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## Hedge Funds, Liquidity and Prime Brokers

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# **HEDGE FUNDS, LIQUIDITY AND PRIME BROKERS**

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## INTRODUCTION

Over the past decade, the hedge fund industry has enjoyed remarkable growth. The media enthusiastically described the success of the top-performing funds and the lavish riches they bestowed on their employees.<sup>1</sup> At the same time, however, there were remarkable stories of failure in the industry.<sup>2</sup> Both politicians and economists warned of the potential dangers hedge funds present to the national and global economies.<sup>3</sup> These warnings and concerns created a debate regarding the level of regulation needed, if any, over what is currently a largely unregulated industry.<sup>4</sup> This Note argues that while increased regulation of the hedge fund industry is necessary, the government's recent and ongoing attempts to increase regulation are misguided. A self-regulating body comprised of the brokers that serve the hedge fund industry is the most efficient and effective instrument to limit the most critical risks hedge funds present, while still maintaining the numerous benefits hedge

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1. See, e.g., Andrew Ross Sorkin, ed., *A Billion-Dollar Year for Top Hedge Fund Managers*, N.Y. TIMES, Apr. 10, 2007, <http://dealbook.blogs.nytimes.com/2007/04/10/for-top-hedge-fund-earners-it-was-a-very-good-year>; *No Hedge Against Salary*, N.Y. POST, Apr. 10, 2007, available at [http://www.nypost.com/seven/04102007/business/no\\_hedge\\_against\\_salary\\_business\\_.htm](http://www.nypost.com/seven/04102007/business/no_hedge_against_salary_business_.htm).

2. See, e.g., *Struggling Citigroup Hedge Fund Bars Withdrawals*, REUTERS, Feb. 15, 2008, <http://www.reuters.com/article/fundsFundsNews/idUSN1551782720080215>; Ann Davis, *How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader*, WALL ST. J., Sept. 19, 2006, at A1, available at <http://online.wsj.com/article/SB115861715980366723-search.html>; John Spence, *Prosecutors Probing Hedge Funds' Demise: Report*, MARKETWATCH, Oct. 5, 2007, <http://www.marketwatch.com/news/story/prosecutors-said-probing-bear-stearns/story.aspx?guid=%7BA26FD326-C6F8-42B8-8DD6-7F83B871AE3E%7D>.

3. See, e.g., *Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, Securities and Exchange Commission); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm>; Nicholas Chan et al., *Systemic Risk and Hedge Funds* (Nat'l Bureau of Econ. Research, Working Paper No. 11200, 2005), available at <http://www.nber.org/papers/w11200>.

4. Recent Cases, *Administrative Law—Judicial Review of Agency Rulemaking—District of Columbia Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule."*—*Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), 120 HARV. L. REV. 1394, 1396 (2007) [hereinafter *Judicial Review of Agency Rulemaking*].

funds bring to economies. Part I provides a general background of the hedge fund industry, the current regulatory environment in which hedge funds operate, and the risks and shortcomings associated with the current regulatory scheme. Part I also presents the failure of the hedge fund Long-Term Capital Management as an example of the risks inherent in the present regulatory scheme. Part II discusses recent efforts to increase regulation and offers an alternative solution. Part III examines the potential benefits and limitations of the alternative solution.

### I. THE BENEFITS AND THE RISKS OF HEDGE FUNDS

The term “hedge fund” generally refers “to 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 [of 1940<sup>5</sup>].”<sup>6</sup> A hedge fund’s goal is to provide an absolute return to its investors regardless of the overall condition of the securities market.<sup>7</sup> Hedge funds trade a variety of securities, such as equities, “fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments.”<sup>8</sup>

Hedge funds offer many advantages, both to their investors and to the securities market as a whole.<sup>9</sup> Hedge funds aim to achieve positive investment returns without the volatility of traditional investments such as stocks and bonds.<sup>10</sup> Hedge fund advisers are able to use more sophisticated and flexible investment strategies than advisers at entities such as mutual funds.<sup>11</sup> Hedge funds offer investors the opportunity to diversify their portfolios by providing alternative investment vehicles

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5. 15 U.S.C. §§ 80a-1 to -64 (2006).

