1997* 21, NBER (June 1998).

Performance

Hedge fund's performance has generally indicated that hedge funds return more profits than Standard and Poor's S&P 500 stock index, and some hedge funds have returned more than other investment vehicles which have had bad returns.[50] However, a study of offshore hedge funds' performance illustrated that average annual offshore hedge fund returns from 1989 to 1995 were lower than the S&P 500 returns.[51]

[50] *The President's Working Group Report*, *supra* note 16; Mark Jickling, *supra* note 5, at 3.
[51] Stephen J. Brown et al., *supra* note 21, at 10.

CHAPTER III

THE LEGAL CHARACTERISTICS OF HEDGE FUNDS

Mutual Funds Structure

Definition

A mutual fund is "an investment company that pools money from shareholders wherein the capital is invested in a diversified portfolio of securities."[52] Section 4 of the Investment Company Act (ICA)[53] divides investment companies into three classes: (1) "Face-amount certificate company,"[54] (2) " Unit Investment trust,"[55] and (3) "Management company." Management companies are again classified into "open-end companies," and "closed-end companies."[56] The so-called "mutual fund" is colloquially termed[57] an "open-end investment company."[58] The open-end investment company is "any investment company which is offering for sale or has outstanding any redeemable security of which it is the issuer."[59] There is also another classification of mutual funds: (1) stock or equity, (2) bond and income, and (3) money market.[60]

The advantages of investing in mutual funds are many: (1) professional management, (2) diversification, (3) economies of scale, (4) liquidity, (5) convenience

---

[52] Robert C. Pozen, THE MUTUAL FUND BUSINESS 16 (1998).
[53] 15 U.S.C. § 80 a-4.
[54] Face-amount certificate is debt obligation. 15 U.S.C. §80a-2(a)(15).
[55] Unit investment trusts are a fixed pool of securities. Gould & Lins, *Unit Investment Trusts*, 43 BUS. LAW. 1177-1205 (1988).
[56] 15 U.S.C. § 80a-5(a).
[57] Joseph R. Fleming, *Regulation of Series Investment Companies under The Investment Company of 1940*, 44 BUS. LAW . 1179 n. 1 (1989).
[58] *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971).
[59] 15 U.S.C. § 80a-5(a)(1).
[60] Robert C. Pozen, *supra* note 52, at 16.

and ease of record-keeping, (6) strict government regulation, and (7) full disclosure.[61]

Structure

A mutual fund can be structured as a corporation or a business trust.[62] In fact, all mutual funds have external management styles.[63] Thus, mutual funds are composed of affiliated organizations and independent contractors who operate mutual funds.[64]

In a typical mutual fund, there are shareholders, a board of directors, an investment adviser or management company, a distributor, a custodian, independent public accounts, and a transfer agent.[65] Among them, the investment adviser or management company manages the fund's portfolio according to the objectives described in the fund's prospectus.[66]

Hedge Funds Structure

Definition

Under the securities regulations, there is no precise legal definition of hedge funds.[67] Hedge funds are described as "a variety of pooled investment vehicles that are not registered under the federal securities laws as public corporations, investment companies, or broker-dealers"[68]or " any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[69]

---

[61] *See A Guide to Understanding Mutual Funds*, 5 ,The Investment Company Institute (1998) [hereinafter *Guide*] <http://www.ici.org >; *See* Victoria E. Schonfeld and Thomas M. J. Kerwin, *Organization of a Mutual Fund,* 49 BUS. LAW . 107 (Nov. 1993).
[62] *See Guide*, *supra* note 61, at 12.
[63] *See Id.*
[64] *See Id.*
[65] *See Id.*
[66] *See Id.*
[67] *See The President's Working Group Report*, *supra* note 16.

The investors of hedge funds are mainly wealthy individuals and sophisticated institutional investors.[70] Because there is no clear definition of hedge funds, their characteristics are often used to determine whether an investment vehicle is a hedge fund.[71] In fact, not all hedge funds use "hedging" even though Jones used "long and short" skills in order to hedge.[72]

There are some contradictions in the definitions of hedge funds. Whether hedge funds could be described as mutual funds is questionable.[73] Soros defined hedge funds as "a mutual fund that employs leverage and uses various techniques of hedging."[74] The chairman of Board of Governors of Federal Reserve System (FED) stated that "LTCM is a hedge fund, or a mutual fund that is structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals and that seeks high rates of return by investing and trading in a variety of financial instruments."[75] On the other hand, Vanguard group provides that hedge funds are not mutual funds.[76] In my view, hedge funds are kinds of derivatives of mutual funds because hedge funds

---

[68] *Hearings 1*, *supra* note 4 (testimony of Arthur Levitt, Chairman, SEC) ; *Hearing 2*, *supra* note 17 (testimony of Richard R. Lindsey, Director, SEC) ; Private investment vehicles that tend to be organized as private limited partnerships and are exempt from regulation under the ICA. *Hearings 1*, *supra* note 4 (testimony of Eugene A. Ludwig, Comptroller, OCC).

[69] *The President's Working Group Report*, *supra* note 16.

[70] *How Hedge Funds differ from Mutual Funds*, The Vanguard Group (1999) [hereinafter *Hedge Funds*] <http://www.vanguard.com/cgi-bin/NewsPrint/908307468>

[71] *See* Phillipp Cottier, *supra* note 22, at 15.

[72] *See* Beverly Chandler, *supra* note 2, at 3.

[73] Other definitions are as follows: (1) an investment partnership or mutual that is unregulated; (2) one that seeks high rates of return by investing or trading in virtually any form of financial instrument; (3) an entity that may take long and short positions and invest in many markets; (4) an entity that uses leverage; and (5) an entity whose manager's compensation is based on its financial performance. *Hearings 1*, *supra* note 4 (statement of John P. Laware, Member, FED).

[74] Alternative Investment Management Association (AIMA), *Hedge funds* (1996); Beverly Chandler, *supra* note 2, at 5; Hedge funds are basically "unregulated mutual funds." Mark Jickling, *supra* note 5, at 3.

[75] *Hearings 2*, *supra* note17 (statement of Alan Greenspan, Chairman, FED).

[76] *Hedge Funds*, *supra* note 70; Hedge funds are "unregulated mutual funds." *But See* Mark Jickling, *supra* note 5, at 1.

adopted their main structure from mutual funds, and their systems are similar to mutual funds.

Classification

Hedge funds can be classified according to the main investment strategy in the funds' management: (1) "global-macro" hedge funds which take positions grounded on their predictions of world macro-economic growths; (2) "event-driven" hedge funds that invest in specific securities concerning bankruptcies, reorganizations, and mergers; and (3) "market-neutral" hedge funds which use relative-value strategies.[77] In addition, there are other classifications such as "long-only" hedge funds, "sectoral" hedge funds, "dedicated short sales" hedge funds, and "funds of funds."[78] Hedge funds are also classified in their use of different types of financial instruments: hedge funds trade equity or fixed income securities and use exchange-traded futures contracts or over-the-counter (OTC) derivatives. Moreover, there are two classes of hedge funds by organizational styles. First, one or more people organize hedge funds with specific trading philosophies;[79] second, an advising vehicle such as the trading departments of investment banks or internationally active commercial banks.[80]

Structure

In order to get "pass-through tax treatment" for investors' profits, hedge funds usually use limited partnerships, limited liability companies, or other vehicles as their structure.[81] Investors and a sponsor or "a general partner," who is usually a manager of

[77] *The President's Working Group Report*, *supra* note 16.
[78] Barry Eichengreen et al., *supra* note 27, at 29.
[79] For example, Soros Fund Management, Tiger Management Corporation, and Steinhardt Management Company. *Hearings 1*, *supra* note 4 (statement of John P. Laware, Member, FED).
[80] *Id.*
[81] *See The President's Working Group Report*, *supra* note 16.

the hedge fund and has a limited liability through a management company, are responsible for guiding investment and risk management.[82] Investment managers have responsibility for selecting and monitoring traders and investment advisers, and assisting managers.[83]

Characteristics

In general, hedge funds have five characteristics of operation unlike other investment instruments. First, hedge funds impose incentive fees according to their performance.[84] Second, hedge funds usually have excessive and aggressive leverage.[85] Third, hedge funds seek short-term investment strategies.[86] Fourth, hedge funds are often established "offshore," i.e., "domiciled outside the United States."[87] Fifth, hedge fund partners also invest their own money.[88] In short, hedge funds have unique characteristics different from mutual funds: "(1) free choice of asset classes, (2) free choice of markets, (3) free choice of trading style, and (4) free choice of instruments."[89]

Sophisticated Investors

There are three types of investors in securities regulations: (1) novices, (2) reasonable investors, and (3) sophisticated investors. Usually wealthy individuals who have $5 million investment capacity and highly sophisticated institutional investors invest in hedge funds. These "high net worth" individuals and sophisticated institutions are not protected by securities regulators due to the belief that they can protect themselves and present no public policy interest. As sophisticated investors, endowment funds and

---

[82] *See* Philipp Cottier, *supra* note 22, at 69.
[83] *See Id.*
[84] *The President's Working Group Report*, *supra* note 16, at Appendix A.
[85] *Id.*
[86] *Id.*
[87] *The President's Working Group Report*, *supra* note 16.

pension funds invest in hedge funds, and the proportion of such investors is increasing because of hedge funds' high returns. When we think about the regulation of hedge funds, we are confronted with this dilemma: should sophisticated investors be protected by securities regulation?

Effects outside Hedge Funds

Hedge funds have a great deal of trading with other financial institutions in the market. Hedge funds use leverage through repurchase agreements (repo), short position, and derivatives.[90] In order to get short-term return, they also take high-risk, aggressive speculation in the world financial market. Banks and securities firms can be lenders or derivatives counterparties.[91] The counterparties of hedge funds are confronted with liquidation problems when hedge funds go bankrupt.[92] Because of wholesale liquidation, hedge funds' insolvency may bring about severe problems for those banks and securities firms.[93] Hedge funds' counterparties function as prime brokers, futures clearing firms, repo and reverse repo counterparties, OTC derivative counterparties, and loan counterparties.[94]

---

[88] Beverly Chandler, *supra* note 2, at 5.
[89] Philipp Cottier, *supra* note 22, at 15.
[90] *See The President's Working report*, *supra* note 16.
[91] *See supra* note 21, at 202.
[92] *See Id.*
[93] *See Id.*
[94] *See The President's Working Group Report*, *supra* note 16.

CHAPTER IV

THE REGULATIONS OF HEDGE FUNDS AND MUTUAL FUNDS

Securities Regulation of Mutual Funds

Registration Requirements

1. Registration

Under the ICA, every investment company is required to register with the SEC,[95] and the activities of a registered investment company and persons connected with it are restricted by the ICA. In addition, a variety of SEC and private sanctions are provided by the ICA. The Securities Act of 1933 (Securities Act) requires every mutual fund to register its shares.[96] The Internal Revenue Code (IRC) mandates that every investment company register as a "regulated investment company"[97] for taxation.

2. Reporting Requirement

Mutual funds must disclose information to their investors about their management, holdings, fees and expenses, and performance.[98] Mutual funds must provide a prospectus and a shareholder report to investors.[99] The mutual funds' objectives, fees and expenses, and investment strategies must be stated in the prospectus.[100] A mutual funds' performance is reported by annual and semiannual shareholder reports.[101]

---

[95] 15 U.S.C. §§ 80a-7 to –8.
[96] 15 U.S.C. §§ 77a to 77aa.
[97] Victoria E. Schonfeld and Thomas M. J. Kerwin, *supra* note 61, at 107; I.R.C. § 851 (a).
[98] *See* D*ifference between Mutual Funds and Hedge Funds*, The Investment Company Institute [hereinafter *Difference*] <http://www.ici.org/issues/diff_mutual_hedge_fund.html>
[99] *See Guide, supra* note 61, at 24.
[100] *See Id.*

<u>Other Restrictions</u>

The advertisements and sales materials of mutual funds are restricted by the National Association of Securities Dealers, Inc. (NASD).[102] Mutual funds must have directors who are responsible for extensive oversight of the fund's policies and procedure; at least forty percent of those directors must be independent of the fund's management under Section 10(a) of ICA.[103] The distributors of mutual funds are regulated as broker-dealers under the Securities Exchange Act of 1934 (Exchange Act).[104] In addition, the investment advisers of mutual funds are registered and regulated by the Investment Advisers Act of 1940 (IAA).[105]

Securities Regulation of Hedge Funds

<u>Registration Requirements</u>

Usually, hedge funds in the United States use the exemption provision of ICA to get more flexibility in management.[106] Thus, most hedge funds are "private" investment companies exempted from Section 3 (c) (1) and 3 (c) (7).[107] In order to use the Section 3 (c) (1) exemption, [108] hedge fund securities should not be owned by "more than 100 persons" or use "public offering."[109] Thus, most hedge funds use private offerings and are

---

[101] *See Id.*
[102] *Difference, supra* note 98.
[103] 15 U.S.C. §80a-10(a).
[104] 15 U.S.C. §78o (a) (1).
[105] 15 U.S.C. §80 b-3.
[106] *See The President's Working Group Report, supra* note 16.
[107] *Id.*
[108] 15 U.S.C. § 80 a-3 (c) (1).
[109] *The President's Working Group Report, supra* note 16, at Appendix A.

therefore exempt from registration requirements under Section 4 (2) of the Securities Act[110] or under Regulation D.

