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Recommended Citation
Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size* , *in* 39 Rutgers Law Journal 657 (2008).
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Citations:

Bluebook 21st ed.
Tamar Frankel, Private Investment Funds: Hedge Funds' Regulation by Size, 39 Rutgers L.J. 657 (2008).

ALWD 7th ed.
Tamar Frankel, Private Investment Funds: Hedge Funds' Regulation by Size, 39 Rutgers L.J. 657 (2008).

APA 7th ed.
Frankel, T. (2008). Private investment funds: hedge funds' regulation by size. Rutgers Law Journal, 39(3), 657-680.

Chicago 17th ed.
Tamar Frankel, "Private Investment Funds: Hedge Funds' Regulation by Size," Rutgers Law Journal 39, no. 3 (Spring 2008): 657-680

McGill Guide 9th ed.
Tamar Frankel, "Private Investment Funds: Hedge Funds' Regulation by Size" (2008) 39:3 Rutgers LJ 657.

AGLC 4th ed.
Tamar Frankel, 'Private Investment Funds: Hedge Funds' Regulation by Size' (2008) 39(3) Rutgers Law Journal 657

MLA 9th ed.
Frankel, Tamar. "Private Investment Funds: Hedge Funds' Regulation by Size." Rutgers Law Journal, vol. 39, no. 3, Spring 2008, pp. 657-680. HeinOnline.

OSCOLA 4th ed.
Tamar Frankel, 'Private Investment Funds: Hedge Funds' Regulation by Size' (2008) 39 Rutgers LJ 657

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PRIVATE INVESTMENT FUNDS: HEDGE FUNDS' REGULATION BY SIZE

*Tamar Frankel**

I. INTRODUCTION

This Article focuses on hedge funds—a species of private investment funds. These funds appeared in the 1950s and remained active but small. Then, in a fairly short period, they grew enormously to over $1.5 trillion, although the estimates vary.[1] Hedge fund managers engage in more than twenty-five different categories of investment strategies.[2] Since 2002, the number of hedge funds has more than doubled to an estimated 9,000 funds,[3] and their assets have grown by 400% to an estimated $1.4 trillion since 1999.[4] Other estimates are higher, suggesting current hedge fund assets at $2 trillion and their number worldwide at 13,000, although the United States

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* Professor of Law, Michaels Faculty Research Scholar, Boston University. I am indebted to Claudia F. Torres, J.D., Boston University Law School, for the research in her paper *Managing the Excessive Use of Leverage by Hedge Funds*, written in satisfaction of a seminar, Investment Company Regulation, Fall 2007. I am also indebted to Sofia Tsachouridou, LL.M., Boston University, for her meticulous and expansive research.

1. In July 2007 the number of hedge funds was estimated to be about 9,000. Their assets have grown by 400% to about $1.4 trillion since 1999. *Hedge Funds and Systemic Risk: Perspectives from the President's Working Group on Financial Markets: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 61-66 (2007) (statement of Robert K. Steel, Treasury Under Secretary For Domestic Finance) [hereinafter *Steel Testimony*]; *see also* SEC. & EXCH. COMM., DIV. OF INV. MGMT. & OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS vii (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC STAFF REPORT].

2. SEC STAFF REPORT, *supra* note 1, at 34 n.120.

3. *Steel Testimony*, *supra* note 1.

4. *Id.*

market accounts for 70% of the funds' assets.[5] The different estimates may be due to the fact that these funds are not required to report as much as other regulated pools of assets are, that the funds are absorbing assets globally, and that their investor and lender base has grown. The number of funds does not represent their asset concentration, however. "The average size of a hedge fund, however, just exceeds $100 million. Thus, ten percent of the hedge funds hold about ninety percent of the total hedge fund assets."[6] Hedge fund managers engage in many different investment strategies.[7] But their size has increased by borrowing and by a variety of indirect leveraging techniques, such as short positions, futures, repurchase agreements, options, and other derivative contracts.[8] In addition, there is also a growing concern over the retailization of hedge funds.[9] Hedge funds have reached small investors' money indirectly by attracting mutual funds and pension funds.[10]

Some hedge funds have produced enormous profits for their investors and their managers. Other funds have suffered significant losses due to fraud,[11] and some have generated devastating losses by speculation and risky structures.[12]

This symposium poses the questions of whether private funds should be regulated, and whether the Securities and Exchange Commission ("SEC") should increase the level of its regulation over these funds. The attempts of the SEC to regulate the managers of hedge funds have been only partially successful.[13]

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5. Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds,* 33 N.C.J. INT'L L. & COM. REG. 1, 12-16 (2007).

6. *Id.* at 16 (footnotes omitted).

7. *Id.* at 17.

8. SEC STAFF REPORT, *supra* note 1, at 37.

9. *Id.* at 80.

10. *Id.* at 81-83.

11. *See, e.g.*, Anuj Gangahar, *Former Hedge Fund Chief Jailed for 20 Years,* FIN. TIMES (USA Edition 2), Jan. 30, 2008, at 17 ("The former finance chief of bankrupt hedge fund company Bayou Management was yesterday sentenced to 20 years in prison, among the harshest sentences meted out in the US for a white-collar crime, for his part in defrauding investors of more than [$400m]."); Lori Montgomery, *2 Former Treasury Chiefs Add Clout to Hedge Funds,* WASH. POST, Oct. 21, 2006, at D01 (Amaranth lost an estimated $6.6 billion).

12. *See, e.g.*, PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 10-22 (1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf [hereinafter PRESIDENT'S WORKING GROUP].

13. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44,756, 44,761 (proposed Aug. 9, 2007) (to be codified at 17 C.F.R. § 270.206(4)-8).

More importantly, the freedom of hedge funds from regulation is important to our financial system.[14] The fund managers are the mavericks, the innovators and risk-takers. They offer experimental and innovative approaches. Some of these approaches contribute to the efficiency of the markets. For example, a number of hedge funds trade in "miss-priced assets" and offer alternative investments to pension funds. These funds perform very well in market downturns.[15] Some funds may provide early danger signals, which are helpful to the markets and the regulators; that is, so long as these funds do not threaten to undermine the entire financial system. These funds did not threaten the financial system. That is when the funds remained small and investors did not clamor to invest in them. So long as they remained unique and out of the ordinary actors they did not endanger the system.

While there is a need to limit the impact of hedge funds on the financial system, I suggest that this goal should be achieved by regulating the size of these funds. Rather than controlling the funds' actions or their actors, it is the source of these funds' assets that requires control. Hedge funds should remain free of additional regulation if they remain small in terms of the amounts that their lenders invest in them. Thus, the necessary regulation of today's hedge funds should focus on how hedge funds grow in terms of assets under management, and who enables them to grow in this way.

This Article suggests that the lenders – the banks and large institutional investors, as well as funds of funds – should be regulated. The regulation of these institutions should induce them to limit the amounts they offer to finance hedge funds by requiring the financing to be kept on their books, prohibiting the sale of this financing and perhaps by increasing the loan loss reserves; our existing philosophy and method of regulation, falling within the duties of these financing institutions to their savings investors.

This Article is organized as follows: Part I outlines the regulation of investment companies and the exceptions that shelter hedge funds from some regulation. Part II examines the source of hedge funds' growth in the past few years. Part III describes the fraudulent behavior of some managers of large hedge funds and the impact of their behavior on the financial system. Part IV suggests principles on which regulation should be based. It emphasizes that regulation aims not only, and perhaps not mainly, at protecting investors as much as it aims at protecting the financial system.