6. STAFF REPORT TO THE SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003) [hereinafter 2003 REPORT].

7. ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS 2-3 (2003) (providing a comparison to a mutual fund, where the goal of a typical fund is to provide a return to the investor that is higher than the related securities market).

8. 2003 REPORT, *supra* note 6, at 3.

9. See Daniel K. Liffmann, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2158 (2005).

10. 2003 REPORT, *supra* note 6, at 4.

11. *Id.*

that offer positive returns, while historically showing a low correlation to traditional investments in the fixed-income and equity markets.<sup>12</sup>

In addition to profiting its own investors, hedge funds also benefit the general securities market. Hedge funds help improve efficiency in pricing securities in the marketplace.<sup>13</sup> Funds may take speculative trading positions based on extensive research about the true value or future value of a security, and then execute a “short-term trading strategy to exploit perceived mispricing of securities.”<sup>14</sup> This behavior tends to cause the market price of the security to move toward its true value.<sup>15</sup>

Hedge funds also help the overall dispersion of risk in the marketplace.<sup>16</sup> For example, they often serve as counterparties to entities that wish to hedge risk.<sup>17</sup> The result is that risk is more properly allocated to participants in the financial markets.<sup>18</sup> In the case of mortgaged-backed securities, for example, the reallocation of risks made possible by hedge funds allows for lower mortgage interest rates throughout the economy.<sup>19</sup> Without hedge funds, the economy would experience a higher overall cost of capital.<sup>20</sup>

Despite its many advantages, hedge funds can also have negative effects on the economy. For instance, the Securities and Exchange Commission (“SEC”) has noted the potential for hedge fund managers to defraud its investors.<sup>21</sup> In recent years, hedge fund investors have filed a number of lawsuits alleging fraudulent conduct and misrepresentations by fund managers.<sup>22</sup> Furthermore, some critics argue that hedge funds can drive the whole market downward by their use of short-selling

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12. *See id.* at 5.

13. *See id.* at 4.

14. *Id.*

15. *Id.*

16. Peter Cook & Scott Lanman, *Paulson Says Regulators Should Watch Systemic Risk, Investors*, BLOOMBERG NEWS, Feb. 22, 2007.

17. 2003 REPORT, *supra* note 6, at 4.

18. *See* PRESIDENT’S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT A-6 (1999), *available at* <http://www.treas.gov/press/releases/reports/hedgfund.pdf> [hereinafter 1999 REPORT].

19. *See id.* at A-7.

20. 2003 REPORT, *supra* note 6, at 5.

21. *See Regulation of Hedge Funds*, *supra* note 3.

22. *See, e.g.*, Complaint, San Diego County Employees Ret. Ass’n v. Maounis, No. 07 Civ. 2618 (S.D.N.Y. Mar. 29, 2007).

(trades based on the expectation that a security's price will decline)<sup>23</sup> and present systemic risk through their ability to affect the liquidity of the markets.<sup>24</sup>

Unlike investment vehicles that "buy and hold" securities hoping to generate a return in the long run, hedge funds generally follow short-term investment strategies.<sup>25</sup> They take what are designed to be temporary positions in stocks or other securities, hoping to unwind them in short periods of time.<sup>26</sup> Any disruption in the liquidity of the securities (or related) markets, therefore, can cause serious disruptions for a fund's positions.<sup>27</sup>

Market liquidity measures the degree of difficulty in exiting a given trading position and the ability to sell a quantity of a security without significantly changing the price.<sup>28</sup> Hedge funds may analyze and undertake market positions based on a different perspective than a more traditional historical or macroeconomic analysis.<sup>29</sup> These types of strategies increase market liquidity because the funds "buy and sell assets against prevailing market sentiment with the effect of mitigating temporary supply and demand imbalances."<sup>30</sup> A phenomenon dubbed "herding" may impair liquidity, however, when multiple hedge funds all use the same strategy and "seek to liquidate their positions at the same time."<sup>31</sup> For example, many funds invest in futures or other derivative contracts that are based on the expected price of a commodity.<sup>32</sup> Unexpected or uncontrollable factors often influence the price of

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23. See e.g., 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, 36 (2007).