Hedge funds are only constrained by "investment agreement" with investors.[111] Before 1996, hedge funds consisted of one general partner and 99 limited investors. Due to the National Securities Market Improvement Act of 1996 (NSMI), the maximum numbers of investor rose from 99 to 500. In addition, hedge funds must sell their securities only to "qualified purchasers" in order to use Section 3(c)(7).[112] The purview of "qualified purchasers" is as follows: "(1) any natural person who owns not less than $5 million in investments, (2) a family-owned company that owns not less $5 million in investments, (3) certain trusts, and (4) any person who owns and invests on a discretionary basis not less than $25 million in investments."[113] Section 3(c)(7) was added to the ICA by the NSMI in 1996.[114] The idea behind Sections 3(c)(1) and 3(c)(7) is that investors in hedge funds are very small in number and have sufficient investment experience for their risk.[115] In other words, there is "no significant public interest."[116]

In order to avoid the "public reporting requirements" of the Securities Exchange Act (Exchange Act), hedge funds must have less than 500 shareholders.[117] Under Section 15(a) of the Securities Act, hedge funds can be excluded from registration as broker-dealers.[118] Hedge funds must also file with the SEC when managers exercise investment

---

[110] 15 U.S.C. § 77 d (2).
[111] *Difference, supra* note 98.
[112] 15 U.S.C. § 80a-3 (c) (7).
[113] *The President's Working Group Report*, *supra* note 16, at Appendix B; *Hearing 2*, *supra* note17 (testimony of Richard R. Lindsey, Director, SEC).
[114] *The President's Working Group Report*, *supra* note 16, at Appendix B; Hal S. Scott and Philip A. Wellons, INTERNATIONAL FINANCE –TRANSACTIONS, POLICY, AND REGULATION 1061 (1999).
[115] *See The President's Working Group Report*, *supra* note 16, at Appendix B.
[116] *See* Joseph R. Fleming, *supra* note 57, at 1184, n 27.
[117] *The President's Working Group Report*, *supra* note 16, at Appendix B.
[118] 15 U.S.C. § 78o(a).

discretion over accounts having more than $100 million in equity securities.[119] Under Section 203(b)(3) of the IAA, fund managers can be exempt from investment adviser registration.[120] Unregulated advisers are regulated by antifraud clause under Section 206 of the IAA.[121]

Other Restrictions

There are also limitations in the redemption and transferability of partnership interests. Due to these facts, hedge funds are illiquid investment entities.[122] Hedge fund investors do not have special government protection because they have sophisticated knowledge of the financial markets.[123]

According to "large trader and large position reporting systems," hedge funds are required to submit reports to SEC when they acquire at least 5% of a publicly traded company's security.[124] The antifraud provisions can regulate hedge funds. Even though hedge funds are not registered under the ICA, they are regulated by the antifraud sections of the Securities Act and the Exchange Act.[125]

Regulation in the Commodity Exchange Act (CEA)

When a hedge fund trades on U.S. Futures and Option Exchanges or has U.S. investors, it must be registered with the Commodity Futures Trading Commission

---

[119] 15 U.S.C. § 78m(f).
[120] 15 U.S.C. § 80b-203(b)(3).
[121] *The President's Working Group Report*, *supra* note 16, Appendix A.
[122] *See* William N. Goetzmann, *supra* note 21; The Task Force on Hedge Funds, *Report on Section 3 (c) (1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchases*, 51 BUS. LAW . 773 (1996).
[123] Congress thought that the hedge funds did not involve "significant public policy issues" and were not properly subject to federal regulation. *See Hearings 1*, *supra* note 4 (statement of John P. Laware, Member, FED); *See Hedge Funds*, *supra* note 70; *See* Steven Scheer, *Hedge Funds Reject Calls for U.S. Govt. Regulations*, REUTERS, Jan. 28, 1999.
[124] 15 U.S.C. § 78m(d).
[125] *The President's Working Group Report*, *supra* note 16, at Appendix A.

(CFTC) as a commodity pool operator (CPO) under the CEA.[126] The hedge fund is also regulated as a CPO by the National Futures Association (NFA). The hedge fund must file its annual financial statements with CFTC and NFA. The hedge fund must provide its investors with copies of annual financial statements and quarterly reporters concerning its NAV as well as maintain books and records, and include all material disclosures in offering memoranda to perspective investors.[127]

Remedies

Hedge funds use "private placement," so only a contract regulates dealings between investors and hedge fund partners except in the case of fraud. Thus, if the problems caused by hedge funds do not belong to the antifraud provision in the Securities Act, investors can only get remedies due to the breach of contract or negligence of trustee.[128]

---

[126] Part 30 of the CFTC's regulations.
[127] *See* The Task Force on Hedge Funds, *supra* note 122.
[128] *See generally* Beverly Chandler, *supra* note 2, at 182-187.

CHAPTER V

DIFFERENCES BETWEEN MUTUAL FUNDS AND HEDGE FUNDS

Regulation

Mutual funds are regulated by the Securities Act, the Exchange Act, the rules of NASD, the ICA, the IAA, and IRC. However, hedge funds are not governed by those regulations.[129]

Investors and Minimum Investment

There are no restrictions regarding sophistication of investors and minimum investment amounts to invest in mutual funds. However, with respect to hedge funds, only sophisticated institutions and wealthy individuals can invest. Additionally, there is a minimum investment of usually $5 million or more for those investing in hedge funds.[130]

Fees

Investors of mutual funds pay an annual fee of approximately 0.24-0.28%, which is based on the fund's net assets. Mutual funds must disclose fees and expenses[131] having regulatory limits.[132] In comparison, there is no limitation on management [133] and performance or incentive fees[134] with respect to hedge funds.[135]

---

[129] *See Difference*, *supra* note 98.
[130] *See Hedge Funds*, *supra* note 70.
[131] Mutual funds' fees and expenses should be disclosed in "a fee table" in the front of the funds' prospectus. *See Guide*, *supra* note 61, at 26.
[132] NASD rules.
[133] Generally, fixed fee: 1-2 percent. William N. Goetzmann, *supra* note 21.
[134] Generally, incentive fee: 10-30 percent, typically 20 percent. *Id.*

Leverage

Securities regulations regulate a mutual funds' ability to leverage and borrow money. The ICA limits the issuance of senior securities as an "asset coverage test," and mutual funds' investments in illiquid assets must be limited to 15 percent of net assets.[136] Additionally, the regulations require disclosure investment policies of mutual funds to investors. However, hedge funds are not subject to restrictions pertaining to leveraging and their policies.[137] Leverage can be restricted "only by the willingness of [the hedge funds'] creditors and counterparties to provide it."[138]In typical hedge funds, a balance-sheet leverage ratio is less than two to one.[139]

Liquidity

Mutual funds must value their daily portfolio and calculate their daily prices. However, there are no restrictions about investors' redemption and no regulations about their portfolio valuation and price calculation with respect to hedge funds.[140]

---

[135] *See Guide, supra* note 61, at 26.
[136] *The President's Working Group Report*, *supra* note 16.
[137] *See Guide, supra* note 61, at 26.
[138] *The President's Working Group Report*, *supra* note 16, at Appendix A.
[139] *See Id.*
[140] *See Guide, supra* note 61, at 26.

Table 1: The difference between hedge funds and mutual funds

	Hedge Funds	Mutual Funds
Regulations	-None	-The Securities Act of 1933 -The Securities Exchange Act of 1934 -The Investment Company Act of 1940 -The Investment Advisers Act of 1940 -The National Association of Securities Dealers, Inc. rules
Investors	-Sophisticated, high net-worth investors (Wealthy individuals or sophisticated financial institutions)	- About 63 million Americans
Minimum investment	-At least $5 million	-$1,000 or less
Fee system and disclosure	-Administrative fee (1-2%) -Incentive fee (20% or more) -no limitation and disclosure on fee system	-Administrative fee(0.24-28%) -Limitation and disclosure on fee system
Leverage	-Often used	-Restriction on leverage and borrowing money
Investment policies	-Do not disclose	-Disclose
Pricing	-No rule on valuation or pricing	-Compute pricing on daily basis
Liquidity	-Restriction on redemption	-Redemption shares on at least daily basis
Antifraud provision	-Applicable	-Applicable
Disclosure	-No disclosure on holdings, performance -Depend on voluntary agreement	-Disclosure on management, holdings, fees and expenses, and performance

Source: data from Investment Company Institute ,http://www.ici.org/issues/diff_mutual_hedge_fund.html.; The Vanguard Group, Inc. <http://www.vanguard.com/cgi-bin/Newprint/908307468>

CHAPTER VI

HEDGE FUND FRAUD AND DEBACLES

Manhattan Investment Fund Fraud Case

Review

On January 18, 2000, the Securities and Exchange Commission (SEC) accused Michael W. Berger,[141] a hedge fund adviser of securities fraud.[142] The SEC also charged Manhattan Investment Fund Ltd. (MIF)[143] and Manhattan Capital Management Inc.[144] Berger established MIF which had a $250,000 minimum investment, a 1 percent management fee, and a 20 percent incentive fee in April 1996.[145] He raised more than $500 million from about 280 investors.[146] Most investors were European banks and institutions, and only eight investors had U.S. addresses.[147]

Berger and MIF had been concealing huge losses since September 1996. They inflated MIF's assets and returns even though MIF lost $300 million by betting against

---

[141] Berger, the general manager and founder, is a 29-year-old Austrian who immigrated to America in the early 1990s.
[142] SEC, *SEC Charges Hedge Fund and Its Adviser With Fraud Emergency Relief Ordered,* Litigation Release No. 16412 (Jan. 19,2000). <http://www.sec.gov/enforce/litigrel/lr16412.htm> Berger, MIF, and Manhattan Capital Management Inc. were charged with "violations of Section 17(a) of the Securities Act of 1933 and Section10 (b) and Rule 10b-5 of the Securities Exchange Act of 1934." In addition, Berger and Manhattan Capital Management Inc. were charged with "violations of Section 206(1) and (2) of the Investment Advisers Act of 1940." *Id.*
[143] An offshore hedge fund organized and managed by Berger and was a British Virgin Islands corporation. Bear Sterns was the fund's clearing broker. Financial Asset Management was the introducing broker. Fund Administration Services (Bermuda) Ltd., an affiliate of Ernst & Young Bermuda, was an administrator.
[144] An offshore hedge fund that operates out of New York. *SEC Investigating Hedge Fund for Possible Misrepresentation,* HOUSTON CHRONICLE, Jan. 19, 2000, at 4.
[145] *Manhattan Investment Fund 'No Malicious Wrongdoing' Claims Berger*, MAR/HEDGE (Jan.17, 2000). <http://www.marhedge.com>
[146] A marketing firm in Paris raised much of the fund's capital from wealthy European investors. *See* Mitchell Pacelle, *Deals & Deal Makers: Hedge Fund Faces Scrutiny in SEC Probe,* WALL ST. J., Jan. 17, 2000, at C17.

high-flying Internet stocks.[148] They paid more money than the real shares' value to investors who wanted to redeem their investments in order to hide MIF's huge losses. Furthermore, Berger informed investors that MIF gained 15 percent in 1996, 30 percent in 1997, 12 percent in 1998, and 14 percent in 1999[149] and had over $427 million in assets as of August 31,1999.[150] In fact, this was untrue: the net market value that day was in fact $27.9 million, and its assets were less than $50 million.[151]

Because Berger thought that market and Internet-related stocks were overvalued, he sold Internet stocks short with hope that those stocks would decline.[152] However, the prices of many Internet stocks increased. Because the losses, $300 million, were huge, he made fake account statements under the name of Financial Asset Management, an introducing broker, even though his clearing broker, Bear Sterns Cos. Inc.(BSC), sent correct account statements.[153] The phony account statements that "materially overstated the performance and value" were provided to his fund's investors, potential investors, the fund's administrator, and the fund's auditor, Deloitte & Touche's Bermuda affiliate.[154]

When Berger sent false information to the auditor, he reprogrammed his fax machine to make it look as though the information had been sent by Financial Asset

---

[147] *SEC Probes Hedge Fund: Manhattan Investment Fund's Profit Reports Subject of SEC Investigation*, CNNFN, Jan. 18, 2000.
[148] *Fund Manager Accused of Fraud; Investment: SEC Says $300 million in Losses on Internet Stocks Was hidden from Investors*, L. A. TIMES, Jan. 19, 2000, at 6 [hereinafter *Fund Manager*].
[149] Mitchell Pacelle, *supra* note 146.
[150] SEC, *supra* note 142.
[151] Mitchell Pacelle, *Deal & Deal Makers: Fund Manager Concocted Fraud, SEC Suit Alleges*, WALL ST. J., Jan. 19, 2000, at C24.
[152] *See Fund Manager, supra* note 148; he felt that many opportunities on the short position. *See* Mitchell Pacelle, *supra* note 146.
[153] Mitchell Pacelle, *supra* note 151.
[154] *See SEC Charges Hedge Fund: Alleges Manhattan Investment Fund Gave False Statements to Investors,* CNNFN, Jan. 19, 2000; Deloitte & Touche resigned recently and withdrew its approval of three years' financial reports from 1996 to 1998.

Management.[155] Even though the administer and the auditor also received accurate information from BSC, Berger advised the fund's administer and auditor to ignore BSC's information because it did not reflect the hedge fund's entire portfolio.[156] The fund was operated as a "Ponzi scheme": old investors who redeemed their shares earlier were paid out more than their share value from capital raised from new investors through Berger's phony statements concerning the performance and value of MIF.[157]

<u>Problem</u>

Berger lied to his investors about MIF's worth: he did not disclose his huge losses by betting Internet-related stocks.[158] This case clearly indicates that MIF did not report its true financial condition to its investors. In addition, due to fake account statements, MIF was able to get more investors. Furthermore, the misrepresentation started in 1996 with the creation of fictitious account statements. Berger misrepresented the fund's financial condition to its independent auditor. The auditor believed Berger's statements without a doubt.

Berger admitted that "there have been substantial losses in the fund over the last few years, and the statements on performance were inaccurate." In addition, he confessed that " I don't expect anyone to like me. I feel bad about the entire situation." However, he did justify his behavior by saying that "I made mistakes, but I haven't stolen anything. The intention of what I did wasn't bad."[159]

In my view, his actions were very harmful because his thoughts did not focus on the notion of trust, transparency, and the protection of investors. Probably, he only

---

[155] *Manhattan Investment Fund*, MAR/HEDGE (Jan.19, 2000). <http://www.marhedge.com>
[156] *Id.*
[157] *Id.*
[158] Mitchell Pacelle, *supra* note 146.

concentrated on making profits without considering good methods. He just wanted to get excellent results with flexible management of money. If he had told the truth to his investors, they would not have invested their money. Berger was aware of that, thus, he did not report the truth to his investors.

According to BSC's statement, BSC noticed Berger's misrepresentation "when an investor contacted [BSC] seeking to verify a reported strong performance for the fund, where [BSC] reports have, for the few years, indicated significant losses."[160] This statement explains that the disclosure and investor protections are problems. It means that investors did not receive the true financial statements from the fund's auditor.

This case also indicates that MIF had problems in "mark-to-market practice" which is used in hedge funds to prohibit the hiding of losses and encourage the proper resolution of problems.[161] In sum, this case demonstrates that the main problems in hedge funds are transparency, disclosure, the role of the independent outside auditor, and an independent regulation system. In order to solve those problems, it is necessary to regulate hedge funds with respect to disclosure and transparency.