14. Justin Fox, *Fear of a Black Box*, FORTUNE, Nov. 14, 2005, at 72.

15. Adrian Blundell-Wignall, *Financial Market Innovation*, http://www.oecd.org/dataoecd/47/56/38674683.pdf (OECD FORUM 2007, Innovation, Growth and Equity, May 14-15, 2007, Paris).

Regulators should keep hedge funds small and relatively free to take risks. The main lenders and institutional investors should be regulated by reducing their incentives to finance hedge funds.

II. THE REGULATION OF INVESTMENT COMPANIES AND THE EXCEPTIONS SHELTERING HEDGE FUNDS

After the U.S. market crash of the late 1920s and the devastating investors' losses, Congress passed laws to regulate intermediaries over the entire financial system: the securities market actors,[16] the banks,[17] and the investment companies.[18]

In all these statutes Congress provided exceptions, distinguishing between Wall Street actors that cater to few members of the public and those that cater to large segments of the public. Congress imposed the highest level of regulation on the larger actors, and excluded the small ones fully or partially from regulation. For example, large advisers are required to register with the SEC. Small advisers, who have less than fifteen clients,[19] need not register. Investment companies with less than 100 holders of voting securities[20] and investment companies whose investors are wealthy and sophisticated are excluded from the definition of an investment company.[21] Thus, with respect to such exemptions there are no limits both on the assets under management and the number of investors.

Similarly, Congress imposed strict regulation on market actions that are widespread, such as public distribution of securities,[22] and imposed a lower level of regulation on more limited distribution of securities such as

16. *See, e.g.*, Securities Act of 1933, 15 U.S.C. §§ 77a-aa (2000 & Supp. II 2002); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (2000 & Supp. II 2002); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-mm (2000 & Supp. II 2002).

17. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

18. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2000 & Supp. II 2002); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2000 & Supp. II 2002).

19. Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(b)(3) (2000).

20. Securities Act of 1933, Regulation D, 17 C.F.R. §§ 230.501-.508 (2007); *see generally* State of Wisconsin Dep't of Fin. Insts., *A Brief History of Securities Regulation*, http://www.wdfi.org/fi/securities/regexemp/history.htm (last visited Mar. 5, 2008).

21. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1), (7) (2007). Courts are not sympathetic to such investors who decide to invest in risky securities and then sue to recover their losses. *See* Moross Ltd. P'ship v. Eckenstein Capital, Inc., 466 F.3d 508 (6th Cir. 2006).

22. Securities Act of 1933, 15 U.S.C. §§ 77a-aa (2000 & Supp. II 2002).

private placements.[23] These distinctions, however, do not apply to the amounts involved but to the number of clients or wealth and sophistication of the investors involved. An unlimited number of banks, for example, may invest unlimited amounts of money in managed pools of money, such as hedge funds. However, because banks are subject to strict substantive regulation on how and where they lend and invest the depositors' and other investors' money, and must diversify their loan portfolios, there are limits on the amounts they can invest in hedge funds.

A number of reasons can explain the distinctions between large and small institutions, whether by number of investors or amounts invested. First, "small" does not mean "less profitable" for investors.[24] Some studies have shown that smaller hedge funds are likely to perform better.[25] Second, when the number of investors or advisees is small, there is a better likelihood that they will be wealthier. Otherwise, the advisers might not find it sufficiently lucrative to operate their business. It is presumed that such wealthy individuals are more sophisticated and that they can fend better for themselves.[26] It is very likely that the clients will directly interact with the managers of their money. Such direct contact is likely to allow investors more control over their money managers. Third, dishonest fund managers, who manage the assets of a larger number of investors, can inflict harm on individual investors. The larger the number of individual investors, the greater the harm they can inflict. Fourth, the larger the number of investors is, the more harm can be inflicted on the entire financial system. As Andy Serwer wrote in *Fortune* about the impact of the financial system on citizens: "Don't for a minute think that this doesn't apply to you. The hedge fund boom has sweeping implications not just for Wall Street traders and a few

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23. *See generally* Mark J. Astarita, *Introduction to Private Placements*, http://www.seclaw.com/docs/pplace.htm (last visited Mar. 5, 2008).

24. Greg N. Gregoriou & Fabrice Rouah, *Large Versus Small Hedge Funds: Does Size Affect Performance?*, J. ALTERNATIVE INVESTMENTS, Winter 2002, at 75; *see also* James R. Hedges, IV, *Size vs. Performance in the Hedge Fund Industry*, 10 J. FIN. TRANSFORMATION 14, 16-17 (2004), *available at* http://www.edge-fund.com/Hedg.pdf; Christine Williamson, *Midsize Funds of Funds Outperform Big, Small*, PENSIONS & INVESTMENTS, Nov. 12, 2007, at 45. *But see* Noël Amenc et al., *The Alpha and Omega of Hedge Fund Performance Measurement* 26 (Feb. 27, 2003), http://www.edge-fund.com/AmCM03.pdf.

25. Mila Getmansky, *Process of Growth of a Hedge Fund: Impact of Size on Performance*, http://systemdynamics.org/conferences/2001/papers/Getmansky_1.pdf (last visited Mar. 4, 2008).

26. This language is borrowed from SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) ("[T]hose who are shown to be able to fend for themselves . . . .").

thousand well-heeled investors, but increasingly for every American businessperson, investor, and retiree."[27]

Disloyal managers of large populated funds can inflict harm not only because the amounts under management are large and not only because they can injure a larger number of investors. Such managers and the reactions of their victims can contaminate other, healthy, institutions and thereby threaten the integrity and sustainability of the financial system as a whole. For example, the contraction of the banking system is the main reason for the government's establishment of the FDIC to guarantee bank deposits.[28] Deposits are expected to be low risk; people would say—"as safe as money in the bank." If one bank fails, depositors are likely to "run over" other banks as well.[29] Bubbles and crashes in the markets exhibit the same phenomenon. Not all investors make their decisions independently of the actions of others, even if the investors are offered relevant information. That is especially so if the investments are expected to be safe. Many investors follow others, rather than evaluate and decide on their own. In some respects, these investors are rational and efficient. Rather than invest time and attention in evaluating market prices, they rely on others, whom they believe have done their homework, and, like free riders, follow the trend.[30]

A similar sensitivity to size is demonstrated by the requirement that certain large investors of publicly held companies disclose their identity.[31] Professor Mark Roe has suggested that diversification, required by the tax code to allow mutual funds to avoid double taxation, was based on the concern that Wall Street might grow sufficiently large and control Main Street.[32]

Where do hedge funds fit in the regulatory scheme? The term "hedge funds" is not defined in law,[33] except by the extent to which they are

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27. Andy Serwer, *Where the Money's Really Made,* FORTUNE, Mar. 31, 2003, at 106.

28. Robert L. Hetzel, *Too Big to Fail: Origins, Consequences, and Outlook,* ECON. REV. (Federal Reserve Bank of Richmond), Nov.-Dec. 1991, at 3, 5-6, *available at* http://www.richmondfed.org/publications/economic_research/economic_review/pdfs/er770601.pdf.