24. Chan, *supra* note 3, at 1.

25. See 1999 REPORT, *supra* note 18, at A-2.

26. *Id.*

27. See Desmond Eppel, *Risky Business: Responding to OTC Derivative Crises*, 40 COLUM. J. TRANSNAT'L L. 677, 688 (2002).

28. See BANK FOR INTERNATIONAL SETTLEMENTS, THE JOINT FORUM, THE MANAGEMENT OF LIQUIDITY RISK IN FINANCIAL GROUPS n.1 (2006), <http://www.bis.org/publ/joint16.pdf>.

29. See 1999 REPORT, *supra* note 18, at A-5.

30. *Id.*

31. Deloitte's Financial Services Group, *Precautions That Pay Off - Risk Management and Valuation Practices in the Global Hedge Fund Industry*, MONDAQ, May 3, 2007, <http://www.mondaq.com/article.asp?articleid=48142>. When a large number of hedge fund advisers are using the same strategy, it is referred to as 'herding' or 'crowded trades.' *Id.*

32. See JAEGER, *supra* note 7, at 153.

commodities, causing the expected future price to be very speculative.<sup>33</sup> Often these speculative contracts are traded on markets that have significantly fewer participants than stock exchanges.<sup>34</sup> Many of these participants are hedge funds that can hold very large portions of the market by leveraging their positions.<sup>35</sup> While this combination of leverage and illiquidity in the market creates the potential for high returns in good times, when adverse market conditions arise, funds may be unable to exit their very large positions (enhanced by leverage).<sup>36</sup> In other words, hedge funds' strategies may put them in a position where they are unable to sell most or all of their securities without substantially affecting the market price. Because of their leverage, hedge funds cannot wait until they can sell at a fair market price. They must meet margin calls from their prime brokers (who extend them credit), and therefore they may be forced to sell huge quantities of assets at unfavorable prices in an illiquid market.<sup>37</sup> These "fire sales" can have extremely adverse effects on both market and non-market participants, to say nothing of the funds' investors who stand to see their investments decline significantly in value.<sup>38</sup>

## II. CURRENT REGULATIONS

The current United States regulatory scheme under which hedge funds operate reflects the federal government's historical belief that it has no "interest in regulating advisers that have only a small number of clients and whose activities are unlikely to affect national securities markets."<sup>39</sup> In other words, the current regulations were designed with

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33. See Neil Behrmann, *Derivatives Trade: Hard to Prepare for the Unexpected*, BUS. TIMES, May 2, 2007, available at 2007 WLNR 8230503; Geithner on Credit Innovations, SEC. INDUS. NEWS, May 28, 2007 available at 2007 WLNR 10050556; Buffet Warns on Investment 'Time Bomb', BBC NEWS, Mar. 4, 2003, <http://news.bbc.co.uk/2/hi/business/2817995.stm>.

34. See JAEGER, *supra* note 7, at 153.

35. See *id.* at 138.

36. See *id.*

37. See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* 42-43 (Random House, 2000).

38. See Matthew Goldstein, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. INT'L BUS. & L. 111, 116 (2007).

39. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 84 SEC Docket 1032 (Dec. 2, 2004), available at <http://www.sec.gov/rules/final/ia-2333.htm> [hereinafter Hedge Fund Rule].

the assumption that the hedge fund industry as a whole has too small an effect on market liquidity to justify significant levels of regulation or monitoring. Recent high-profile failures of hedge funds, however, raise the question whether it is necessary to rethink the past wisdom regarding hedge fund regulation (or lack thereof).<sup>40</sup> The following securities acts comprise the regulatory framework in which hedge funds currently operate.

#### A. *The Securities Act of 1933*

Under the Securities Act of 1933 (“‘33 Act”), anyone who wishes to make a public offering of a security must file a registration statement with the SEC.<sup>41</sup> The ‘33 Act requires the registering entity to provide purchasers with a prospectus containing specific information about the issuer and the security offered, unless an exemption is available from the registration requirement.<sup>42</sup> To avoid the registration requirement, many hedge funds rely on the private offering exemption in section 4(2) of the ‘33 Act.<sup>43</sup> These funds use Rule 506 of Regulation D to comply with the requirements of section 4(2).<sup>44</sup> Rule 506 states that funds meet the requirements of 4(2) (and are therefore exempt from registration) if they refrain from engaging in “general solicitation or advertising” and if they make offerings only to “accredited investors,” meaning investors who meet certain income and/or net worth requirements.<sup>45</sup>

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40. See Kevin Carmichael, *Paulson Names Panels to Draft Hedge-Fund Guidelines*, BLOOMBERG NEWS, Sept. 25, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ac1R2q8srB08> (discussing Henry Paulson’s formation of a committee to draft “best practices” guidelines to curb fears that hedge funds, which “have more than tripled in the past decade,” pose a risk to the financial system because of their “lack of transparency”).