---

[159] Jaye Scholl, *Boom! A Bet Against Stocks Blows up Fund,* BARRON'S 27 (Jan. 17, 2000).
[160] *Manhattan Investment Fund*, MAR/HEDGE (Jan.18, 2000). <http://www.marhedge.com>

Hedge Funds Debacles

Askin Capital Management (ACM)

1. Review

In 1994, three hedge funds--Granite Corp., Granite Partners Limited Partnership, and Quartz Hedge Fund--managed by David Askin in New York, with assets of $2 billion, collapsed due to high leverage.[162] Askin lost more than $570 million.[163]

Askin had achieved good returns from his management of two Granite funds (Granite Corp. and Granite Partners) in 1992: 21.8 percent in Granite Corp. and 21.15 percent in Granite Partners.[164] After that, he established ACM in January 1993 and acquired Granite Corp. and Granite Partners.[165] He offered a "market-neutral" investment strategy that made him attractive to sophisticated investors in Wall Street and Europe.[166] He wanted to get at least 15 percent annual return [167]according to one private placement memorandum.[168]

However, he did not follow the strategy and appeared over-leveraged and underhedged.[169] He borrowed $2.50 per dollar that he invested in his funds [170] in order to

---

[161] *See The President's Working Group Report*, *supra* note 16.
[162] Saul Hansell, *Investment Funds are Liquidated*, N.Y. TIMES, April 1, 1994, at D1 ; "Lehman Government Securities Inc. accused four of failing to meet a series of margin calls after sharp losses, totaling $6.6million, by the Askin funds." Michael Siconolfi, *Tumble in Mortgage Securities Sparks Lawsuit,* WALL ST. J., April 8, 1994, at C1.
[163] Jack Willoughby, *Askin Examiner Will Study Street's Role in Collapse*, INVESTMENT DEALERS' DIGEST 8 (July 25, 1994).
[164] Barry B. Burr, *Firm Targets Mortgage Securities,* PENSIONS & INVESTMENTS, 30 (Feb. 22, 1993).
[165] *Id.*
[166] Jaye Scholl, *How Did Askin Really Collapse?* BARRON'S 20 (May 9, 1994).
[167] *See* Barry B. Burr, *supra* note 164.
[168] *See* Jack Willoughby, *Askin Fund Assessor: Granite Appeared Unhedged, Over-Leveraged,* INVESTMENT DEALERS' DIGEST 8 (May 23, 1994).
[169] *Id.*
[170] *Hearings 1*, *supra* note 4 (testimony of Arthur Levitt, Chairman, SEC) ; Because of this failure, SEC and the President's Working Group on Financial Markets reviewed the structure and activity of hedge funds and released a report, "An Assessment of Developments with Potential Implications for Market Price Dynamics and Systemic Risk." *Hearing 2*, *supra* note 17 (testimony of Richard R. Lindsey, Director, SEC).

enhance the investments' returns.[171] He leveraged approximately $2 billion with $600 million.[172] Because of increasing interest rates, he cleared his funds through "fire sales" on March 31, 1994.[173] His funds' losses were increased by the high leverage.[174]

After two brokerage firms, the funds' debtors, filed lawsuits on April 7, 1994, he submitted "Chapter 11 bankruptcy."[175] In a six-week period, he had huge losses of 35% ($165 million of $470 million of capital).[176] His instrument was "risk-balanced mortgage-backed securities which consisted of being long interest-only (IOs) and long principal-only strips (POs),"[177] and he gained great profits for four years without fault.[178]

His funds' debacle came from an investment strategy which did not fit increasing interest rates, and he was confronted with "the liquidity squeeze" because he could not satisfy margin calls for his leverage positions.[179] In other words, because his funds' value dropped within fast a few months, he sold off fund holdings at a loss to satisfy margin calls.[180] Because of that, he could not recover his losses. He concealed the actual losses of Granite Partners to his investors in February 1994 in order to escape redemption.[181]

Because of ACM's collapse, some investment banks which had financed his mortgage derivatives trades had severe losses: for example, the financial exposure of

---

[171] Jaye Scholl, *supra* note 166. This news also handled investors' difficulties in appointing an examiner instead of a trustee to investigate funds' history from April 1993 to March 28, 1994; the U.S. Bankruptcy court appointed Goldin as a trustee to compromise "between Askin and his investors on one side, and the Wall Street firms." Jaye Scholl, *Goldin Compromise,* BARRON'S 14 (June 6, 1994).
[172] *Id.*
[173] Saul Hansell, *supra* note 162; Brett D. Fromson, *Hedge' Fund Falls Victim to Downturn,* WASH. POST, April 1, 1994, at F8.
[174] *See* Paul G. Barr, *Firms Profit from Askin Fallout*, PENSIONS & INVESTMENTS 3 (May 2, 1994).
[175] Saul Hansell, *Facing Suits, Askin Funds Seek Chapter 11 Protection,* N. Y. TIMES, April 8, 1994, at D2; Philipp Cottier, *supra* note 22, at 50-51.
[176] Laura Jereski, *Cracks Appear in Granite Partners Fund*, WALL ST. J., Mar. 30, 1994, at C1.
[177] Philipp Cottier, *supra* note 22, at 50-51.
[178] *Id.*
[179] *Id.*
[180] *Hearings 1*, *supra* note 4 (testimony of Arthur Levitt, Chairman, SEC)

Kidder, Peabody Group Inc.[182] to ACM was about $200 million.[183] Securities firms had a "symbiotic relationship" with ACM, which means that Askin was "a leading buyer of Wall Street's 'nuclear waste'" to give some benefits to securities firms, and because of that, he received some help from the firms in inflating returns to his investors early in 1994.[184] The creditors of the Granite Partners Funds were Kidder Peabody, Lehman Brothers, Donaldson Lufkin Jenrette, Morgan Stanley, Merill Lynch, Nomura Securities, Salomon Brothers, Smith Barney, and UBS Securities.[185]

On May 23, 1995, Askin accepted SEC charges of engaging in misleading and fraudulent conduct to his investors, and agreed to a two-year suspension from securities industry and a fine , which would be placed in escrow to compensate former clients of ACM.[186]

<u>2. Problem</u>

In the ACM case, Askin promised investors that he would keep liquidity high and portfolio leverage low by buying only high-quality mortgage securities that had been thoroughly analyzed. However, he broke his promises.[187] In addition, he concealed the

---

[181] *See* The actual loss was 21.89 percent in Feb. 1994, but he disclosed that the loss was 1.5 percent that month. *See* Laura Jereski, *supra* note 176.

[182] "The biggest player in the mortgage-backed securities (MBS) area and the one with the largest collaterized mortgage obligation (CMO) inventory." Elisa Herr, *Revaluation of MBS Holdings Leaves Pain and Opportunity,* INVESTMENT DEALERS' DIGEST 15 (Apr. 25, 1994).

[183] Michael Siconolfi, *Kidder Discloses Scam in Bonds, Fires Top Trader --- It Sets $350 Million Charge, Says Scheme Involved Government-Strip Deals*, WALL ST. J., April 18, 1994, at A3; Michael Siconolfi, *Kidder Had Major Exposure in Collapse of Askin, Jett Is Said to Have Told U.S.* WALL ST. J., July 27, 1994, B2; Marion Merill Dow had $11million loss and sued ACM that had allegedly mismanaged Marison's derivative contracts. Donna Rosato, *Trading Losses Take Toll*, B2, USA TODAY, Apr. 28, 1994, at B2.

[184] Gary Weiss, *The $700 Million Mystery*, BUSINESS WEEK 76 (Dec. 18, 1995).

[185] Jack Willoughby, *supra* note 163.

[186] Kenneth N. Gilpin, *Founder of Askin Capital Agrees to Settlement of SEC Charges*, N. Y. TIMES, May 24, 1995, at D8; Laura Jereski, *David Askin Settles SEC Proceedings Accusing Him of Fraudulent Conduct*, WALL ST. J., May 24, 1995, at B5.

[187] Jack Willoughby, *Investors in Askin Funds Sue Street for $700 Mil*, INVESTMENT DEALERS' DIGEST 3 (April 1, 1996).

actual losses to investors. This case indicates the importance of transparency, risk management, and investor protection. In particular, high leverage was the main reason for this debacle.

Argonaut Capital Management (ARCM)

1. Review

The value of ARCM in New York went down 28 percent between January and July of 1994.[188] ARCM was managed by David Gerstenharber and Barry Bausano, former managers of Tiger Management (Tiger): Gerstenharber was "an economist by training," and Bausano was "an [executor] of Gerstenhaber's concepts" at Tiger.[189] They made good returns: 45 percent in 1991, 23 percent in 1992, and 61 percent in 1993.[190]

ARCM raised an investment of $400 million within just a few weeks in the summer of 1993 despite having a 2 percent management fee (compared with a 1 percent in most hedeg funds), a 20 percent incentive fee, and a $5 million minimum investment.[191] But, ARCM lost $110 million in 1994 from the initial $400 million invested, and investors withdrew approximately $225 million and left $65 million in ARCM.[192] After Bausano left ARCM, Gerstenhaber managed ARCM with $50 million[193] (returning 31.5 percent gains to his U.S. investors and 65.1 percent gains to offshore investors in 1996), and at last, he joined in Soros Fund Management.[194]

---

[188] Philipp Cottier, *supra* note 22, at 51-52.
[189] Laura Jereski, *Argonaut Hedge Fund Loses Its Luster; One Founder Resigns as Losses Mount*, WALL ST. J., Aug.11,1994, at A.
[190] Stephen Taub, *The Hedge Rows of Wall Street*, FINANCIAL WORLD 38 (Sept. 13, 1994).
[191] Laura Jereski, *supra* note 189.
[192] *Id* ; Philipp Cottier, *supra* note 22, at 51-52 ; Stephen Taub, *supra* note 190; Laura Jereski, *Argonaut Fund Capital Shrinks after Big Losses*, WALL ST. J., Aug. 17, 1994, at C.
[193] Caroline, Waxler, *Oil's Well*, FORBES 202 (Feb. 10, 1997).

2. Problem

In this case, there was no breach of contract, but we can see the importance of risk management because ARCM had huge losses within a short period.

Vairocana Ltd.

1. Review

David de Jongh Weill[195] managed Vajra Fund, Dorje Fund, and some managed accounts in London.[196] He managed these funds excellently for six years with good records, averaging 36 percent annual gains.[197] In particular, while he was managing $1.2 billion in 1993, he returned 63 percent profit to investors compared to about 55 percent in 1992.[198] The funds' assets grew to $75 billion at the end of 1993, compared to $200 million at the end of 1992.[199]

He and his wife, an ex-options trader, managed the fund with his eight staff.[200] His original strategy of investment was "interest rate neutral yield-curve arbitrage strategies with European bonds."[201] He, however, changed investment strategy without giving notice to his investors and had stated betting on European interest rates with a 10 to 1

---

[194] Robert Bonte-Friedheim and Laura Jereski, *Hedge-Fund Group of George Soros Hires Gerstenhaber*, WALL ST. J., Oct. 2, 1997, B19.
[195] He was born in Atlanta and is an ardent Buddhist and 36 years old. Vairocana is Sanskrit for "the great conqueror," and Dorje is "thunderbolt" in Tibetan. While he studied at the University of Georgia, he also learned "volatile interest- rate futures on an almost –daily basis" on an account at Merrill Lynch. Laura Jereski, *The Wrong Stuff: Good Connections Put Hedge Fund in Business But a Bad Bet Sank It --- Manager David Weill, Suave and Impressive, Drew in Europe's Wealthy Class --- Adieu to a Gilded World*, WALL ST. J., Sept. 28, 1994, at A1.
[196] Philipp Cottier, *supra* note 22, at 52
[197] Laura Jereski, *supra* note 195.
[198] *Id.*
[199] *Id.*
[200] *Id.*
[201] Philipp Cottier, *supra* note 22, at 52.

leverage.[202] Initially, he achieved large gains through huge leverage, but over a few months in 1994, he lost $700 million from his initial investment of $1.2 billion, i.e., in a seven months, he lost 60 percent of the initial investment (he lost 20 percent just in August).[203]

His investors could not receive a correct Net Asset Value (NAV) because his investment position was too complex to calculate it.[204]His investors withdrew their investments from the fund; thus, he disposed of all remaining positions and cleared the two funds.[205] He also concealed his losses from his investors: he reported on May 27, 1994 that he had lost 3 percent for the month.[206] However, a few days later, the auditor found a 17 percent decline during May. Furthermore, he charged his year-end bonus on the basis of on the valuation of March 31, 1994.[207]

2. Problem

This case indicates the risk of high leverage in the financial market. In addition, there was a lack of disclosure to investors.