29. George G. Kaufman, *Bank Runs: Causes, Benefits, and Costs,* 7 CATO J. 559, 561-63 (1988), *available at* http://www.cato.org/pubs/journal/cj7n3/cj7n3-2.pdf.

30. *See* Shane Oliver, *Its [sic] All in the Mind – Investor Psychology* (Oct. 9, 2002), http://www.ampcapital.co.nz/MarketViews/Economic/Investmentpsychology.pdf.

31. Securities Exchange Act of 1934, Rule 13d-1(a), 17 C.F.R. §240.13d-1(a) (2007).

32. Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry,* 139 U. PA. L. REV. 1469, 1478-79 (1991).

33. GERALD T. LINS ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1:1, Westlaw, SEC Hedge Database (last updated Nov. 2007).

regulated. They are "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act."[34] Hedge funds have escaped strict investment companies' and securities' regulation by following the exceptions in the law (e.g., the limits on the number and quality of advisees and investors and offerees of securities). However, the SEC has continuously been attentive to them.[35] "As early as 1969, the Commission investigated hedge funds . . . ."[36]

Thus, functionally, hedge funds fall within the definition of an investment company because they issue securities and invest in securities.[37] However, these funds are exempted from registration as investment companies under either section 3(c)(1) or section 3(c)(7) of the Investment Company Act.[38] To qualify for exemption under section 3(c)(1), a hedge fund may not be beneficially owned by more than 100 persons.[39] To qualify for exemption under section 3(c)(7), a hedge fund may sell its securities only to qualified purchasers.[40] Further, to qualify for exemption under either section 3(c)(1) or section 3(c)(7), the hedge fund must not make or propose to make a public offering of its securities.[41]

Therefore, it is up to creditors, counterparties, and hedge funds themselves to place limits on the amount of leverage that hedge funds use.[42] In recent years, small investors' money could reach hedge funds through registered funds that distribute their securities to the public but invest their

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34. *See* SEC STAFF REPORT, *supra* note 1, at 3.

35. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,171, 45,174 (July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter Proposed Rule].

36. *Id.*

37. Investment Company Act of 1940, 15 U.S.C. § 80a-3(a)(1)(A) (2000) defines an investment company as an issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." Investment Company Act of 1940, 15 U.S.C. § 80a-3(a)(1)(C) (2000) defines an investment company as an issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of [its] total assets (exclusive of Government securities and cash items) on an unconsolidated basis." *See* SEC STAFF REPORT, *supra* note 1, at 11 (concluding that most hedge funds meet both of these definitions). *See generally Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds* (Mar. 26, 2008), http://www.sec.gov/answers/hedge.htm.

38. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1), (7) (2000).

39. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1) (2000).

40. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(7) (2000).

41. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1), (7) (2000).

42. PRESIDENT'S WORKING GROUP, *supra* note 12, at 4-5.

assets in hedge funds.[43] Thus, public investors' money does seep through to hedge funds through the pools in which the public invests its money.

Hedge funds are free of a number of constraints which apply to publicly held investment companies. One important constraint is the prohibition on borrowing. The law prohibits investment companies from borrowing, with very few limited exceptions.[44] The concern about excessive borrowing by investment companies led to the passage of section 18 of the Investment Company Act.[45] Before the Act, some investment companies were highly leveraged,[46] resulting often in highly speculative investments.[47] Section 18 of the Investment Company Act[48] imposes asset coverage requirements upon the issuance of senior securities.[49]

Open-end investment companies are prohibited from issuing or selling any class of senior security,[50] and may only borrow from banks, subject to a 300% asset coverage requirement.[51] While the Investment Company Act does not prohibit mutual funds from investing in any specific type of instrument, including derivatives, mutual funds must disclose information about these transactions and their risks in the prospectus.[52]

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43. *After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds? Testimony Before the Domestic Policy Subcomm. of the H. Comm. on Oversight and Government Reform* 3-4 (July 11, 2007) (statement of Peter J. Tanous), *available at* http://domesticpolicy.oversight.house.gov/documents/20070712164945.pdf.

44. Allan F. Conwill, Director, SEC Div. Corp. Regulation, Protection or Oppression? The Investment Company Act Impact on the Publicly Held SBIC (Oct. 3, 1963), *available at* http://www.sec.gov/news/speech/1963/100363conwill.pdf; *see also Sarbanes-Oxley to Impose Restrictions on Publicly Held Companies: Compliance Costs May Increase More than 100%,* BUS. WIRE, May 27, 2003.

45. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-279, pt. 3 (1939).

46. SEC. & EXCH. COMM'N DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 80 (1992).

47. *Id.*

48. Investment Company Act of 1940, 15 U.S.C. § 80a-18 (2000).

49. 3 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 21.05[C], at 21-92 (2d ed. 2001); *see also* Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing,* 25 ANN. REV. BANKING & FIN. L. 235, 287-93 (2006) (the operations of large investment companies (e.g., mutual funds) are currently regulated, and these regulations seem sufficient to protect the financial system, notwithstanding the scandals in which mutual funds have been recently involved).

50. Investment Company Act of 1940, 15 U.S.C. § 80a-18(f)(1) (2000); SEC. & EXCH. COMM'N DIV. OF INV. MGMT, *supra* note 46, at 432.

51. Investment Company Act of 1940, 15 U.S.C. § 80a-18(f)(1) (2000).

52. PRESIDENT'S WORKING GROUP, *supra* note 12, at app. 2.

Hedge funds are not required to maintain maximum leverage ratios under the Investment Company Act because they are structured so as to qualify for exclusion from registration as investment companies under the Act.[53] Since hedge funds are not confined by the leverage and borrowing restrictions that apply to registered investment companies under the Act, hedge funds are free to use large amounts of leverage to engage in risky investments.[54] In fact, hedge funds often use leverage aggressively. At the extreme, hedge funds leverage their capital thirty times,[55] or even fifty or more as in the case of Long-Term Capital Management.[56]

In addition, there are a number of trading techniques that regulated investment companies may not practice. Most importantly, hedge funds need not disclose their investment policies and how they trade, while regulated investment companies must disclose these policies.[57]

Historically, hedge funds traded in the securities markets. They adopted various trading strategies designed to capture the inefficiencies in the markets. And they borrowed, thus increasing their returns as well as their risks. When one trades successfully on borrowed money, one can increase the returns by capturing the profits minus the cost of the borrowing. However, if the trading is unsuccessful, the losses not only affect one's investment; the fund must pay the lenders the borrowed amounts and the interest due. In addition, speculative trading can turn into gambling ("I am sure to win this time!") and such gambling can turn into an addiction ("Just one more time and I will regain my losses!"). Examples, such as the Amaranth hedge fund and Bear Stearns funds, have demonstrated such a behavior and such an addiction.[58]

In recent years hedge funds have turned to acquiring corporations that are rich in cash but slow in rising profits and share prices. Some funds turned such corporations into more profitable businesses long-term; others have

53. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1), (7) (2000); PRESIDENT'S WORKING GROUP, *supra* note 12, at app. 1-2.

54. PRESIDENT'S WORKING GROUP, *supra* note 12, at app. 1.

55. *Id.* at 5.

56. Barry Eichengreen & Bokyeong Park, *Hedge Fund Leverage Before and After the Crisis*, J. ECON. INTEGRATION 5 (forthcoming), *available at* http://www.econ.berkeley.edu/~eichengr/research/hedgefunddec20.pdf.