41. 15 U.S.C. §§ 77a-aa (2006).

42. 2003 REPORT, *supra* note 6, at 13.

43. *Id.* at 14 (exempting any “transactions by an issuer not involving any public offering”).

44. *Id.*

45. *Id.* at 14-16. “[G]eneral solicitation is not present when there is a pre-existing, substantive relationship between an issuer or its broker-dealer, and the offeree.” *Id.* at 16. For hedge funds the relationship must have been established 30 days before the investor can make an investment. *Id.*



*B. The Securities Exchange Act of 1934*

The Securities Exchange Act of 1934 (“‘34 Act”) is meant to protect, *inter alia*, the efficiency and honesty of the financial markets.<sup>46</sup> Section 15 requires “dealers” to register with the SEC.<sup>47</sup> The ‘34 Act defines a “dealer” as “a person that is engaged in the business of buying and selling securities for its own account.”<sup>48</sup> It also distinguishes “dealers” from “traders.”<sup>49</sup> A trader buys and sells securities, not in the course of business, but solely in an individual or trustee capacity.<sup>50</sup> Traders are not required to register with the SEC.<sup>51</sup> Entities like hedge funds that buy and sell securities for investment generally are considered traders rather than dealers, and are therefore not required to register under the ‘34 Act.<sup>52</sup>

*C. The Investment Company Act of 1940*

Most hedge funds have substantial investments that bring them within the definition of an “investment company” under the Investment Company Act of 1940 (“‘40 Act”).<sup>53</sup> Hedge funds typically rely, however, on a statutory exclusion from the definition of “investment company,” either § 3(c)(1) or § 3(c)(7), to avoid the regulatory provisions of the ‘40 Act.<sup>54</sup> Funds tend to choose § 3(c)(7) because it permits them to have an unlimited number of “qualified purchasers.”<sup>55</sup>

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46. 15 U.S.C. §§ 78a-78ll (2006).

47. *Id.* § 78o.

48. 2003 REPORT, *supra* note 6, at 18.

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *See id.* at 11. Section 3(a)(1)(A) defines *investment company* as “any 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.” 15 U.S.C. § 80a-3(a)(1)(A). Section 3(a)(1)(C) defines *investment company* as

any issuer which 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 such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a)(1)(C).

54. 2003 REPORT, *supra* note 6, at 11-12. Section 3(c)(1) excludes from the

*D. The Investment Advisers Act of 1940*

Almost “all hedge funds’ advisers meet the definition of ‘investment adviser’ under the [Investment] Advisers Act [of 1940 (“Advisers Act”)]<sup>56</sup>.”<sup>57</sup> All investment advisers must register with the SEC and comply with the provisions of the Advisers Act.<sup>58</sup> Section 202(a)(11) of the Advisers Act states that an “investment adviser” is

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.<sup>59</sup>

Investment advisers are required to register with the SEC by using Form ADV and must keep their information current and provide their clients with disclosure statements that include certain information provided in Form ADV.<sup>60</sup> Among other things, investment advisers must disclose to the SEC and to their clients information regarding their

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definition of investment company “any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” 15 U.S.C. § 80a-3(c)(1). Section 3(c)(7) excludes from the definition of investment company “any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” 15 U.S.C. 80a-3(c)(7).

55. See 2003 REPORT, *supra* note 6, at 13.

56. 15 U.S.C. §§ 80b-1 to -21 (2006).

57. 2003 REPORT, *supra* note 6, at 20.

58. *Id.*

59. 15 U.S.C. § 80b-2(a)(11); see also 2003 REPORT, *supra* note 6, at 20 n.64 (noting an exception for certain professionals giving advice only about U.S. government securities).