Fenchurch Capital Management (FCM)[208]

1. Review

FCM, a subsidiary of United Kingdom investment bank Kleinwort Benson and a commodity-trading adviser and investment-fund operator, was organized in Chicago in 1985.[209] The Fenchurch Gamma fund (Gamma fund), a listing fund on the Dublin stock exchange, gained 23 percent annual returns in 1985 and for a five-year period continued

---

[202] *Id.*
[203] *Id*; Laura Jereski, *supra* note 195.
[204] Philipp Cottier, *supra* note 22, at 52.
[205] *Id.*
[206] Laura Jereski, *supra* note 195.
[207] *Id.*

to be the highest-performing.[210] Marcus A. Hutchins, a president and chief trader of FCM, returned 17 percent profits to his investors for 1992 with $111 million under management.[211]

In 1994, FCM managed $650 million with leverages of up to approximately $30 billion in arbitrage positions and earned 15 percent in the first eight months of 1994 with "relative value trades" in the fixed-income instruments.[212] Investors were insurance companies, non-U.S. banks, pension funds, wealthy individuals, and fund of funds managers.[213]

At the beginning of 1995, FCM managed $700 million in the Gamma fund and in Fenchurch Beta Fund Limited Partnership (Beta fund), having increased from $350 million in 1994 and $150 million in 1993.[214] Thus, FCM was one of the fastest-growing American hedge funds from 1992 to 1994.[215]

On June 1, 1995, Marcus Hutchins reported to investors that FCM fell 11.5 percent in May. FCM dropped about seven percent in one day of September 1995, declined 22 percent within that month, and was down during nine months in 1995.[216] Gamma fund and Beta fund declined 41 percent between March and November 1995[217]

---

[208] Philipp Cottier, *supra* note 22, at 52-53.
[209] Miriam Bensman, *Psst, We're Market-Neutral*, INSTITUTIONAL INVESTOR 37 (Jan. 1995).
[210] *Id.*
[211] Ginger Szala, *Fenchurch Spreads Profits as Other Managers Retrench*, FUTURES 58 (July 1992).
[212] *Defying the Odds*, FORTUNE 84 (Oct. 17, 1994); Miriam Bensman, *supra* note 209.
[213] *Id.*
[214] Andrew Bary, *Trading Points: Floating Like a Butterfly, Fund Gets Stung By a Bee*, BARRON'S MW12 (June 26, 1995).
[215] *Id.*
[216] Robert Bonte-Friedheim and Michael R. Robert, *Fenchurch's Highflying Chief Crashes as Its Global-Bond Funds Take a Dive*, WALL ST. J., Nov. 6, 1995, at A; Michael R. Sesit, *Despite '95 Rally in Global Bond Markets, Many Traders Aren't Reaping Rewards*, WALL ST. J., Nov. 13, 1995, at C1.
[217] Philipp Cottier, *supra* note 22, at 52.

because they had huge losses in "a German yield-curve trade and a German-French interest-rate arbitrage."[218]

FCM lost $1,264 million within eight months of that year. Because investors pulled out their money, the total assets of FCM decreased from $1.403 billion to $139 million within eight months[219] and dropped to only about $75million in 1996.[220] In particular, the manager of the fund changed the hedge fund strategy without notifying the investors.[221]

2. Problem

In this case, there were several problems: high leverage, lack of disclosure, and lack of investor protection.

Comments

Table 2 shows common problems of hedge funds such as lack of disclosure, high leverage, and change of investment strategy without notice. With respect to disclosure, MIF made phony account statements, and ACM and Vairocana both concealed the real losses to their investors. FCM did not disclose its change in investment strategy to its investors. Those facts indicated that there is problem in disclosure and in investor protection. ACM, Vairocana, and FCM used high leverage, which amplified their losses. On the other hand, huge losses in hedge funds occurred quickly over a few months. This means that even if a hedge fund was returning good profits, it could suffer a huge loss

[218] Andrew Bary, *Trading Points: After Some Good Years, Euro Bond Market Batters Some Big Investors*, BARRON'S MW12 (Oct.2, 1995).
[219] Philipp Cottier, *supra* note 22, at 52-53.
[220] Andrew Bary, *Trading Points: Fenchurch Affair: Trouble for the Repo Market?* BARRON'S MW11 (July 15, 1996).
[221] *Id.*

within short period of time. In short, compounding the problem, there were disclosure problems for investors, and the funds were too highly leveraged.

Table 2: Hedge funds' fraud and debacles (M: Million)

	MIF	ACM	ARCM	Vairocana	FCM
Principals	Michael W. Berger	David Askin	Gerstenharber / Bausano	David de Jongh Weill	Marcus A. Hutchins
Main Office	New York	New York	New York	London	Chicago
Losses	\$300M	\$570M	\$110M	\$700M	\$1,264M
Disclosure	Made phony account statements	Concealed the actual losses	-	Concealed the actual losses	Did not disclose strategy change
Leverage	-	High leverage	-	High leverage	High leverage
Investment strategy	-	Market-neutral Did not follow the strategy	-	Interest-rate neutral yield curve	-

Source: data from the summary of this chapter.

CHAPTER VII

LONG-TERM CAPITAL MANAGEMENT EPISODE

Review

Establishment

LTCM was started with $1.01 billion capital in February 1994 by former Salomon Brothers' vice president John Meriweather and other partners, including two Nobel prize winners, Myron Sholes and Robert Merton, and U.S. Federal Reserve former vice-chairman David Mullins.[222] In particular, it was managed by 25 Ph.D.s.[223] LTCM was a "Delaware limited partnership" whose main office was located in Connecticut.[224]

However, the name "Long-Term" which translates into "patience" or "patiently trading"[225] does not match the characteristics of hedge funds because they usually take "short-term investment strategies."[226]

Structure and Development

LTCM was one of the biggest hedge funds in the world[227] due to "its assemblage of talent in pricing and trading financial instruments" and "its large initial capital

---

[222] Nicholas Dunbar, INVESTING MONEY- THE STORY LONG-TERM CAPITAL MANAGEMENT AND THE LEGENDS BEHIND IT xi-xii (2000); David Mullins joined in summer and was not partner at the outset. Merrill Lynch & Co., *Long-Term Capital, L.P., Private Placement of Limited Partnership Interests*, 1, 16-17 (Oct. 1, 1993).

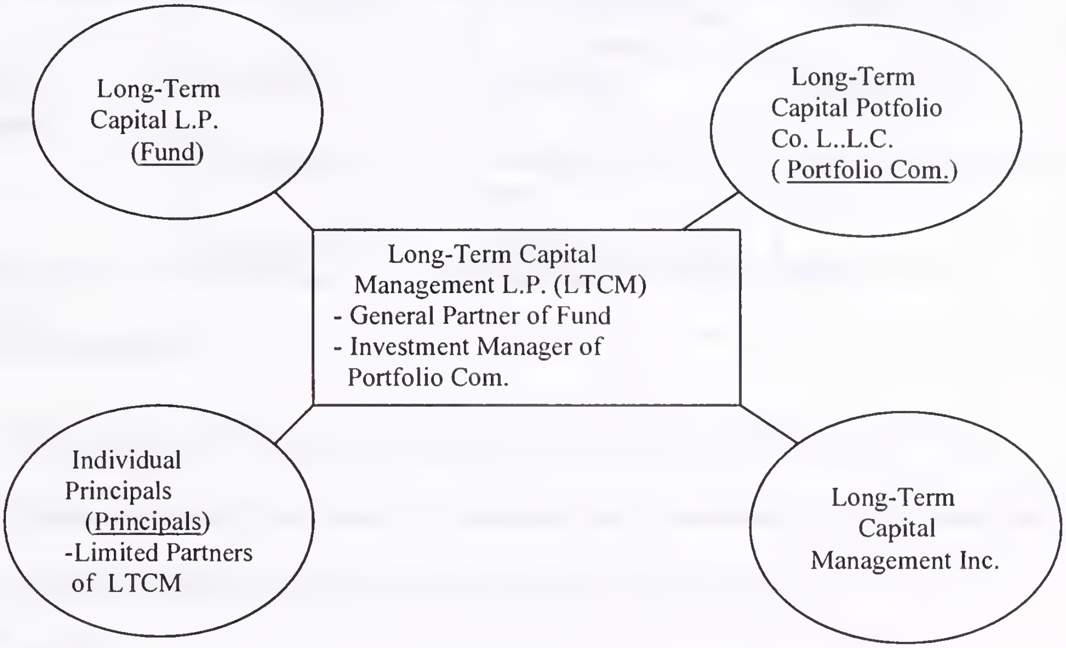
[223] Michael Siconolfi et al., *All Bets are off: How the Salesmanship and Brainpower Failed at Long - Term Capital*, WALL ST. J., Nov. 16, 1998, at A1.

[224] (1) Fund was a newly formed Delaware Limited Partnership. (2) Portfolio com. was a newly formed Delaware Limited Liability Company. (3) Long-Term Capital Mangement Inc. was a Delaware Corporation. Merrill Lynch & Co., *supra* note 222, at 1, 3; In the Report of The President's Working Group on Financial markets, Long-Term Capital Portfolio L.P. was a Cayman Islands partnership. *But see The President's Working Group Report*, *supra* note 16 ; *But see* Nicholas Dunbar, *supra* note 217, at 126.

[225] *Living large*, GRANT'S INTEREST RATE OBSERVER (Nov. 5, 1993). <http://wysiwyg://4/http://www.grantspub.com/dispatch/0001.html>

stake."[228] It raised its capital with "a private offering of limited partnership interests" through its placement agent, Merrill Lynch & Co.[229] Figure 1 shows the structure of LTCM.

Figure 1: LTCM Structure



Source: data from Merrill Lynch & Co., Long-Term Capital, L.P., Private Placement of Limited Partnership Interests, 1 (Oct. 1, 1993).

Its investment strategy was to get gains from "discrepancies in the relative value of government bonds, fixed-income derivatives, equities and equity derivatives primarily in the U.S., Japanese, and European markets."[230]

[226] *The President's Working Group Report*, *supra* note 16, at Appendix A; LTCM was the largest hedge funds by asset size in 1996. Beverly Chandler, *supra* note 2, at 126.
[227] *See* Philipp Cottier, *supra* note 22, at 26, Table 2-4.
[228] *Hearings 1*, *supra* note 4 (statement of Alan Greenspan, Chairman, FED).
[229] *See* Merrill Lynch & Co., *supra* note 222.
[230] *Outlook Dec. 1998, supra* note 18, at III, 54, Box 3.4.

Table 3 shows that LTCM was a unique hedge fund in the industry: (1) it had a three-year redemption restriction; (2) its high minimum investment was $10 million; and (3) it had a 2 percent annual management fee on the assets basis and a 25 percent performance fee on the profits basis.[231]

Table 3: Comparison between LTCM, Common Hedge funds, and Mutual Funds

	LTCM	Common Hedge Funds	Mutual Funds
Minimum investment	$10 million	$5 million	$1,000 or less
Fees	Administrative :2% Incentive: 25%	Administrative:1~1.5% Incentive :15~25%	Administrative:1.24%
Restriction on redemption	Three years	Quarterly or Yearly	Daily

Source: data from summary.

LTCM wanted to "[suck] up nickels from all over the world" but failed.[232]In addition, Scholes answered with pride to a question from a potential LTCM investor that "[a]s long as there continue to be people like you, [it will] make money."[233]

Near Bankruptcy

LTCM returned about $2.7 billion to its investors at the end of 1997, made its capital $ 4.8 billion, but did not reduce its leverage size.[234] LTCM managed about $120 billion in balance sheet positions. Its leverage ratio was 25-times its capital[235]but later

[231] Michael Siconolfi et al., *supra* note 223; Merrill Lynch & Co., *supra* note 222, at 2, 4-5.
[232] Michael Siconolfi et al., *Id.*
[233] *Id.*
[234] *The President's Working Group Report*, *supra* note 16, at Appendix A.
[235] *Outlook Dec. 1998, supra* note 18, at III, 54, Box 3.4; *But see* Meriwether insisted that "LTCM's leverage was not excessive." Nicholas Dunbar, *supra* note 222, at 226.

became 100 times its capital due to LTCM's decline.[236] LTCM had "a notional value" of about $1.25 trillion-1,000 times its capital-in derivatives positions.[237]

Huge losses were incurred during August and September 1998.[238] According to Meriwether's letter to his investors on September 2, 1998, LTCM had $2.5 billion in losses.[239] In particular, the $2.1 billion losses happened only in August.[240] LTCM's capital was $4.1 billion on August 1, 1998 and $2.3 billion by September 1, 1998 (the leverage ratio became 50 times its capital).[241] After 16 days, its capital dropped to $1.5billion and at last fell to $600 million (the leverage ratio became 167 times its capital) on September 23, 1998.[242] LTCM lost 90 percent of its equity within only 55 days.[243]

These enormous losses could possibly have disrupted or weakened the international financial market,[244]i.e., the meltdown of LTCM could have caused "a global systemic crisis that could [have harmed] financial institutions and investors worldwide, given the size and extent of [its] positions."[245] For this reason, FRBNY intervened to solve the problem even though LTCM was a private limited partnership.[246]

---

[236] Brooksley Born, *Regulatory Responses to Risks in the OTC Derivatives Market*, Comm. on Federal Regulation of Securities ABA Section of Business Law (Nov. 13, 1998) <http://www.cftc.gov/opa/speeches/born-40.htm>
[237] *Id.*
[238] *Hearings 2*, *supra* note 17 (testimony of Richard R. Lindsey, Director, SEC).
[239] David Shirreff, *Lessons From the Collapse of Hedge Fund, Long-Term Capital Management* (IFCI). <http://www.risk.ifci.ch/146520.html>
[240] *Id.*
[241] Steve Mufson, *Fund's Big Betters Learned That Risk Trumps Math, History*, WASH. POST, Sept. 27, 1998, at H01; *Outlook Dec. 1998, supra* note 18, at III, 55, Box 3.4.
[242] Steve Mufson, *Id*; *Outlook Dec. 1998 Id.*
[243] Steve Mufson, *Id*; *Outlook Dec. 1998 Id.*
[244] *See Hearings 3*, *supra* note 10 (testimony of Brooksley Born, Chairperson, CFTC); *See Outlook Dec. 1998, supra* note 18, at III, 54, Box 3.4.
[245] Thomas A. Russo and Marlisa Vinciguerra, *Regulation in the Wake of Long-Term Capital's Rescue*, 11 FUTURES & DERIVATIVES L. REP. (Feb. 1999).
[246] One general partner has unlimited liability, and multiple limited partners have limited liability. Phillipp Cottier, *supra* note 22, at 56, 60.

became 100 times its capital due to LTCM's decline.[236] LTCM's [illegible]

about $1.25 trillion-1,000 times its capital-in derivatives [illegible]

Huge losses were incurred during August and [illegible]

Meriwether's letter to his investors [illegible]

losses.[238] In particular, the $2.3 billion [illegible]

capital was $4.1 billion on August [illegible]

leverage ratio became 50 times its capital.[239] [illegible]

$1.5 billion and a hundred [illegible]

capital) on September 23, 1998 [illegible]

date.[240]

These comments [illegible]

international financial markets.[241] [illegible]

systemic [illegible]

given the [illegible]

solve the problems [illegible]

---

[236] Roundtable Hears [illegible] Regulation of [illegible] http://www.[illegible]

[237] Id.

[238] Hearing [illegible]

[239] David Siegel [illegible] http://www.[illegible]

[240] Id.