57. Investment Company Act of 1940, 15 U.S.C. §§ 80a-8(b)(1), (2) (2000); *see* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181-82 (1963); *see also Westly Calls for Increased Disclosure and Transparency for Hedge Funds*, BUS. WIRE, May 12, 2003.

58. Carl Bialik, *Billionaire NBA Owner's Gamble on a Hedge Fund Faces Long Odds*, WALL ST. J. ONLINE, Dec. 9, 2004, http://www.unc.edu/~cigar/BETTING_MEDIA/WSJ_9Dec2004.htm.

turned their acquired corporations into more profitable operations short-term, but depleted the corporations long-term.[59] The main point is that, throughout their history, hedge funds have adopted various trading techniques, invested in various corporations, and were successful as well as unsuccessful. Some behaved with integrity and some turned out to be the rogue actors on Wall Street.

III. THE SOURCE OF HEDGE FUNDS GROWTH IN THE PAST FEW YEARS

A. How did Hedge Funds Grow to Such an Extent?

The first hedge fund, distinguished from other pooled funds by its investment strategy, was established in 1948, by Alfred Winslow Jones.[60] Others followed this strategy, and by 1968, the number of similar hedge funds grew to be nearly two hundred.[61] In the 1990s, their number and assets under management exploded. If hedge funds were subject to limits on the number and quality of investors, and if for so many years their size was minimal as compared to other publicly held managed investment pools, how did their assets under management grow to such an extent during the past ten years? Before the year 2000, most hedge fund investors were wealthy individuals. Since then, institutional investors, such as pension funds, endowment funds, and sovereign wealth funds, have invested in hedge funds. Infusion of money increased their size and raised the complexity of hedge fund groups.[62]

One reason for their rapid growth may be the funds' spectacular performance. This performance was remarkable as compared to the declining

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59. Andrew Dolbeck, *Hedging Bets on Acquisitions: Hedge Funds and M&A*, WEEKLY CORP. GROWTH REP., Aug. 2, 2004, at 1-2, *available at* http://findarticles.com/p/articles/mi_qa3755/is_200408/ai_n9422950.

60. Jonathan J. Katz, Note, *Barbarians At The Ballot Box: The Use of Hedging to Acquire Low Cost Corporate Influence and Its Effect on Shareholder Apathy,* 28 CARDOZO L. REV. 1483, 1492 (2006).

61. *Id.* at 1493.

62. Deborah Brewster, *As Hedge Funds Swell So Do Demands on Brokers*, FIN. TIMES, Jan. 14, 2008, at 1, *available at* http://www.ft.com/cms/s/0/e2b0a0de-c242-11dc-8fba-0000779fd2ac.html; *see also* Tim Price, *Why You Should Be Wary of Hedge Funds,* MONEYWEEK, Mar. 30, 2006, at 1, *available at* http://www.moneyweek.com/file/10589/why-you-should-be-wary-of-hedge-funds.html. Some argued, however, that hedge funds that carried pension fund investments managed lower risk portfolios. *See* PRESIDENT'S WORKING GROUP, *supra* note 12, at 1; Steve Rosenbush, *Hedge Funds Inc.*, BUS. WK., May 23, 2007, http://www.businessweek.com/bwdaily/dnflash/content/may2007/db20070522_571588.htm.

market prices in the early 2000s. This performance was achieved in large part by leveraging, that is, "the use of credit to enhance one's speculative capacity"[63] or more broadly: the risk taken as compared with the ability to bear it,[64] or the ratio of assets to net worth.[65] Hedge funds leverage by using strategies that create greater exposure to risk and benefit than the invested amount,[66] such as buying securities with borrowed money.[67] In this Article, I focus only on borrowing, that is, not on the rise in risk but on the rise in hedge funds' assets under management.

Thus, the main source of hedge funds' enormous returns was increased borrowing. Some borrowing was direct, but new types of speculation by investing in various derivatives, for example, increased the assets far more. "Hedge Funds [that] have been around for a long time [have grown to about] $1.4 trillion in mid 2007. But the leverage hedge funds use alongside of this is much bigger. [The writer estimated that leverage] could be well *over $5 trillion*, if derivatives are taken properly into account."[68]

B. Where is the Source of Hedge Funds' Borrowing?

Hedge funds rarely borrow from individuals. The exemptions under which they function prohibit them from publicly offering securities, including bonds. Besides, the hedge funds' individual investors and institutions invest in equity securities, rather than bonds. Thus, hedge funds' sources of borrowed capital are the banks, investment bankers, large broker dealers and underwriters. In the last analysis, the public's deposit and savings money has in fact found its way into, and caused the enormous growth of, hedge funds (and other private funds).[69]

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63. MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 687 (10th ed. 1993).

64. Dr. John Kambhu, *Banking Supervision and Government Policy: Intermediation in Today's Financial Markets*, 4 FORDHAM J. CORP. & FIN. L. 41, 44 (1999).

65. PRESIDENT'S WORKING GROUP, *supra* note 12, at 4.

66. George A. Martin, Assoc. Dir., CISDM, University of Massachusetts, *Getting Exposure: Hedge Funds, Leverage, and Derivatives* 3, http://cisdm.som.umass.edu/resources/pdffiles/2005/Conference/Martin-1-2005.pdf (last visited Mar. 6, 2008).

67. SEC STAFF REPORT, *supra* note 1, at 37. Today, hedge funds increase leverage by methods that do not appear on the balance sheet (e.g., short positions, futures, repurchase agreements, options, and other derivative contracts).

68. Blundell-Wignall, *supra* note 15 (emphasis added).

69. Hedge funds that held securities backed by subprime mortgage loans lost significant amounts, especially if their investments were highly speculative. *See* Ashley Seager, *Even Armageddon Has a Silver Lining*, THE GUARDIAN, Aug. 13, 2007, at 24.

Thus, while in the past the main source of funding for hedge funds was wealthy investors, and to a lesser extent lenders, during the past ten years the source of lending has expanded dramatically. Banks have considered hedge funds to be valuable customers and have lent to hedge funds enormous amounts.[70] Since 2001, banks have been competing to lend to hedge funds, offering these funds loans at an increasingly high leverage ratio. The funds' equity amounts were falling, and the "cushion" for the banks' loans was falling as well. The source of hedge fund loans expanded to foreign countries. Japan, for example, was often mentioned as a source of low interest loans.[71] Another example is the Long-Term Capital Fund. At the end of its life, the leverage ratio of this fund's assets turned out to be $1 investment for every $25 of borrowed money.[72] When the Russian government defaulted on its bonds,[73] the Fund failed, causing very serious losses to a number of banks. The lenders and investors bore the heavy burden. Because the lenders were banks and other regulated lending institutions, the government intervened to support coverage of the losses.[74] Otherwise, the financial system may have been adversely affected.[75] In 2001, the Federal Reserve Board lowered the interest rates for banks to 1%. This move caused refinancing capacity to rise and allowed hedge funds to grow. Hedge funds allowed managers to reap a significant amount by participating in the profits of their fund's investments. The gains provided a strong incentive to continue increasing profits by borrowing to increase investment assets.[76]

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70. Marian Micu, *Determinants of International Bank Lending to Emerging Market Countries* 4-5 (May 11, 2007), http://www.dallasfed.org/news/research/2007/07crossborder_micu.pdf; *see also Bank Lending to and Other Transactions with Hedge Funds: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking and Financial Services* (March 24, 1999), *available at* http://commdocs.house.gov/committees/bank/hba55787.000/hba55787_0.HTM.