60. See 17 CFR 275.204-3 (2007). Advisers use Form ADV not only to register as an adviser with the SEC but also for state registration. See Sec. & Exch. Comm’n, Answers to Questions About Form ADV, <http://www.sec.gov/answers/formadv.htm> (last visited Mar. 17, 2008) (stating that “Part 1 contains information about the adviser’s education, business and disciplinary history within the last ten years. . . . Part 2 includes information on an adviser’s services, fees, and investment strategies.”).

business practices and disciplinary history.<sup>61</sup> They must also maintain records that are subject to periodic examination by the SEC.<sup>62</sup>

Although most hedge fund advisers fit the definition of an “investment adviser,” many avoid the registration requirements by relying on the Advisers Act’s *de minimis* exemption.<sup>63</sup> This exemption, found in § 203(b), “excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company.”<sup>64</sup> Under current SEC rules, a “legal organization,” such as a hedge fund, is considered a single client.<sup>65</sup> Therefore, the rules permit an investment adviser to manage up to fourteen hedge funds without having to register with the SEC.<sup>66</sup>

#### *E. Case Study: Long-Term Capital Management*

Long-Term Capital Management (“LTCM”) was a hedge fund founded in 1994.<sup>67</sup> It employed a variety of trading strategies, such as convergence trading and dynamic hedging.<sup>68</sup> From its inception, LTCM enjoyed a prominent position in the financial community due to the reputation of its principals<sup>69</sup> and its large initial capital stake.<sup>70</sup> While it

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61. 2003 REPORT, *supra* note 6, at 21.

62. *Id.*

63. *Id.* (noting that hedge funds are still not exempt from the antifraud provisions found in the '34 Act).

64. *Id.*

65. *Id.* The SEC changed the definition of a client under § 203(b) in December 2004. *See infra* Part II.F. The new rule was eventually struck down, however, by the D.C. Circuit Court of Appeals. *See id.*

66. 2003 REPORT, *supra* note 6, at 21.

67. 1999 REPORT, *supra* note 18, at 10.

68. *Id.* Convergence trading is “the practice of taking offsetting positions in two related securities in the hopes that the price gap between the two securities will move in a favorable direction.” *See id.* at 10 n.13. Dynamic hedging is “the practice of managing nonlinear price exposure (i.e., from options) through active rebalancing of underlying positions, rather than by arranging offsetting hedges directly.” *See id.* at 10 n.14.

69. *See* LOWENSTEIN, *supra* note 37, at xix. The fund was run by John W. Meriwether, a bond trader at Salomon Brothers in the 1980’s and well-known on Wall Street. *See id.* The fund also boasted many former professors, Ph.D.’s, and two Nobel Prize winners. *See id.*

70. *Id.*

managed money for only one hundred investors and employed just under two hundred people, LTCM invested in thousands of derivative contracts resulting in more than \$1 trillion worth of exposure.<sup>71</sup>

In its early years, LTCM reported stellar returns, ranging from approximately forty percent in 1995 and 1996 to slightly less than twenty percent in 1997.<sup>72</sup> In 1998, LTCM's balance sheet included over \$125 billion in assets and a balance-sheet leverage ratio of more than twenty-five to one.<sup>73</sup> The fund held large positions in several markets; in some cases these positions gave the fund ownership positions in futures that represented more than ten percent of the open interest in foreign futures exchanges.<sup>74</sup> Due to LTCM's vast size, leverage, and trading strategies, it became vulnerable during the extreme market conditions that followed from the devaluation of Russia's currency on August 17, 1998.<sup>75</sup> Russia's actions, combined with other events that destabilized the financial markets,<sup>76</sup> sparked a "flight to quality" in which investors sought to limit their exposure to risky securities, thereby increasing risk spreads and liquidity premiums across the world.<sup>77</sup> LTCM bet heavily that risk spreads would decrease, and therefore began to lose millions of dollars by the minute in August 1998.<sup>78</sup>

With its total equity rapidly dwindling,<sup>79</sup> LTCM needed to exit its positions quickly, since its potent level of leverage and immense position greatly magnified even the smallest change in risk spreads.<sup>80</sup> At this point LTCM desperately needed a cash infusion and was truly beginning to feel the pain of illiquidity in the marketplace.<sup>81</sup> LTCM's

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71. *Id.* at xviii-xix.