[241] Steve Mufson, [illegible] 1998, at D1 [illegible]

[242] Steve Mufson, Id. [illegible]

[243] Steve Mufson, Id. [illegible]

[244] See Hearings [illegible] supra note [illegible] 1998, supra note 19, at [illegible]

[245] Thomas A. Russo and Marlisa Vinciguerra, [illegible] FUTURES & DERIVATIVES L. REP. [illegible]

[246] One general partner has unlimited liability [illegible] Castor, supra note 22, at 36, [illegible]

Rescue Plan

On September 28, 1998, a \$3.6 billion bailout package of LTCM was planned by a consortium of fourteen major international financial institutions including global commercial and investment banks which were LTCM's counterparties, creditors, and investors. [247] The rescue package was as follows: (1) eleven institutions[248] took equity stakes of \$300 million in LTCM; (2) two institutions[249] took stakes of \$125 million; and (3) one institution [250] took a stake of \$100 million. Furthermore, Union Bank of Switzerland (UBS) wrote down its original equity stake in LTCM of \$685 million.[251] Through a bailout plan, the consortium owned 90 percent equity in LTCM.[252]

After the bailout of LTCM, those institutions had a hard time. In October 1998, the stock price of Merrill Lynch fell 75 percent, compared to the beginning price of 1998.[253] Goldman Sachs postponed its IPO.[254] The stock price of Lehman Brothers declined 60 percent, and, as a result, the company suffered from bankruptcy rumors.[255]

In December 1999, after LTCM repaid its consortium members, LTCM was closed.[256] However, some investors still have losses.[257]

---

[247] They are creditors of LTCM, and some of them are LTCM's swaps counterparties. *Hearings 2*, *supra* note 17 (testimony of Brooksley Born, Chairperson, CFTC).
[248] Banker's Trust, Barclays, Chase Manhattan, Credit Suisse, First Boston, Deutsche Bank, J.P. Morgan, Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter, Travelers, and Union Bank of Switzerland.
[249] Societe Generale and Lehman Brothers.
[250] Paribas
[251] *Outlook Dec. 1998, supra* note 18, at III, 54, Box 3.4.
[252] *Hearings 1*, *supra* note 4 (testimony of Richard R. Lindsey, Director, SEC)
[253] Nicholas Dunbar, *supra* note 222, at 225.
[254] *Id.*
[255] *Id.*
[256] *Trillion Dollar Bet*, PBS TV(Feb 8. 2000) [hereinafter *Trillion Dollar Bet*]. <http://www.pbs.org/wgbh/nova/transcripts>
[257] *Id.*

The Failure of Economic Genius

The LTCM episode indicated again the failure case of "economic genius" in the financial world,[258] which means there were gaps between the academic field and the real business field.

> The LTCM episode is not the first time that economic genius has tripped over market reality. Irving Fisher, the great American economist, managed Yale's endowment portfolio in the 1920s and is said to have lost much of it in the crash of 1929. In the early 1920s, John Maynard Keynes lost his wealth speculating in foreign exchange, and was saved from bankruptcy by family and friends. [259]

The UBS Fiasco

UBS, the biggest loser, wrote off $685 million in LTCM.[260] The transaction system between UBS and LTCM was as follows: (1) in June, August, and October 1997, UBS sold "the right to the managers of [LTCM] to buy from UBS a fixed number of shares" in LTCM[261]; (2) the seven-year European call option could be operated in 2004; (3) in order to hedge its position, UBS bought shares in LTCM to the value of $800 million; and (4) additionally, UBS invested $266 million in LTCM.[262]

Due to the good returns of LTCM, UBS risk managers never considered the possibility of a collapse of LTCM which would have left them with a large degree of exposure.[263] Because of this failure, the chairman of UBS Board of Directors resigned. Throughout 1997, UBS discussed with the partners of LTCM a structured transaction

---

[258] *See* George H. Borts, *Building a Better Hedge Fund* (Brown University Faculty Governance). <http://facgov.brown.edu/facgov/facbulletin/March99Issue/borts.html>
[259] *Id.*
[260] David Shirreff, *supra* note 239.
[261] UBS, *The LTCM Dealing* (UBS news) <http:// www.ubs.com/e/index.htm>; David Shirreff, *Id.*
[262] UBS, *Id*; David Shirreff, *Id*; Scholes devised this transaction. Michael Siconolfi et al., *supra* note 223.
[263] *See* David Shirreff, *supra* note 239.

together with an investment in the shares of the fund. UBS had been interested in acquiring a stake in LTCM.

LTCM was seen by the investment community as a successful and well managed fund which had consistently produced outstanding returns for its investors. UBS and LTCM agreed to enter into a series of transactions on the understanding that a proprietary investment in the fund could be made by UBS. There were two restrictions to the overall transaction. Investors in LTCM were required to commit to an initial investment period of three years. Additionally, restrictions were imposed by the managers on the hedged shares. This made UBS' investment extremely sensitive to a drop in the value of the fund. Losses by the fund left UBS with a significant writedown in its LTCM investments. In sum, UBS Chief Executive Officer confessed in a disclosure that " [a]t no time was this structure justifiable from a risk/return perspective."[264]

In particular, Switzerland's Federal Banking Commission (SFBC) examined UBS' Global Equity Derivatives Business unit.[265]After that, the SFBC ordered UBS to "take organizational actions with respect to internal controls."[266] After the LTCM was already near-bankruptcy, however, UBS disclosed the huge losses.[267] If SFBC had investigated more carefully, the huge losses of UBS would have been reduced or escaped.

---

[264] Nicholas Dunbar, *supra* note 222, at 226.
[265] *Hearing 1*, *supra* note 4 (written testimony of Henry T. C. Hu, Professor of Law, University of Texas).
[266] *Id.*
[267] *Id.*

Other Losers

Due to LTCM's near bankruptcy, its investors also had losses like its counterparties. Table 4 shows other losers and their losses. In particular, St. Jones University Endowment Fund and University of Pittsburgh invested in the LTCM.

Table 4: Investors and losses (M: Million)

Name	Amount(USD)	Notes
Liechtenstein Global Trust	30 M	
Bank of Italy	100M	
Credit Suisse	55M	
UBS	685M	
Merrill Lynch	22M	Employees' deferred payment
Donal Marron	10M	Chairman of Paine Webber
Sandy Weill	10M	Co-CEO Citicorp
Mckinsey executives	10M	
Bear Sterns executives	20M	
Dresdner Bank	145M	
Sumitomo Bank	100M	
Prudential Life Corp.	5.43M	
Bank Julius Baer	N.R.(Not Reported)	Clients' investment
Republic National Bank	N.R.	
St. Johns University Endowment Fund	N.R.	
University of Pittsburgh	N.R.	
LTCM partners	1,100M	1,500M at the beginning of 1998, offset by their $400M stake in the rescued fund

Source : The International Finance and Commodities Institute <http://www.risk.ific.ch/146520.html>

Problems

Unsound Practices

Lending institutions' credit risk management and their decision making were faulty in the LTCM case.[268] Those lending institutions[269] should have been aware of the risk of their loan to hedge funds. LTCM partners consisted of famous experts in the financial markets. Because of its partners' reputation, [270] it became an unusually large hedge fund through excessive leverage:[271] many international institutions willingly lent to LTCM.[272]

On the other hand, institutions usually have derivatives contracts with hedge funds. If hedge funds fail to perform the contracts, institutions face a counterparty risk.[273] In the LTCM debacle, that problem arose. LTCM often used unlimited borrowing power in the OTC derivatives market, borrowing as much as 1,300 times its capital.[274]

---

[268] "Good judgment" is one issue in LTCM. *Hearings 3*, *supra* note 10 (statement of William J. Mcdough, President, FRBNY).

[269] The examples of banking services to hedge funds are as follows: (1) Direct lending, secured and unsecured; (2) Lines of credit for foreign exchange, derivatives, fixed income securities, precious metals, and emerging markets trading; (3) Lines of credit for government securities repurchase agreements; (4) Standby letters of credit; (5) Payment services for foreign exchange trading; (6) Custodial services; (7) Securities clearance; (8) Brokerage services for execution and clearing of trades; and (9) cash management services. Franklin R. Edwards, *supra* note 21, at 190-91; *Hearings 2*, *supra* note 17 (testimony of Julie L. Williams, Acting Comptroller, OCC).

[270] "Creditors' normal risk management standards were compromised" as a result of "placing too much reliance on assumed financial strength and reputation . . .." *Hearings 3*, *supra* note 10 (testimony of Leon M. Metzger).

[271] LTCM was very a unique hedge fund because of great leverage and capital. *Hearings 3*, *supra* note 10 (testimony of Leon M. Metzger).

[272] *See Hearings 2*, *supra* note 17 (statement of William J. Mcdough, President, FRBNY), (testimony of Julie L. Williams, Acting Comptroller, OCC).

[273] *See Hearings 2*, *supra* note 17 (statement of Donna Tanoue, Chairman, Federal Deposit Insurance Corp.) ; Chase Manhattan Corp. disclosed $3.2 billion of its total loan portfolio which is exposed to hedge funds. *Fed Chief Defends Bailout*, CNNFN, Oct. 1, 1998.

[274] CFTC chairperson compared this unlimited borrowing in the OTC derivatives market to the unlimited borrowing on securities that contributed to the Great Depression. *Hearings 2*, *supra* note 17 (testimony of Brooksley Born, Chairperson, CFTC).

Problems

Unsound Practices

Lending institutions' credit risk management [illegible]

fically in the LTCM case.[266] These lending institutions[267] [illegible]

risk of their loan to hedge funds. LTCM [illegible]

financial markets. Because of [illegible] reputation [illegible]

hedge fund through excessively [illegible]

LTCM.[270]

On the other hand, [illegible]

funds. If hedge funds [illegible]

risk.[271] In the LTCM episode, [illegible]

power to the OTC derivatives [illegible]

---

[266] "Good [illegible] President, FRBNY [illegible]

[267] The examples [illegible] unsecured (2) [illegible] and emerging [illegible] Stanley [illegible] Securities [illegible] services. Franklin R. Edwards [illegible] Williams, Acting Comptroller, OCC).

[269] "Creditors' normal risk management [illegible] reliance on assumed [illegible] M. Metzger).

[270] LTCM was very [illegible] hedge fund [illegible] (testimony of Leon M. Metzger).

[271] See Hearings [illegible] supra note [illegible] (statement of [illegible] Julie L. Williams, Acting Comptroller, OCC).

[273] See Hearings 2, supra note [illegible] (statement of [illegible] Corp.); Chase Manhattan Corp. disclosed $5. [illegible] funds. Fed Chief Defends Bailout, CNNfn, Oct. 1, 1998.

[274] CFTC chairperson compared the unlimited borrowing [illegible] borrowing on securities that contributed to the Great Depression [illegible] Brooksley Born, Chairperson, CFTC).

Co-chairman of Citigroup Inc. recalled that the LTCM "never wanted to discuss what the whole picture was," and Merrill Lynch chairman said that " [w]e really only saw that part of the portfolio that we did business with."[275]

CFTC's Mistakes

The regulation system was deficient in the LTCM episode. LTCM's structure was also a limited partnership because of exemption from the regulation of the SEC. However, it was registered with the CFTC as a CPO, was a member of NFA, and reported large investment in U.S. Futures Exchanges. In addition, as a CPO, LTCM reported its financial statements to the CFTC, namely, LTCM was only subject to oversight by CFTC.

Even though the regulation of hedge funds was insufficient as the CFTC stated,[276] the CFTC was able to examine LTCM's financial statements.[277] However, the CFTC received the news of LTCM's near-bankruptcy from the Department of Treasury,[278] indicating that CFTC did ignore the financial condition of LTCM even though the normal leverage ratio of hedge funds is two to one.

> The financial statements of LTCM's largest fund (in which the other funds invest) showed total assets of about $129 billion, total capital of about $4.67 billion and net income from operations of about $1.4billion. Footnotes to the statements showed that the fund held swap agreements with a notional value of about $697 billion and U.S. and foreign exchange-traded futures with a notional value of about $471 billion. Nothing in the financial statements indicated reason for concern about the funds' financial condition. LTCM's largest fund had 1997 income from operations of about 30% of its year-end capital, and its

[275] Michael Siconolfi et al., *supra* note 223.
[276] There are no reporting requirements concerning OTC derivatives positions. *Hearings 3*, *supra* note 10 (testimony of Brooksley Born, Chairperson, CFTC).
[277] *But see* CFTC chairperson said that the annual financial reports filed with CFTC do not fully reveal off-balance sheet transactions' positions. Thus, CFTC suggested the need for reporting, recordkeeping, disclosure and price transparency in the OTC derivatives market. *Hearings 2*, *supra* note 17 (testimony of Brooksley Born, Chairperson, CFTC).
[278] *Hearings 3*, *supra* note 10 (testimony of Leon M. Metzger).

> asset to capital ratio was about 28 to one. During 1995 and 1996, its annual rate of return on capital had exceeded 40%, and the amount of its leverage had been approximately the same. The fund was well capitalized and very profitable. Its asset to capital ratio was similar to that some other hedge funds as well as many major investment banks and commercial banks.[279]

After the near-bankruptcy of LTCM, CFTC recommended that "the need for increased transparency, the need to eliminate excessive leverage, the need for better prudential controls, and the need for enhanced international cooperation and harmonization of regulations" are necessary in hedge funds.[280] In my view, however, CFTC used unsound practices without examination, and we should note the mistakes of CFTC and solve the problems in order not to make same mistakes in the future.

Risk Management

Similar to other hedge funds cases, LTCM had enormous losses during August and September 1998. Thus, the risk management of LTCM itself and investors' protection were problematic. Even though Merton and Scholes had pioneered the theory of options pricing, they did not succeed in risk management.

Transparency and Disclosure

Transparency and disclosure are issues in the LTCM episode. At the first stage, LTCM had a good reputation due to high returns: 20 percent in 1994, 43 percent in 1995, 41 percent in 1996, and 17 percent in 1997.[281] Because the hedge fund's average

---

[279] *Hearings Before the Senate Comm. on Agriculture, Nutrition, and Forestry*, 105th Cong. (1998) (testimony of Brooksley Born, Chairperson, CFTC).<http://www.cftc.gov/opa/speches/born-41.htm>
[280] *Hearing Before the Subcomm. on Risk Management and Specialty Crops of the House Comm. on Agriculture,* 106th Cong.(1999) (testimony of Brooksley Born, Chairperson, CFTC). <http://www.cftc.gov/opa/speeches/born-49.htm>
[281] *Outlook Dec.1998, supra* note 18, at III, 54 Box 3.4

performance was 16 percent in 1995 and 17 percent in 1996, LTCM's returns were excellent.[282]

LTCM was highly leveraged, but many institutional investors invested in LTCM because of its high returns and partners' fame. Its portfolio, however, was not disclosed to its investors,[283] and it was famous for "the paucity of information distributed."[284] Thus, for example, institutional investors and individuals did not receive full information about the hedge fund. They, therefore, were unable to act until LTCM failed - by then, it was too late. Because the failure of LTCM could have had severe consequences for the international market,[285] the FRBNY intervened in the LTCM bailout plan. In my view, hedge funds should be regulated in order to make hedge funds transparent in the financial market.