71. Jim Jubak, *Drowning in Cheap Money*, http://articles.moneycentral.msn.com/Investing/JubaksJournal/DrowningInCheapMondy.aspx (last visited Mar. 6, 2008).

72. PRESIDENT'S WORKING GROUP, *supra* note 12, at 12.

73. *Id.*

74. *Id.* at D-1.

75. Grace Wong, *An Era of Cheap Money – Gone*, CNNMONEY.COM, June 14, 2007, http://money.cnn.com/2007/06/14/markets/cheap_money_gone/index.htm?postversion=2007061414 (stating that a rise in global interest rates after a period of historically low interest rates signals the end of an era of cheap money).

76. Rich Miller & Jesse Westbrook, *Hedge-Fund Borrowing Examined by Fed, SEC, European Regulators*, BLOOMBERG, Jan. 9, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aMFZqx2S1aWg; *see also* Randall Smith & Susan Pulliam, *As Funds Leverage Up, Fears of Reckoning Rise*, WALL ST. J., Apr. 30, 2007, at A1. However,

The regulators in the U.S. and the U.K. expressed worries about the quality of these loans and about the fact that the banks were not receiving sufficient security to back these loans. However, only with the severe losses in subprime loans did regulators begin investigations. The SEC, the Federal Reserve Bank of New York and the Financial Services Authority in London are conducting a joint investigation into whether banks and securities firms set strict enough limits on loans made to hedge funds.[77] The concern is that competition on borrowers has led to lower lending standards.

Because hedge funds are not required to disclose their leverage ratio, the current leverage of hedge funds can only be derived from past information relating to failed funds. For example, it is known that the impact of the failure of Long-Term Capital Management Company caused reduced credit for hedge funds which led to lower leverage ratio and size.[78]

IV. ROGUE BEHAVIOR OF HEDGE FUNDS

Hedge funds experiment and innovate. Some funds have refined trading techniques. Others have moved to acquire or affect corporations that have potential for short-term profits.[79] Only a few hedge funds have taken the long-term route.[80] The creativity of hedge funds is undeniable, but that does

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currently, the Bank of Japan changed its policy, which suggests that low interest loans from foreign countries will not be available to the extent they were available until 2006. *See* Hisane Masaki, *Japan Signals End of World's Cheap Money Era,* ASIA TIMES ONLINE, Mar. 11, 2006, http://www.atimes.com/atimes/Japan/HC11Dh01.html; *see also* Adrian Ash, *Cheap Money Continues to Wash Across the Globe from Japan,* DAILY RECKONING (UK Edition), July 13, 2007, http://www.dailyreckoning.co.uk/article/cheapmoneycontinuestowashacrosstheglobe fromjapan0353.html; Mike Larson, *The Real Reason for the the* [sic] *Stock Market Falls - Cheap Money from the Bank of Japan,* MARKET ORACLE, Mar. 3, 2007, http://www.marketoracle.co.uk/Article446.html; *Japan to End Cheap Money Policy Soon:Report,* CBC NEWS, July 4, 2006, http://www.cbc.ca/money/story/2006/07/04/japan-tues.html;

77. Miller & Westbrook, *supra* note 76.

78. Eichengreen & Park, *supra* note 56, at 20.

79. *See, e.g.*, Barnet D. Wolf & Jeffrey Sheban, *Pensions Driving Takeover Binge; Inflow of Money, New Attitude Behind Private-Equity Splurge,* COLUMBUS DISPATCH, May 27, 2007, at 1D (noting that hedge funds "tend to be short-term investors that aggressively seek the biggest returns possible"). The article describes hedge funds acquiring stakes in Wendy's International Inc. and forcing changes to improve share price.

80. *See, e.g.,* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing face of Corporate Bankruptcy Practice,* 25 AM. BANKR. INST. J. 24, 24 (2006/2007) ("While some hedge funds pursue long-term investment strategies, the liberal redemption policies offered by most hedge funds require more short-term strategies in order to maintain sufficient fund liquidity.").

not mean that the level of fraud posed by such funds has risen. There may have been more failures resulting from speculation and risk-taking.[81] Perhaps more frauds were caused by the greater temptations which accompanied the enormous growth of these funds.

Amaranth, a Greenwich, Connecticut based hedge fund,[82] reported losses of $3 billion to $5 billion and was being investigated by Connecticut Attorney General Richard Blumenthal. Arguably, "Amaranth's losses of about $5 billion in one week don't appear to be a systemic problem. 'An over confident trader, under lax supervision, lost billions of dollars.'"[83]

According to the *Wall Street Journal,* Barclays Bank lost all $400 million that it lent to two big hedge funds managed by Bear Stearns Cos. that collapsed.[84] The bank brought suit against Bear Stearns Cos. and two of its fund managers.[85] Barclays argues that it was misled as to the "performance of the highly leveraged funds."[86] The hedge funds' investors lost $1.6 billion.[87] Bear Stearns Cos.' position is that the investors and lenders were sophisticated and knew that the high returns might also result in high losses.[88] The main issue is the time in which the managers of the funds knew about the funds' problems and to what extent they misled or had to warn the investors and lenders of the precarious position of the funds.

It is interesting to note that when the SEC proposed to increase the financial qualification of investors in hedge funds, small investors rose to protest.[89] For them, hedge funds meant that the rich could get richer, while they would be barred from the opportunity to become rich. Possible losses were not counted for much. Perhaps people who do not have much to lose

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81. *See* Eichengreen & Park, *supra* note 56, at 2 (suggesting that "the use of credit by highly-leveraged institutions declined significantly in the wake of Russia-LTCM crisis, which suggested to fund managers, shareholders and counterparties that the risks of highly-leveraged investment strategies may have been underestimated.").

82. Shaheen Pasha, *Amaranth Debacle Raises Cry for Regulation,* CNNMONEY.COM, Sept. 29, 2006, http://money.cnn.com/2006/09/20/markets/amaranth_hedgefunds/index.htm.

83. *Id.*

84. Kate Kelly, *Barclays Sues Bear Over Failed Funds,* WALL ST. J., Dec. 20, 2007, at C3.

85. *Id.*

86. *Id.*

87. *Id.*

88. *See Bear Sued by Barclays,* NAT'L MORTGAGE NEWS, Dec. 31, 2007, at 14 ("Bear describes Barclays as a 'highly sophisticated financial institution with scores of analysts and economists capable of evaluating investment risk.'").

89. Sara Hansard, *200 Have Filed Comments on SEC Hedge Fund Plan,* INV. NEWS, Feb. 19, 2007, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070219/FREE/70216042/1009/TOC.

are more willing to take risks in the hope of gaining very large amounts. After all, their losses can result in bankruptcy, and for many that is not a sufficient deterrent as weighed against the chance of high profits.

V. THE GUIDING PRINCIPLES FOR REGULATING ACTORS IN THE FINANCIAL MARKETS

A. *Protecting the Individual Investor and the System*

The guiding principles of market regulation in the United States have aimed at protecting investors who cannot rationally protect themselves.[90] For example, if the information that is necessary for investors to make a rational decision is generally too costly to acquire and understand, the law might interfere to require that the information be offered in plain English.[91] In addition, and perhaps more importantly, the purpose of regulation is to protect the financial system. The protection of investors and the protection of the system go hand in hand. But the system must be protected even at the cost of some investors and some managers.

B. *How Do We Regulate?*

In the 1940s, Congress was not as reluctant as it currently is to dictate how small investors should invest their money. With time, and with the rising belief that the market (whatever it is) is the best judge of the quality and value of investments, Congress has increasingly become more averse to regulating the manner in which money managers invest. Today, rightly or wrongly, we believe that the managers must disclose their investment policies to investors and let the investors and the markets determine the value and risk level and justified return from investments that follow these policies. If hedge funds are offered to sophisticated and wealthy investors that can protect themselves from losses and fraud,[92] and if hedge funds do not violate

90. *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 94 (3d ed. rev. 1998) (noting extensive role of government in investor protection).

91. *See* Plain English Disclosure, Securities Act Release No. 7497, Exchange Act Release No. 39,593, Investment Company Release No. 23,011, 63 Fed. Reg. 6370 (Feb. 6, 1998) (requiring use of plain English in prospectuses).

92. *See, e.g.*, Securities Act of 1933, Rule 144A, 17 C.F.R. § 230.144A (2008) (providing exemption from registration requirement for certain private resales of securities to institutions); Moross Ltd. P'ship v. Eckenstein Capital, Inc., 466 F.3d 508 (6th Cir. 2006) (the court rejected the claim of a sophisticated investor).

their fiduciary duties to their investors,[93] then, at the most, regulation would require hedge funds to offer information to investors. Otherwise, the funds should remain free to adopt investment policies as their managers choose. Hence, our culture points to freedom of hedge funds to act, subject to a prohibition on fraud and the requirement of disclosure.

However, we have in the past, and should in the present, regulate the banks and other lenders or holders of other people's money that is pooled for efficient investment. Banks and similar institutions are the main source of our system's liquidity and should not invest in speculative enterprises above a limited amount. Therefore, banks are required to account for the amounts they lend and provide backing in the form of loan loss reserves for these amounts.[94] This accounting system reduces bank dividends and bank stock prices (on which bank management depends for a significant part of their compensation).[95] Self-interest presses bank management to reduce loan loss reserves and to remove liabilities off its balance sheet.[96] There are many ways to do that, and we need not discuss them here. The creative talent of the accounting profession is boundless, and the regulators are attempting to limit the techniques which banks use to reduce the loans on their balance sheets.

To be sure, bank management strives to provide profits to its shareholders. While in the past the number of bank shareholders was relatively small, many banks are currently publicly held.[97] The pressure to

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93. *See, e.g.*, Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(4) (2000) (prohibiting investment advisers from engaging in fraudulent acts); Andrew M. Kulpa & Butzel Long, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. Davis Bus. L.J. 78, 89 (2005) ("[M]ost types of institutional investors, such as pension funds and trusts, may owe fiduciary duties to their constituents," hedge funds "do not have any enhanced legal fiduciary duty to investors because of the private nature of the funds and the resulting sophistication of the investors.").

94. *See, e.g.*, *Loan Loss Reserves: Hearing before the Subcomm. On Financial Institutions and Consumer Credit of the H. Comm. on Banking and Financial Services*, 106th Cong. (1999), http://www.fdic.gov/news/news/speeches/archives/1999/sp16jun99.html (statement of Donna Tanoue, Chairman, Fed. Deposit Insurance Corporation) (defining loan loss reserves and describing how they are determined).

95. *Id.* (stating that the establishment of a reserve is "a loss against current earnings"; a later increase is "an expense to current earnings and, therefore, a reduction in equity capital").

96. *See, e.g.*, *Recent Developments in Loan Loss Positioning* FRBSF ECON. LETTER (Federal Reserve Bank of San Francisco), July 25, 1997, http://www.frbsf.org/econrsrch/wklyltr/el97-21.html ("The loan loss reserve account appears on a bank's balance sheet as a *contra asset* -- a deduction from the bank's outstanding loans . . . .").

97. According to a 2007 survey, 29% of banks with assets from $100 million to $20 million are publicly held, based on completed questionnaires. GRANT THORNTON, 14TH

increase profits and thereby bank share prices is rising. In addition, bank management is compensated by "performance" like any other enterprise. Hence, the pressures to finance and profit by various means have increased. Financing hedge funds and private equity funds provided one such means.

C. The Systemic Risk of Market Collapse

Highly leveraged financial institutions such as hedge funds have the potential of disrupting the financial markets.[98] The collapse of one large fund or several small funds using leverage could cause the default of obligations and direct losses for creditors and trading counterparties.[99] The inability of many debtors to pay their obligations at the same period can cause the collapse of the entire financial system.[100]

Even market participants that are not direct creditors or counterparties of a defaulting hedge fund may be affected by its default if highly leveraged investors are overwhelmed by market shock or liquidity shock. When the investors who are ready to bear high risks disappear, other market participants can be affected by price changes.[101] Falling prices can deepen uncertainty about credit risk. This uncertainty could cause credit, liquidity, and economic activity to contract.[102]

D. A Number of Hedge Funds that Collapsed Offer Examples of Such Possibilities

Long-Term Capital Management was a prestigious hedge fund which earned "spectacular returns" for its investors on a portfolio of $125 billion.[103] In 1995 and 1996 this hedge fund produced returns, net of fees, of approximately 40%, and slightly less than 20% in 1997.[104] However, in order

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ANNUAL SURVEY OF BANK EXECUTIVES (2007), http://www.denovobanks.com/downloads/Grant_Thornton_Survey_Bank_Executives_07.pdf.

98. PRESIDENT'S WORKING GROUP, *supra* note 12, at 12; *see also* Ivy Schmerken, *Credit Crisis in Sub-Prime Mortgages Affects Hedge Funds Trading in Other Asset Classes*, ADVANCED TRADING, Sept. 30, 2007, http://www.advancedtrading.com/featured/showArticle.jhtml?articleID=201805585&pgno=3 (arguing that hedge fund losses were caused by leveraging).

99. PRESIDENT'S WORKING GROUP, *supra* note 12, at 23.

100. *Id.*

101. *Id.*

102. *Id.*

103. ALAN GREENSPAN, THE AGE OF TURBULENCE 193 (2007).

104. PRESIDENT'S WORKING GROUP, *supra* note 12, at 11.

to profit the fund had to borrow from banks and "leverag[e] its bets" with over $120 billion.[105] It seems that Long-Term Capital "had less than $1 billion in capital to offset positions in securities worth $120 billion and derivatives with a notional value of $1.3 trillion,"[106] at an estimated on-balance sheet leverage ratio of fifty.[107] The precise level of the leverage is not known because the financial derivatives were not reflected on the balance sheet.[108]