No Sharing of Information among the Federal Regulators

Even though the CFTC had the financial information about LTCM and knew the level of debt, the CFTC did not act on the information or share any information with other federal regulators.[286] The document LTCM filed with the CFTC in mid-March 1998 indicated that the LTCM had borrowed total $125 billion on $4.7 billion capital ($25 per

---

[282] Michael Siconolfi et al., *supra* note 223; *Trillion Dollar Bet*, *supra* note 256.

[283] *See* Hal S. Scott and Philip A. Wellons, *supra* note 114, at 1069.

[284] *LTCM: One Bad Apple*? [hereinafter *One Bad Apple*] <http://www.assetpub.com/archives/ps/9-10psnov/nov98PS14.html>

[285] *See Outlook Dec.1998*, *supra* note 18, at III, 54 Box 3.4; *Hearings 2*, *supra* note 17 (statement of Alan Greenspan, Chairman, FED); *See Hearings 3*, *supra* note 10 (testimony of Lewis A. Sachs, Deputy Assistant Secretary, U.S. Dept. of the Treasury); Barry Eichengreen and Donald Mathieson, *supra* note 48.The Dow Jones Industrial Average was down 283 points by noon. Michael Siconolfi et al., *supra* note 223.

[286] *See* Kathleen Day, *Top Regulator Was Aware of Fund's Debt; CFTC's Born Failed to Act on Long-Term Capital Data*, WASH. POST, Nov. 18, 1998, at C11.

$1 of its equity capital) and had huge derivatives exposure, $1.3 trillion as of Dec. 31, 1997.[287]

The CFTC could easily have shared LTCM's information at a meeting of the President's Working Group on Financial Markets, where staff members from the CFTC, SEC, FED, and Treasury meet every two weeks to share "information about the markets, the major players in those markets, and any potential problems that might be emerging in the markets."[288] But CFTC did not share LTCM's information with other regulators. CFTC explained that Section 8 (e) of the CEA prevents CFTC from sharing information with other federal regulators in any time unless other regulators ask for the information.[289] Furthermore, the CFTC did not inform the other regulators of LTCM's financial information, its debt level, until several days after its bailout by a consortium.[290] In my judgment, the "perpetual conflict" between SEC and CFTC is the one of reasons for that situation.[291]

Too-Big-To-Fail Doctrine

In LTCM's case, the too-big-to fail doctrine, which was abandoned after it was abused by banks and S&Ls in the 1980's, was applied. [292] Because LTCM was so big, and its impact was so great, it was secured by government intervention. Due to its reputation and performance, LTCM was able to use excessive leverage, borrow money, and have many transactions with international major banks and securities firms. With its

---

[287] *Id.*
[288] *Id.*
[289] *Hearing Before the Subcomm. on Capital Markets, Securities and Government Sponsored Enterprises of the House Comm. on Banking and Financial Services*, 106th Cong. (1999) (testimony of Brooksley Born, Chairperson, CFTC).<http://www.cftc.gov/opa/speeches/born-43.htm>
[290] *See* Kathleen Day, *supra* note 286.
[291] *See* Thomas A. Russo and Marlisa Vinciguerra, *supra* note 245.

partners' reputations and its high returns, LTCM had huge transaction with banks and securities firms in the financial market. The effects outside hedge funds, thus, were very huge.

LTCM had $ 1.3 trillion OTC derivatives position as of Dec. 31, 1997, had about 72 conterparties on repo and reverse repo transaction and approximately 50 counterparties on OTC derivative transactions.[293] Bear Sterns, LTCM's prime broker, was also a clearing firm for LTCM's U.S. exchange-traded futures and Merrill Lynch was a clearing firm for non-U.S. exchange-traded futures. If the international financial community had not rescued it, the effect on the financial market would have been severe: there are possibilities of domino effect liquidation among counterparties in the financial market. The LTCM bailout plan came form that background.

However, with the too-big-to-fail doctrine, every hedge fund may want to have a lot of leverage and borrow more money in order to be safe at any difficult time with that doctrine. Therefore, this standard goes against the principle of capitalism, and it should not be applied in the financial market again.

A Double Standard

When Asian countries went through economic crises, the IMF and the U.S. regulators requested that the indebted companies be closed and that they sell their assets to creditors.[294] However, the U.S. regulators handled the case of LTCM differently. The

---

[292] *See Hearing 1*, *supra* note 4 (written testimony of Henry T. C. Hu, Professor of Law, University of Texas); *See* Paul Krugman, *Rashomon in Connecticut What Really Happened to Long-Term Capital Management?* Slate (Oct. 1, 1998). <http://slate.msn.com/Dismal/98-10-01/Dismal.asp>
[293] The President's Working Group Report, *supra* note 16.
[294] Ellen Frank, *Double dealing*, NEW INTERNATIONALIST (May 1999). <http://oneworld.org/ni/issue312/dealing.htm>

LTCM rescue revealed the inequality of a system in which there is only one standard;[295] "whether in Korea, Thailand, Connecticut [in LTCM], or Brazil, U.S.- and IMF - organized bailouts conform to the same guiding principle: whatever happens, whoever is at fault, the wealth of Western creditors must be protected and enhanced."[296]

The Failure of Regulators' Prediction

During the April 13, 1994 hearing, regulators discussed the leverage and impact of hedge funds. The main concerns of the hearing were "(1) does lending to the funds put insured depository institutions at risk? and (2) do their speculative trading strategies make markets more volatile and less stable than they would be otherwise?"[297] However, regulators failed to regulate the leverage because they thought the potential problem would not happen. Five years later, the LTCM near-bankruptcy occurred.

The LTCM debacle case indicated that one hedge fund "could have potentially impaired the economies of many nations, including [America.]"[298] Table 5 shows that there was a failure of regulators' prediction.

---

[295] *Id.*
[296] *Id.*
[297] Mark Jickling, *supra* note 5, at 5.
[298] *Hearings 1*, *supra* note 4 (statement of Alan Greenspan, Chairman, FED)

Table 5: The Difference of Regulators opinions (between 1994 and 1999)

	House Hearing(April 1994)	The President's Working Group on Financial Markets(April 1999)
Does lending to hedge funds put insured depository institutions at risk?	Consensus of banking regulators present at hearing was that lending to hedge funds does not pose significant risk to banks as such loans were generally well-collaterized and very small	-Excessive leverage increases likelihood of break down in functioning of financial markets -The near-collapse of LTCM illustrates need for all participants in financial system to face constraints on amount of leverage assumed
Do hedge funds' speculative trading strategies make markets more volatile and less stable than they would be otherwise?	Witnesses agreed that hedge funds were not unique in their trading practices, but were only one among many groups of institutional investors active in markets -Witnesses also stressed that the amount of capital managed by hedge funds is "modest" in comparison to the total turnover in global currency and securities markets	-Concerns expressed about activities of highly leveraged institutions with respect to impact on market dynamics vulnerable economies -Activities of hedge funds can affect markets in some circumstances and for limited periods although the activities of highly leveraged institutions have not played a significant role in precipitating financial market crises of past few years
Participants	-FED, SEC, CFTC, OCC	-Department of the Treasury, FED, SEC, CFTC

Source: data from House Hearing (Apr. 1994), The President's Working Group on Financial Markets (Apr. 1999),and Mark Jickling, Hedge Funds, Congressional Research Service Report for Congress 5 (June 21, 1994).

Leverage

Leverage is not always bad in the financial market. In particular, it has two functions: (1) "it creates and enhances the risk of default by market participants"; and (2) "rapid deleveraging can cause major disruptions in the financial market by exaggerating market movements."[299] In particular, LTCM described leverage in its prospectus: "the

[299] *Outlook Dec.1998*, *supra* note 18, at III, 51, Box 3.3.

Portfolio Company will typically be very highly leveraged, and such leverage will fluctuate depending on market conditions."[300]

Research about leverage of hedge funds showed that their leverage degree is proper.[301] The results of that research were as follows: first, about 30 percent of all hedge funds did not use leverage; second, about 54 percent of all hedge funds used less than 2 to 1 leverage; third, about 16 percent of all hedge funds used more than 2 to 1 leverage; and fourth, a few hedge funds used more than 10 to 1 leverage.[302]

If so, LTCM had very high leverage, 25 times its capital, at the end of 1997. Furthermore, the leverage ratio became higher due to LTCM's losses. LTCM had so high a leverage system that it could not control "the risk factors present in today's global markets."[303]

---

[300] Merrill Lynch &Co., *supra* note 222, at 8.
[301] *Hearinds 1*, *supra* note 4 (statement of Steven Lonsdorf, President, Van Hedge Fund Advisers International).
[302] *Id.*
[303] *Id.*

CHAPTERVIII

THE ACTIVITIES OF FINANCIAL COMMUNITY

The President's Working Group on Financial Markets (President's Working Group) [304]

The President's Working Group made a report entitled "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management (President's Working Group Report)" in April 1999.[305] This report suggested many methods: "[improving] transparency in the [financial] system, [enhancing] private sector risk management practices, [developing] more risk-sensitive approaches to adequacy, [supporting] financial contract netting in the event of bankruptcy, and [encouraging] offshore financial centers to comply with international standards."[306]

The report stated that " [t]he near collapse of LTCM illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume"[307] and "in the case of LTCM, its investors, credits, and counterparties did not provide an effective check on its overall activities."[308]

---

[304] Members are as follows : Dep. of the Treasury, FED, SEC, CFTC, 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.
[305] The President's Working Group Report, *supra* note 16.
[306] *Id.*
[307] *Id.*
[308] *Id.*

Consequently, the President's Working Group suggested not "direct regulation"[309] but "indirect regulation."[310]

The Counterparty Risk Management Policy Group (CRMPG)

In January 1999, twelve leading international institutions organized the CRMPG to improve principles for reinforcing risk management practices for banks, securities firms and, other institutions which offer credit-based services to HLIs in the financial markets.[311] The CRMPG made a report, "Improving Counterparty Risk Management Practices," in June 1999.[312] This paper recommended "enhanced information sharing between counterparties; an analytical framework for evaluating the effects of leverage on market liquidity and credit risk; improved credit risk estimation techniques; stronger internal limit setting; collateral, margin and other credit risk management practices; improved risk reporting to senior management and regulators; and stronger harmonized market conventions for key credit documentation."[313]

---

[309] Direct regulation is "the imposition of a range of regulatory requirements directly on a firm-- including requirements to report to regulators on the firm's activities and financial affairs, and setting minimum requirements." Report of the Technical Committee of the International Organization of Securities Commissions, *Hedge Funds and Other Highly Leveraged Institutions*, 1 n.5 (Nov. 1999) [hereinafter IOSCO Report].
[310] The President's Working Group Report, *supra* note 16.
[311] *Improving Counterparty Risk Management Practices* (Counterparty Risk Management Policy Group, June 1999). <http://www.crmpolicygroup.org>; IOSCO Report, *supra* note 309, at 2.
[312] *Id.*

The Basle Committee on Banking Supervision (Basle Committee)

The Basle Committee made two papers, which were made by a Working Group of the Basle Committee,[314] in January 1999: (1) Banks' Interactions with Highly Leveraged Institutions and (2) Sound Practices for Banks' Interactions with Highly Leveraged Institutions.

Banks' Interactions with Highly Leveraged Institutions

After reviewing the LTCM episode, the Basle Committee indicated the insufficiencies in the internal controls and unsound risk management practices of the counterparties to LTCM.[315] The paper recommended promoting sound practices, enhancing transparency of the activities of large HLIs and other global financial institutions, and regulating HLIs directly.[316]

Sound Practices for Banks' Interactions with Highly Leveraged Institutions

This paper recommended sound practices to improve credit risk management when dealing with HLIs as counterparties.[317] The specific recommendations are as follows: "(1) establishing clear policies and procedures for banks' involvement with HLIs as part of their overall credit risk environment; (2) information gathering, due diligence, and credit analysis of HLIs' activities, risk, and operations; (3) developing more accurate measures of exposures resulting from trading and derivatives transactions; (4) setting

---

[313] *Id.*
[314] The Working Group on Highly Leveraged Institutions was set up by the Basle Committee in October 1998. It has a mission to analyze the nature of the risks posed by highly leveraged institutions, to assess banks' risk management practices with respect to HLIs, and to evaluate potential policy responses to address these risks.
[315] *Banks' Interactions with Highly Leveraged Institutions*, 2-3 (Basle Committee on Banking Supervision, Jan. 1999).
[316] *Id.* at 7.
[316] A committee of the central banks of the Group of Ten countries.
[317] *Sound Practices for Banks' Interactions with Highly Leveraged Institution*, 3 (Basle Committee on Banking Supervision, Jan. 1999).

meaningful overall credit limits for HLIs; (5) linking credit enhancement tools, including collateral and early termination provisions, to the specific characteristics of HLIs; and (6) closely monitoring credit exposure vis-à-vis HLIs, including their trading activities, risk concentration, leverage, and risk management processes."[318]

The Financial Stability Forum (Forum)

The Finance Ministers of the Group of Seven (G-7) organized the Financial Stability Forum.[319] Its purpose is that "national and international communities can more effectively co-operate to promote international financial stability, improve the functioning of the markets, and reduce systemic risk."[320] The Forum established three working groups in April 1999.[321]

The Basle Committee and the Technical Committee of International Organization of Securities Commissions (IOSCO)

Together, these organizations made a paper, "Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms."[322] In this paper, they made two recommendations: "(1) institutions should provide financial statement users with a clear picture of their trading and derivatives activities, the major risks associated with these activities, and their performance in managing these risks; and (2) institutions should disclose information produced by their internal risk measurement

---

318 *Id.*
319 IOSCO Report, *supra* note 309, at 2.
320 *Id.*
321 *Id.*
322 *Id.* at 3.

and management systems on their risk exposures and actual performance in managing these exposures."[323]

The Committee on the Global Financial System (CGFS)

The CGFS, former Euro-Currency Standing Committee, established two working groups to "address the need for additional information in the marketplace:" the "Working Group on Disclosure" and the "Working Group on Market Information."[324] The purpose of the Working Group on Disclosure is to explore "what information should be publicly disclosed by financial intermediaries to provide a clear view of their exposures to market and credit risks," and the focus of the Working group on Market Information is to consider "how the provision of additional aggregate market information could improve the functioning and stability of markets by contributing to better risk management and more informed policy decisions."[325]

IOSCO

After the near collapse of LTCM, the Technical Committee of the IOSCO established a special Task Force on Hedge Funds and Other Highly Leveraged Institutions (Task Force).[326] Its aim was to handle regulatory issues concerning the activities of HLIs.[327] The Task Force released a paper: "Hedge Funds and Other Highly Leveraged Institutions."[328]

---

[323] *Id.*
[324] *Id.*
[325] *Id.*
[326] *Id.* at i.
[327] *Id.*
[328] *Id.*

This paper made several recommendations: "(1) strengthening risk management processes at securities firms that act as counterparties to HLIs; (2) guidance to securities regulators on the scrutiny which should be applied to regulated firms handling HLIs and the means by which firms should be encouraged to adopt sound practices; (3) improving information flows about HLI activities to regulated counterparties of HLIs, regulators, market authorities and to the public more generally; and (4) the advisability of further work by IOSCO in cooperation with other interested parties, including the Basle Committee and private sector groups."[329]

[329] *Id.* at i-ii.