The size of the fund's assets and the extent of its leverage made Long-Term Capital extremely "vulnerable to [certain] market conditions that emerged" when Russia defaulted on its debt.[109] The fund lost nearly $5 billion "practically overnight."[110] The losses and its failure to raise new capital[111] endangered Long-Term Capital's ability to meet its cash flow obligations.[112] At the time, it was estimated that its top seventeen counterparties would have lost about $3 to $5 billion.[113] The collapse of this hedge fund could have had extreme adverse consequences for world markets at the time,[114] and the Federal Reserve was concerned that if the hedge fund sold all its assets at once, "prices could collapse."[115] "That would set off a chain reaction" of other firms' bankruptcies.[116] Therefore, Bill McDonough, the head of the New York Federal Reserve, decided to intervene.[117] He convened the "top officials of sixteen of the world's most powerful banks and investment houses" and induced them to bail out the hedge fund.[118] Fourteen firms finally participated in infusing $3.6 billion in cash into Long-Term Capital to enable it to "dissolve in an orderly way."[119]

A second example is Amaranth Advisors, LLC, which lost an estimated $6.6 billion in September 2006 – the largest hedge fund loss in history.[120]

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105. GREENSPAN, *supra* note 103, at 193.
106. Eichengreen & Park, supra note 56, at 8.
107. *Id.* at 1-2.
108. GREENSPAN, *supra* note 103, at 194.
109. PRESIDENT'S WORKING GROUP, *supra* note 12, at 13.
110. GREENSPAN, *supra* note 103, at 194.
111. PRESIDENT'S WORKING GROUP, *supra* note 12, at 12.
112. *Id.*
113. *Id.* at 17.
114. *Id.* at 12.
115. GREENSPAN, *supra* note 103, at 194.
116. *Id.*
117. *Id.* at 193-94.
118. *Id.* at 194.
119. *Id.*; PRESIDENT'S WORKING GROUP, *supra* note 12, at 17.
120. Lori Montgomery, *2 Former Treasury Chiefs Add Clout to Hedge Funds,* WASH. POST, Oct. 21, 2006, at D01.

Amaranth actively traded in natural gas contracts, equities, equity-linked derivatives, credit derivatives, and bank loans.[121] The banks and securities firms which acted as dealers and counterparties to Amaranth had significant credit exposures to Amaranth.[122] So did pension funds. California's San Diego County employee pension fund lost an estimated $85 million in an Amaranth investment.[123]

It should be noted that even though Amaranth's losses in dollar terms were higher than Long-Term Capital's, the fund's collapse was met with a "shrug," because the market at the time could easily absorb the losses.[124] In contrast to Long-Term Capital, Amaranth borrowed far less and had far smaller positions.[125] "Leverage in [Amaranth's] energy portfolio was 5.21 and 6.56 in its commodity portfolio," as compared to Long-Term Capital's estimated leverage level of fifty.[126]

A third example of high leverage and the effect of its collapse is the case of three Bear Stearns hedge funds in the summer of 2007[127] and in January 2008.[128] Together, the three funds lost $2 billion from investments mostly in the subprime mortgage market.[129] The collapse of these funds was similar to that of Long-Term Capital. The investment strategy of these funds required increased borrowing; banks lent the funds about $14 billion, and additional millions were borrowed by issuing short-term debt.[130] At some point the

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121. Annette L. Nazareth, Commissioner, U.S. Sec. & Exch. Comm'n, Remarks Before the Conference of Business Economists, Washington, D.C. (Feb. 8, 2007), *available at* http://www.sec.gov/news/speech/2007/spch020807aln.htm.

122. *Id.*

123. *Officials Offer Hedge Fund Guidelines,* AFX.COM, Feb. 23, 2007.

124. Steven Mufson, *Hedge Fund's Collapse Met With a Shrug: Amaranth's Loss in Natural Gas Gamble Not Seen as Affecting Broader Market,* WASH. POST, Sept. 20, 2006, at D01.

125. *Id.*

126. Alistair Barr, *Amaranth Energy Trades Leveraged Five Times in May,* MARKET WATCH, Sept. 25, 2006, http://www.marketwatch.com/news/story/amaranths-energy-portfolio-leveraged-five/story.aspx?guid=%7B0BE8C84D-6245-49FC-93C7-A1EAB32352D9%7D. However, leverage in energy, particularly in natural gas, is unusual because of the high volatility. *See also* Ashley Seager, *Even Armageddon Has a Silver Lining,* THE GUARDIAN, Aug. 13, 2007, at 24. ("The crisis affecting markets around the world means a healthier sharing of risks.").

127. Matthew Goldstein & David Henry, *Bear Bets Wrong,* BUS. WEEK, Oct. 22, 2007, at 50.

128. *Bear Stearns Shuts Asset-Backed Hedge Fund After Loss,* FIN. WEEK, Jan. 10, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080110/REG/172666948/1014/NEWS.

129. Goldstein & Henry, *supra* note 127.

130. *Id.*

funds bought "$60 worth of securities for every $1 of investors' money."[131] When the lenders began to demand repayment, "the funds held only about 1% of their assets in cash."[132] These examples demonstrate the effect of borrowing on the stability of the financial system, including institutional lenders, such as the banks.

E. Proposed Solutions

There are numerous proposals to solve the leverage problem. One proposal calls for imposing leverage limitations on hedge funds by subjecting them to regulation under the Investment Company Act of 1940.[133] The Act requires investment companies to maintain a very low maximum leverage ratio.[134] Congress could implement this proposal by amending the Investment Company Act to require that all funds exempted from registration under 3(c)(1) or 3(c)(7) of the Investment Company Act must comply with the leverage restrictions of section 18 of the Act.[135] This leverage ratio would reduce systemic risk that hedge funds have created because the funds would have sufficient assets to pay off obligations.[136]

Another proposal is to impose leverage restrictions based on non-balance sheet methods of measuring leverage.[137] Such leverage restrictions would be based on a "ratio of potential gains and losses relative to net worth" (e.g., "value-at-risk relative to net worth").[138] This method might capture risks which are not reflected on the balance sheet.[139]

Third, small (retail) investors need either additional protections from the misused leverage by hedge funds, or for the indirect sale of hedge fund investment to small investors to be discontinued.[140]

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131. *Id.*

132. *Id.*

133. Sean M. Donahue, Note, *Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors from the Problems Created by Hedge Funds*, 55 CLEV. ST. L. REV. 235, 261 (2007).

134. *Id.* at 265-66.

135. *Id.* at 266.

136. *Id.*

137. PRESIDENT'S WORKING GROUP, *supra* note 12, at 24.

138. *Id.*

139. *See* Goldstein & Henry, *supra* note 127 (arguably, the level of leverage used by the Bear Stearns hedge funds in the latest round of hedge fund collapses points to continued misuse of leverage by hedge funds).

140. Donahue, *supra* note 133, at 264-66.

The debate on regulating hedge funds has resurfaced with "vigor" recently.[141] Dr. John Kambhu notes the arguments against direct regulation of hedge funds, especially the regulation of leverage by imposing "leverage ratios." After all, different investors have different risk tolerance.[142] Some investors seek restricted exposure to leverage but others could tolerate a higher risk level. Alan Greenspan has stated that "[i]mposing a blanket of costly regulation will succeed only in stifling the enthusiasm for seeking niche profits."[143] In his opinion, regulation would cause the disappearance of hedge funds.[144] Similarly, if the same leverage ratio imposed on investment companies under section 18 of the Investment Company Act[145] applied to hedge funds,[146] they might become indistinguishable from investment companies. Besides, there are leveraging techniques that are not reflected on the balance sheet.[147] For example, derivative securities raising liabilities several times the value of the initial margin that the trader taking that position must put up, that never show up on the balance sheet.[148] For this reason, regulations, such as leverage ratios, which employ balance sheet-based measures of leverage may fail to capture the actual use of leverage by a hedge fund.[149] Long-Term Capital Fund demonstrates the failure of the balance sheet leverage ratio to measure leverage.[150] It is now estimated that Long-Term Capital's economic leverage was substantially higher than the estimated on-balance sheet leverage ratio of fifty.[151]

In addition, hedge funds constantly change their holdings,[152] and that would require the regulators to examine the funds' portfolios "practically minute by minute."[153] It is hard to value non-balance sheet based leverage ratios.[154] In addition, high capital requirements might create a perverse

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141. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Res. Sys., Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia: Hedge Funds and Systemic Risk (May 16, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm.