CHAPTER VIX

BENEFITS AND COSTS OF REGULATION

Law Professors' Opinions

There were many hearings in the United States after LTCM's rescue. During those hearings in the House and Senate, a few law professors presented their opinions on regulation of hedge funds. Table 6 shows the summary of their opinions.

Table 6: Law Professors' recommendations

Name	Recommendations
David S. Ruder	- Oct. 1, 1998 Hearing - If needed, SEC use emergency power to examine carefully - Necessary information should be placed in the hands of responsible regulators who will preserve its confidentiality
Henry T.C. Hu	- Oct. 1, 1998 Hearing - Some issues occurred (complex-exotic financial products, issues of transparency as to products and institutions, multiple national jurisdictions, and the optimal as well as feasible limits of regulatory reach)
John C. Coffee, Jr.	- May 6, 1999 Hearing - Additional hedge fund regulation does not need to protect investors, counterparties, or creditors, except at the international G7 level - Appropriate legislative focus should be on excessive leverage and the deficiencies in the risk management practices of banks and securities firms, not investor protection

Source: data from hearings (Oct. 1, 1998, May 6, 1999)

The Hedge Funds Disclosure Act

Richard Baker, a republican Congressman, introduced "The Hedge Fund Disclosure Act" in order to require "unregulated hedge funds" to submit regular reports to the FED.[330] This proposed legislation requires large funds to make themselves and

[330] A republican Richard Baker introduced. H.R.2924, 106th Cong. (1999).

their financial dealings transparent to the public and to securities and banking regulators. Moreover, under the proposed bill, a hedge fund with more than $3 billion of capital or with assets in excess of $20 billion must file quarterly reports with the FED, the Treasury Department, and the SEC.[331]This bill is criticized, however, because it applies only to a very small number of hedge funds, i.e., fewer than ten will be regulated under the bill from among about 5,830 hedge funds.[332]

In my view, this regulation of hedge funds is a welcomed first step. However, in order to regulate hedge funds, we must first consider the definition of hedge funds.[333] If hedge funds are described as a type of mutual fund, even though there are some differences, then mutual fund regulations can be applied to hedge funds. In addition, this bill requests that hedge fund information should be revealed to the public, but, in my opinion, this information should be limited to regulators.

Benefits and Costs in Regulation of Hedge Funds

Table 7 shows the benefits and costs of regulation and deregulation. In regulation, there are two approaches. First, direct regulation imposes regulatory requirements directly on hedge funds by, for example, reporting their activities and financial statements and setting minimum requirements.[334] Second, indirect regulation controls hedge funds indirectly through counterparties such as banks, securities firms, and other institutions which have relationships with hedge funds through trading

---

[331] Section 4. (Public reports required). *Id.*
[332] M. Corey Goldman, *supra* note 1.
[333] "There are a number of critical obstacles to the direct regulation HLIs. It cited difficulties in giving a precise legal definition of "highly leveraged institution." in the "Report on Highly Leveraged Institutions" (HILs). *Basle Committee Urges Hedge Funds Risk Assessment*, REUTERS, Jan. 28, 1999.
[334] IOSCO Report, *supra* note 309.

transactions or the lending of money. Regulators can get a great deal of information from hedge funds through direct regulation, but this has some disadvantages for hedge funds can have disadvantage because their rivals can get their confidential information. In addition, hedge funds do not like direct regulation because they are accustomed to deregulation and flexible management. On the other hand, indirect regulation has less regulation effect because hedge funds' counterparties control them. With sound practices, banks and securities firms indirectly regulate hedge funds. However, there is the possibility of returning to unsound practices as in the LTCM case. If regulators and counterparties do not regulate hedge funds, potential risks or market turbulence will continue to exist in the financial market.

Table 7: Comparison between regulation and deregulation

	Benefits	Costs
Direct Regulation	-Protect potential risk or turbulence in the financial market -Investor protection	-An exodus of U.S. hedge funds to offshore - Disclosure management confidentiality to rivals -Inflexibility in management -Interference in financial innovation
Indirect Regulation	-Protect potential risk or turbulence in the financial market -Investor protection	-Less regulation effect -The possibility of return to unsound practices
Deregulation	-Flexibility in management -Protect management privacy -Prevent an exodus of U.S. hedge funds to offshore	-Existence of potential risk -No investors protection

Source: data from summary.

Discussion

Financial Innovation exceeds Regulation

Some experts argue that "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."[335] From this viewpoint, they recommended that "the optimal approach is a global voluntary initiative of 'best practices'[-- market risk management, credit procedures, and information availability, sales and documentation practices, and internal and external audits--] that covers not only major commercial and investment banks, but also significant end users, including hedge funds such as LTCM."[336]

If an instrument threatens the world financial market, however, we should think differently. In the above-mentioned MIF case, external auditors, one of the "best practices," did not work. On the other hand, Julian Robertson, the operator of one of the world's foremost hedge fund, stated that "some additional regulation in [the transparency] area would be beneficial."[337]Additionally, in my judgment, hedge funds are one of derivatives of mutual funds. The regulation of hedge funds, therefore, would not be difficult.

---

[335] Thomas A. Russo and Marlisa Vinciguerra, *supra* note 245.
[336] *Id.*

Significant Public Interest

After LTCM's near-bankruptcy and bailout, arguments have continued about the necessity of new regulatory measures and the character of regulation in hedge funds.[338] The idea of investor protection in hedge funds is that wealthy and sophisticated investors can protect their risk on their own.[339] If all investors were wealthy people, there would be no argument because the bankruptcy of the hedge fund would just be the problem of individuals.

In fact, most investors in hedge funds during the 1960's and 1970's were "private individuals."[340] After that, however, "high net worth" individuals, "fund of funds," and "feeder funds" became investors in hedge funds.[341] In addition, private banks, university endowment funds, pension plans, and insurance companies appeared as investors in hedge funds.[342] Nowadays, most institutions, for example, investment banks, insurance companies, and commercial banks, invest in hedge funds. In 1996, pension funds and other qualified plans comprised 14 percent, and endowments and foundations comprised 6 percent.[343]

If there is a big loss in the hedge funds in which they invest, the investors of those institutions will receive the same loss. Also, fiduciary institutions, for example, pension funds and charity foundations, invest in hedge funds; thus, the failure of hedge funds will

---

[337] Remarks of Brooksley Born, Chairperson Commodity Futures Trading Commission, Fordham University School Law 1999 Derivatives & Risk Management Symposium (Jan. 28, 1999). <http://www.cftc.gov/opa/speeches/born-42.htm>
[338] *See* Thomas A. Russo and Marlisa Vinciguerra, *supra* note 245.
[339] *See* Franklin R. Edwards, *supra* note 21, at 190-91; The task Force on Hedge Funds, *supra* note 122.
[340] *See* Matthias Bekier, *supra* note 20, at 98.
[341] *See Id.*
[342] *See generally Id.* at 98-99.
[343] *One Bad Apple*? *supra* note 284.

have effects on the beneficiaries of the fiduciary institutions.[344] If so, the bankruptcy of hedge funds can be a social problem and can be of "significant public interest." Foe example, in the LTCM debacle, both the St. Johns University endowment fund and the University of Pittsburgh were investors and both suffered.[345] In those cases, we should handle the situation differently.

When we consider UBS' situation with regard to LTCM, it appears to be urgent to protect the investors in hedge funds. In reality, sophisticated investors do not evaluate the merits and risks of their investments in hedge funds as we can see in the LTCM episode. Usually, hedge funds borrow money from banks to leverage their investments.[346] Thus, if hedge funds have large losses, they will default on their loans, and banks will be negatively impacted. Banks should become aware of and consider the inherent risks of investing in hedge funds.

Banks should also check their loans for hedge funds.[347] However, in reality, banks often do not pay attention to those risks, but merely rely on the reputation of managers of hedge funds, as in LTCM. If the counterparty risks to hedge funds are calculated with more precision, banks will be able to predict risks and avoid a financial fiasco.[348]

Exodus of U.S. Hedge Funds

Most regulators worry about an "exodus" of U.S. hedge funds to offshore as a result of the regulation of hedge funds in the United States.[349] In addition, regulators argue that the "exodus" of U.S. hedge funds indicates that "the business would be

---

[344] *See* Franklin R. Edwards, *supra* note 21, at 190-91.
[345] David Shirreff, *supra* note 239.
[346] *See Hearings 1*, *supra* note 4 (statement of John P. LaWare, Member, FED).
[347] *See Hearings 1*, *supra* note 4 (statement of Rep. Bernard Sanders).
[348] After LTCM episode, regulators focused on this counterparty risk: thus, there are more regulations than before.

transplanted in jurisdictions with weaker or nonexistent regulatory regimes and less developed legal and judicial systems, with the result of increasing systemic risk worldwide."[350]

> It is questionable whether hedge funds can be effectively directly regulated in the United States alone. While their financial clout may be large, hedge funds' physical presence is small. Given the amazing communication capabilities available virtually around the globe, trades can be initiated from almost any location. Indeed, most 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. [351]

However, about 70 percent of hedge fund assets under management in 1997 already had "offshore jurisdiction."[352] If there are some relationships with the U.S. (i.e., when hedge funds trade on U.S. Futures and Option Exchange or have U.S. investors), hedge funds must be registered with CFTC and NFA under the CEA provision. Thus, there will be no difference from the current system. Therefore, the "exodus" of U.S. hedge funds will not be a big problem.

---

[349] *See* Thomas A. Russo and Marlisa Vinciguerra, *supra* note 245; Barry Eichengreen et al., *supra* note 27, at 23.
[350] Thomas A. Russo and Marlisa Vinciguerra, *Id.*
[351] *Hearings 1*, *supra* note 4 (statement of Alan Greenspan, Chairman, FED).
[352] Barry Eichengreen et al., *supra* note 27, at 32 Table 3.3 (source: MAR/HEDGE).

Moral Hazard

It is worth mentioning that Meriwether[353] and his former five partners have established a new hedge fund whose investment strategies are similar to LTCM's[354] since negotiating with Wall Street executives about the possibility of creating a new fund.[355] LTCM was a limited partnership, but it was bailed out by the intervention of the Federal Reserve. Even though LTCM caused major problems in the financial market, it received no penalty whereas Askin in ACM received sanctions from the SEC.

---

353 A news story indicated the morality of Meriwether. "Meriwether signed an 'interspousal transfer grant deed' transfering a 20-acre vacant lot in a tony residential area of Pebble Beach, Calif., to his wife… A Business Week examination of public records shows that long before the Aug.27 transfer, Meriwether had shielded his own and his partners assets in the event LTCM ever got into trouble." *Meriwether Transferred Property to Wife During LTCM's Fall*, BUSINESS WEEK, Oct.8, 1998. <http://www.businesswire.com/webbox/bw.1008998/831675.htm>

354 Sholes is doing business in "a new on-line trading venture," and Merton is at Harvard University and JP Morgan consultant. *Trillion Dollar Bet*, *supra* note 256.

355 *LTCM to Repay Debts Original Investors in Long-Term Capital to Get Money Back,* CNNFN, Jan. 18, 1999.

CHAPTER VX

CONCLUSION

Merton confessed that "[LTCM's near-bankruptcy was] like getting hit by a truck," and Sholes stated that "I personally don't think that [the Black-Scholes models are] the reason. It could be inputs to the models, it could be the models themselves, it could be a combination of many things. And so just saying models were flawed is not necessarily the right answer."[356] Peter Fisher, executive vice president of the FRBNY, said that "I can suppose what [the reason for LTCM's debacle] would be, but I don't yet know [whether the LTCM episode] was a random event or whether [the LTCM episode was caused by] negligence on [LTCM] and [LTCM's] creditors' parts."[357]

The LTCM case indicates that hedge funds could produce "a significant public interest" in the United States and the world. The conflict between "flexible management" and "public interest" should be solved. If something causes "a public policy issue," regulators should take an action. Furthermore, in my judgment, hedge funds are "essentially unregulated mutual funds," thus, the concept of regulation should come from the regulation system of mutual funds. The LTCM case also presented the cost of deregulation and the cost of regulation of hedge funds. Even though it was just one case, it indicated the huge potential cost of deregulation.

---

[356] *Trillion Dollar Bet, supra* note 256.
[357] *Id.*

One possible reason for the excellent returns of hedge funds could be their freedom from regulation,[358] thus we should not destroy this advantage. However, we should consider the regulation of hedge funds step by step. In addition, the starting point of regulation is not commodity but mutual funds.

In my view, we should have two approaches to regulation of hedge funds. First, with respect to investor protection, if there is the possibility of the cause of a significant public interest, regulators should use direct and indirect regulation. For example, if investors are pension plans or university endowment funds, the concept of mutual funds should be adopted. Second, with respect to market turbulence protection, indirect regulation is more useful. However, if there is an urgent situation, emergency power should be used by regulators. In addition, the cooperation of regulators should be enhanced by legislation.