142. Kambhu, *supra* note 64, at 45.

143. GREENSPAN, *supra* note 103, at 370.

144. *Id.*

145. Investment Company Act of 1940, 15 U.S.C. § 80a-18 (2000).

146. Donahue, *supra* note 133, at 266.

147. Eichengreen & Park, *supra* note 56, at 3-4.

148. *Id.* at 4.

149. *Id.*

150. *Id.* at 4-5.

151. *Id.*

152. GREENSPAN, *supra* note 103, at 372.

153. *Id.*

154. PRESIDENT'S WORKING GROUP, *supra* note 12, at 24.

incentive for funds to take additional risks in order to meet return targets on the required capital.[155] This would result in higher costs,[156] and drive some hedge funds offshore.[157]

Arguably, non-regulatory solutions provide a balance between the benefits and risks of leverage.[158] These non-regulatory solutions include, for example, counterparty discipline.[159] Counterparties, creditors, and investors assess each other's ability to bear credit exposure.[160] They limit the use of leverage by requiring collateral, imposing trading limits, counterparty limits, margin requirements, and "ongoing monitoring of credit quality."[161] Yet, even proponents of this solution admit that counterparty discipline often fails to protect against failures, as the descriptions of the large hedge fund disasters have demonstrated.[162] The near-collapse of Long-Term Capital Management and the failures of the Bear Stearns funds are examples of major failures in counterparty discipline. In the case of Long-Term Capital, none of its investors, creditors, or counterparties provided an effective check on the fund's activities or borrowing.[163] Further, a large part of Long-Term Capital's lines of credit was unsecured.[164]

In other cases, counterparty discipline may not be effective if "the incentives or the means [for discipline] are lacking."[165] Creditors might have no incentive to discipline if a fund's "obligations are guaranteed by a financially strong third party."[166] During favorable economic conditions, the incentives for discipline may become distorted.[167] Besides, retail investors may lack the "means to accurately evaluate" the fund's risk level.[168] And even when the incentives and means are not lacking, counterparty discipline may fail because of the difficulty in measuring risk[169] and the rise in errors in

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155. Kambhu, *supra* note 64, at 45.
156. PRESIDENT'S WORKING GROUP, *supra* note 12, at 42.
157. *Id.*
158. Kambhu, *supra* note 64, at 45-46.
159. Bernanke, *supra* note 141, at 5.
160. Kambhu, *supra* note 64, at 46.
161. *Id.*; PRESIDENT'S WORKING GROUP, *supra* note 12, at 35.
162. Kambhu, *supra* note 64, at 46; GREENSPAN, *supra* note 103, at 371; *see* PRESIDENT'S WORKING GROUP, *supra* note 12, at 15 (Long-Term Capital Management did not give counterparties adequate collateral).
163. PRESIDENT'S WORKING GROUP, *supra* note 12, at 14-16.
164. *Id.* at 19.
165. *Id.* at 25.
166. *Id.*
167. *Id.* at 30.
168. *Id.* at 26.
169. *Id.*

evaluation and judgment as happened in Long-Term Capital, Amaranth, and the Bear Stearns funds.[170]

There are also proposals for enhanced disclosure as a means for effectively controlling the use of leverage. The President's Working Group recommended that hedge funds be required to submit additional and more updated information to the public.[171] Unless disclosure is made mandatory, however, disclosure of certain hedge funds may be limited either because of their stature or the reputation of its principals, as was the case of Long-Term Capital.[172] To increase the current level of disclosure by hedge funds, Congress must act.[173] Yet, even mandatory disclosure may not always provide the meaningful information that will be necessary for creditors, counterparties, and investors to assess risk. Balance sheets and income statements may not accurately reveal the extent of the fund's risk and exposure.[174] Hedge funds' positions and strategies change constantly.[175] Meaningful information would require continuously updated information that accurately reflects off-balance sheet use of leverage.

VI. CONCLUSION

The solution suggested in this Article is not to regulate leverage, nor to impose restrictions on hedge funds. The solution proposed here is to regulate the main sources of hedge funds' leverage. The regulation need not cover all sources so long as it covers the main sources. The regulation need not set up limits on lending either. It should, however, introduce disincentives for the lenders.

Regulated lenders, such as banks and broker dealers, should be required to keep hedge fund borrowing on their balance sheet, and prohibit them from selling the loans they made or covering their risks by any form of derivatives, third party obligations, insurance, and any other mechanisms currently available or in designed in the future.[176] The regulators should be granted authority to determine the level percentage of loans that should be

170. *Id.*

171. *Id.* at 31.

172. *Id.* at 15.

173. *Id.* at 33.

174. *Id.* at 15.

175. GREENSPAN, *supra* note 103, at 372.

176. Hedge funds can be defined as entities that are outside the applicability of the Investment Company Act of 1940 by virtue of sections 3(c)(1) and 3(c)(7). Proposed Rule, *supra* note 35, at 45,173-74.

covered by these limits, from 100% to not more than 50%, for example. That permission would introduce some flexibility to the system but would be linked to the amount of assets under hedge fund management. As to other lenders, such as pension funds, a requirement for publicity could be imposed. Let the public and the regulators know the extent to which the pension funds have lent to hedge funds. In sum, the risk of such loans should remain with the lenders and be either regulated or publicized! These measures might limit the size of hedge funds and allow them to engage in risky investments without threatening the financial system.

The guiding principle relating to hedge funds leverage should be: Keep hedge funds small and relatively regulation-free to take investment risks. Let hedge funds be financed by investors and lenders that can take care of their own interests, and allocate their capital sources wisely.

However, the source of hedge funds' asset growth is the lenders – mainly regulated lenders. Therefore, these lenders should be regulated with respect to the funding of hedge funds. The following rule must apply to any bank, any bank holding company and its subsidiaries, any entity that has a relationship with a bank, except a borrowing relationship, and any broker-dealers. All these entities (and there may be others that should be added to the list) may make loans to hedge funds directly or indirectly only if they keep the loans on their balance sheets. Thus, the risks involved in these loans may not be transferred to others or covered by derivatives of any kind. Loans to hedge funds must stay on the lenders' books and, if so required by law – carry loss reserves. No other rule is required. No changes should be made in the regulation of the financial system as a whole, and no government interference should be made in the trading or lending or investing. The restriction is not very intrusive, since these actors in the financial system are already subject to regulation including the requirement that they engage in prudent lending. Hopefully, this restriction would dampen the growth of hedge funds, leave them free to roam the field of the financial system, innovate, succeed and fail, but never endanger the financial system.