Nobody can confirm whether the regulation of hedge funds is a good idea at this time. However, the remarks of the FED chairman provide some indications about the future regulation of hedge funds: "We do not yet fully understand the new [global financial] system's dynamics. We are learning fast, and need to update and modify our institutions and practices to reduce the risks inherent in the new regime."[359]

---

[358] *See* Mark Jickling, *supra* note 5, at 5.
[359] *Outlook Dec.1998*, *supra* note 18, at III, 65, n. 27.

BIBLIOGRAPHY

A Guide to Understanding Mutual Funds, The Investment Company Institute. 1998.

Banks' Interactions with Highly Leveraged Institutions, Basle Committee on Banking Supervision, Jan. 1999.

Barr, Paul G. "Firms Profit from Askin Fallout." Pensions & Investment May 2, 1994.

Bary, Andrew. "Trading points: After Some Good Years, Euro Bond Market batters Some Big Investors." Barron's Oct.2, 1995 :MW12.

Bary, Andrew. "Trading Points: Fenchurch Affair: Trouble for the Repo Market?" Barron's July 15, 1996: MW11.

Bary, Andrew. "Trading Points: Floating Like a Butterfly, Fund Gets Stung by a Bee." Barron's June 26, 1995 : MW12.

"Basle Committee Urges Hedge Funds Risk Assessment." Reuters, Jan. 28, 1999.

Bekier, Matthias. Marketing of Hedge Funds 1996.

Bensman,Miriam. "Psst, We're Market-Neutral." Institutional Investor, Jan. 1995.

Bonte-Friedheim, Robert and Jereski, Laura. "Hedge-Fund Group of George Soros Hires Gerstenhaber." Wall Street Journal Oct. 2, 1997 : B19.

Bonte-Friedheim, Robert and Robert, Michael R. "Fenchurch's Highflying Chief Crashes as Its Global-Bond Funds Take a Dive." Wall Street Journal Nov. 6, 1995: A

Born, Brooksley. "Regulatory Responses to Risks in the OTC Derivatives Market, Committee on Federal Regulation of Securities ABA Section of Business Law." Nov. 13, 1998. http://www.cftc.gov/opa/speeches/born-40.htm

Borts, George H. "Building a Better Hedge Fund." Brown University Faculty Governance http://facgov.brown.edu/facgov/facbulletin/March99Issue/borts.html

Brown, Stephen J. et al. "Hedge Funds and the Asian Currency Crisis of 1997." NBER Working Paper No. 6427, Feb. 1998.

Brown, Stephen J. et al. "Offshore Hedge Funds: Survival & Performance 1989-1995." Jan. 2, 1998.

Burr, Barry B. "Firm Targets Mortgage Securities." Pensions & Investments Feb. 22, 1993.

Chandler, Beverly. Investing with the Hedge Fund Giants 1998.

Corrigan, Louis. "Endowments Hedging Their Bets: Is This How You Want Your Donations Invested?" Nov. 4, 1998. http://www. Fool.com

Cottier, Phillip Hedge Funds and Managed Futures 1997.

Day, kathleen. "Top Regulator Was Aware Of Fund's Debt CFTC's Born Failed to Act on Long-Term Capital Data." The Washington Post Nov. 18, 1998 : C11.

"Defying the Odds." Fortune Oct. 17, 1994.

"Difference between Mutual Funds and Hedge Funds." The Investment Company Institute. http://www.ici.org/issues/diff_mutual_hedge_fund.html

Dunbar, Nicholas. Investing Money - The Story Long-Term Capital Management and the Legends Behind It. 2000.

Edwards, Franklin R. "Hedge Funds and the Collapse of Long -Term Capital Management." Journal of Economics Perspectives 1999 : 189-210.

Eichengreen, Barry and Mathieson, Donald. "Hedge Funds: What Do We Really Know?"

IMF, 19 Economic Issues, Sept. 1999.
http://www/imf.org/external/pubs/ft/issues/issues19/index.htm

Eichengreen, Bary et al. Hedge Funds and Financial Market Dynamics, Occasional Paper No.166, IMF May 1998.

"Fed Chief defends Bailout." CNNfn, Oct. 1, 1998.

Fleming, Joseph R. "Regulation of Series Investment Companies Under The Investment Company of 1940." 44 Business Lawyer 1989: 1179-1205.

Frank, Ellen. "Double dealing." New Internationalist May 1999.
http://oneworld.org/ni/issue312/dealing.htm

Fromson, Brett D. "Hedge' Fund Falls Victim to Downturn." The Washington Post April 1, 1994: F8.

"Fund Manager Accused of Fraud; Investment: SEC says $300 Million in Losses on Internet Stocks Was Hidden From Investors." The LosAngeles Times Jan. 19, 2000: 6.

Gilpin, Kenneth N. "Founder of Askin Capital Agrees to Settlement of SEC Charges." NewYork Times May 24, 1995: D8.

Goetzmann, William N. "Hedge funds." Yale School of Management BZW Presentation 1997. http://viking.som.yale.edu/will/presentatations/hedge/sld001.htm

Goldman,M. Corey. "House Eyes Fund Rules Legislation Expected Thursday, though Experts Deem It Too Little Too Late." CNNfn Sept. 22, 1999.
http://cnnfn.com/1999/09/22/news/hedge

Gould and Lins, "Unit Investment Trusts." 43 Business Lawyer 1988: 1177- 1205.

Hansell, Saul. "Investment Funds Are Liquidated." NewYork Times April 1, 1994; D1.

Hansell, Saul. "Facing Suits, Askin Funds Seek Chapter 11 Protection." NewYork Times April 8, 1994: D2.

Hearing Before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, 106th Congress 1999. http://www.cftc.gov/opa/speeches/born-49.htm

Hearing Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the House Committee on Banking and Financial Services, 106th Congress 1999. http://www.cftc.gov/opa/speeches/born-43.htm

Hearings Before the Senate Committee on Agriculture, Nutrition, and Forestry, 105th Congress 1998. http://www.cftc.gov/opa/speeches/born-41.htm

Hearings Before the Subcommittee on Capital Markets of the House Committee on Banking and Financial Services, 106th Congress 1999.

Hedge Fund Operations: Hearings Before the House Committee on Banking and Financial Services, 105th Congress 1998.

Hedge Funds: Hearings Before the Subcommittee on Financial Institutions of the House Committee on Banking and Financial Services, 106th Congress 1999.

Herr, Elisa. "Revaluation of MBS Holdings Leaves Pain and Opportunity." Investment Dealer' Digest April 25, 1994.

"How Hedge Funds Differ from Mutual Funds." The Vanguard Group 1999.

"Improving Counterparty Risk Management Practices." Counterparty Risk Management Policy Group, June 1999. http://www.crmpolicygroup.org

"Japan LDP to Debate Ways to Curb Hedge Funds." Reuters, Jan.26, 1999. http://biz.yahoo.com/rf/990126/b4a.html

Jereski, Laura. “Argonaut Fund Capital Shrinks after Big Losses.” Wall Street Journal August 17, 1994: C.

Jereski, Laura. “Argonaut Hedge Fund loses its Luster; One Founder Resigns as Losses Mount.” Wall Street Journal August 11,1994: A.

Jereski, Laura. “Cracks appear in Granite Partners Fund.” Wall Street Journal March 30, 1994 : C1.

Jereski,Laura. “David Askin Sttles SEC Proceedings Accusing Him of Fraudulent Conduct.” Wall Street Journal May 24, 1995: B5.

Jereski, Laura. “The Wrong Stuff: Good Connections Put Hedge Fund in Business But a Bad Bet Sank it --- Manager David Weill, Suave and Impressive, Drew in Europe’s Wealthy Class --- Adieu to a Gilded World.” Wall Street Journal September 28, 1994 : A1.

Jickling, Mark. “Hedge Funds.” Congressional Research Service Report for Congress, June 21, 1994.

Karchmer, Jennifer. “Tiger Management Closes Its Doors.” CNNfn. March 30,2000

Krugman, Paul. “Rashomon in Connecticut What Really Happened to Long-Term Capital Management?” Slate Oct. 1, 1998. http://slate.msn.com/Dismal/98-10-01/Dismal.asp

“Living Large.” Grant’s Interest Rate Observer Nov. 5, 1993. http://wysiwyg://4/http://www.grantspub.com/dispatch/0001.html

“LTCM to Repay Debts Original Investors in Long-Term Capital to Get Money Back.” CNNfn, Jan. 18, 1999.

“LTCM: One Bad Apple?”

http://www.assetpub.com/archives/ps/9-10psnov/nov98PS14.html

"Manhattan Investment Fund 'No Malicious Wrongdoing' Claims Berger." Mar/hedge Jan.17, 2000. http://www.marhedge.com

"Manhattan Investment Fund." Mar/hedge Jan.18, 2000. http://www.marhedge.com

"Manhattan Investment Fund." Mar/hedge Jan.19, 2000. http://www.marhedge.com

"Meriwether Transferred Property to Wife During LTCM's Fall." Business Week, Oct.8, 1998 http://www.businesswire.com/webbox/bw.1008998/831675.htm

Merrill Lynch & Co., "Long-Term Capital, L.P., Private Placement of Limited Partnership Interests." October 1, 1993.

Mufson, Steve. "Fund's Big Betteors Learned that Risk Trumps Math. History." Washingtoin Post September 27, 1998: H01

Nakao, Takehiko. "Hedge Funds and International Financial Markets" July 1999. http://www.mof.go.ijp/english/if/if006.htm

Pacelle, Mitchell. "Deals & Deal Makers: Hedge Fund Faces Scrutiny in SEC Probe." Wall Street Journal Jan. 17, 2000: C17.

Pacelle, Mitchell. "Deal & Deal Makers: Fund Manager Concocted Fraud, SEC Suit Alleges." Wall Street Journal January 19, 2000: C24.

Pozen, Robert C. The Mutual Fund Business 1998.

"Remarks of Brooksley Born, Chairperson Commodity Futures Trading Commission, Fordham University School Law 1999 Derivatives & Risk Management Symposium." Jan. 28, 1999. http://www.cftc.gov/opa/speeches/born-42.htm

"Report of The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" April, 1999.

"Report of the Technical Committee of the International Organization of Securities Commissions, Hedge Funds and Other Highly Leveraged Institutions." Nov. 1999.

Risks that Hedge Funds Pose to the Banking System: Hearings Before the House Committee on Banking, Finance and Urban Affairs, 103rd Congress 1994.

Rosato, Donna. "Trading Losses Take Toll." USA Today, April. 28, 1994:B2.

Russo, Thomas A. and Vinciguerra, Marlisa. "Regulation in the Wake of Long-Term Capital's Rescue." 11 Futures & Derivatives Law Rep. Feb. 1999.

Scheer, Steven. "Hedge Funds Reject Calls for U.S. Govt. Regulaions." Reuters January 28, 1999.

Scholl, Jaye. "Boom! A Bet Against Stocks Blows Up Fund." Barron's Jan. 17, 2000.

Scholl, Jaye. "Goldin Compromise." Barron's June 6, 1994.

Scholl, Jaye. "How Did Askin Really Collapse?" Barron's May 9, 1994.

Schonfeld, Victoria E. and Kerwin,Thomas M. J. "Organization of a Mutual Fund." 49 Business Lawyer Nov. 1993: 107-161.

Schroeder, Michael. "Hedge Funds Blast Plan [for] Disclosure of Internal-Financial Data." Dow Jones Newswires May 7, 1999.

Scott, Hal S. and Wellons, Philip A. International Finance-Transactions, Policy, and Regulation 1999.

"SEC Charges Hedge Fund Alleges Manhattan Investment Fund Gave False Statements to Investors." CNNfn Jan. 19, 2000.

"SEC Investigating Hedge Fund for Possible Misrepresentation." Houston Chronicle Jan. 19, 2000: 4.

"SEC Probes Hedge Fund Manhattan Investment Fund's Profit Reports Subject of SEC Investigation." CNNfn Jan. 18, 2000.

SEC, "SEC Charges Hedge Fund and Its Adviser with Fraud Emergency Relief Ordered." Litigation Release No. 16412, January 19, 2000. http://www.sec.gov/enforce/litigrel/lr16412.htm

Sesit, Michael R. "Despite '95 Rally in Global Bond Markets, Many Traders Aren't Reaping Rewards." Wall Street Journal Nov. 13, 1995: C1.

Shirreff, David. "Lessons From the Collapse of Hedge Fund, Long-Term Capital Management." IFCI. http://www.risk.ifci.ch/146520.html

Siconolfi, Michael et al. "All Bets Are off: How the Salesmanship and Brainpower Failed at Long-Term Capital." Wall Street Journal Nov. 16, 1998: A1.

Siconolfi, Michael. "Tumble in Mortgage Securities Sparks Lawsuit." Wall Street Journal April 8, 1994: C1.

Siconolfi, Michael. "Kidder Discloses Scam in Bonds, Fires Top Trader --- It Sets $350 Million Charge, Says Scheme Involved Government-Strip Deals." Wall Street Journal April 18, 1994: A3.

Siconolfi, Michael. "Kidder Had Major Exposure in Collapse of Askin, Jett Is Said to Have Told U.S." Wall Street Journal July 27, 1994: B2.

"Sound Practices for Banks' Interactions with Highly Leveraged Institution." Basle Committee on Banking Supervision, Jan. 1999.

Szala, Ginger. "Fenchurch Spreads Profits As Other Managers Retrench." Futures July 1992.

Taub, Stephen. "The Hedge Rows of Wall Street." Financial World September 13, 1994.

The Task Force on Hedge Funds, "Report on Section 3 (c) (1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchases." 51 Business Lawyer 1996: 773-794.

"Trillion Dollar Bet." PBS TV, Feb 8. 2000.

UBS, "The LTCM Dealing (UBS news)." http://www.ubs.com/e/index.htm

Waxler, Caroline. "Oil's Well." Forbes Feburary 10, 1997.

Weiss, Gary. "The $700 Million Mystery." Business Week Dec. 18, 1995.

Willoughby, Jack. "Askin Examiner Will Study Street's Role in Collapse." The Investment Dealers' Digest July 25, 1994.

Willoughby, Jack. "Askin Fund Assessor: Granite Appeared Unhedged, Over-Leveraged." The Investment Dealers' Digest May 23, 1994.

Willoughby, Jack. "Investors in Askin Funds Sue Street for $700 Mil." The Investment Dealer's Digest April 1, 1996.

"World Economic Outlook and International Capital Markets Interim Assessment" IMF, December 1998.

"World Economic Outlook." IMF, May 1998.