72. 1999 REPORT, *supra* note 18, at 11.

73. *Id.* at 12.

74. *Id.*

75. *Id.*

76. *See* LOWENSTEIN, *supra* note 37, at 141 ("[M]arkets shuddered from a swelling list of negatives: the crisis in Russia, weakness in Asia, Iraq's refusal to permit full weapons inspections, the possibility of China devaluing *its* currency, and President Clinton's testimony about his relationship with a White House intern, Monica Lewinsky.").

77. *See id.*; 1999 REPORT, *supra* note 18, at 12.

78. LOWENSTEIN, *supra* note 37, at 145.

79. *See id.* at 147 (noting that LTCM lost fifteen percent of its capital in one day in late August 1998, and that from the end of April 1998 to the end of August 1998, it lost more than a third of its equity).

80. *See id.* at 146.

81. *See id.* at 151.

traders from many geographic areas, including Brazil, the United Kingdom, and Japan, all reported that there was no demand for the fund's positions.<sup>82</sup> In other words, LTCM was unable to "get out of its humongous trades without moving the markets even more."<sup>83</sup> It was necessary that LTCM not think about long-term plans,<sup>84</sup> but rather unwind its 60,000 trading positions in order to free up cash to meet margin calls.<sup>85</sup> LTCM's previously flexible credit arrangements grew rigid as the fund's lenders became more contentious with their daily mark-to-market valuations for collateral calls.<sup>86</sup>

By early September 1998, LTCM needed new capital by the end of the month or it would no longer survive.<sup>87</sup> The fund's troubles became a major concern for many market participants<sup>88</sup> who feared that if LTCM suddenly collapsed it could devastate the already-fragile world markets.<sup>89</sup> While seemingly everyone was liquidating their bonds at falling prices, LTCM found itself effectively immobilized.<sup>90</sup> Due to the immense size of LTCM, the sale of even a small fraction of one of its large positions would cause the price of the security to plummet and would reduce the value of its remaining holdings.<sup>91</sup> Compounding immobility concerns, LTCM had already lost over sixty percent of its capital in September 1998 alone.<sup>92</sup>

Wall Street banks worried because many of them held the same trading positions as LTCM, so any sale of an LTCM position would be devastating.<sup>93</sup> The banks that traded with LTCM and lent money realized it was in their interest to find an alternative solution that would

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82. *See id.* at 147-48.

83. *Id.* at 148.

84. *See* LOWENSTEIN, *supra* note 37, at 151.

85. 1999 REPORT, *supra* note 18, at 11.

86. *Id.* at 12-13; *see also* LOWENSTEIN, *supra* note 37, at 156 ("What's more, many of [LTCM's creditors] were themselves under stress. This is a timeless irony: when you need money most, the most likely sources of it . . . are likely to be hurting as well.").

87. LOWENSTEIN, *supra* note 37, at 165.

88. *See id.* at 164; 1999 REPORT, *supra* note 18, at 13.

89. 1999 REPORT, *supra* note 18, at 13; *see also* Katherine M. Reynolds, *U.S. Regulators May Limit Bank Loans to Hedge Funds*, BLOOMBERG NEWS, Dec. 16, 1998 (noting fears that the LTCM collapse could disrupt international markets).

90. *See* LOWENSTEIN, *supra* note 37, at 169.

91. *Id.*

92. *See id.* at 181.

93. *See* 1999 REPORT, *supra* note 18, at 13.

cost them less than would a default by LTCM.<sup>94</sup> Concerns over an LTCM meltdown, however, extended far beyond the fund's banks. According to Alan Greenspan,

Financial market participants were already unsettled by recent global events. Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own.<sup>95</sup>

Eventually the Federal Reserve Bank of New York became involved, and a consortium of banks agreed to invest approximately \$3.6 billion in the fund in return for a ninety percent equity stake in LTCM's portfolio, as well as operational control of the fund.<sup>96</sup> Disaster was averted. However, the systemic risk that an LTCM collapse presented to the broader financial system induced government officials, academics, and professionals in the financial community to reexamine the regulation of, and practices conducted by, hedge funds.

In April 1999, the President's Working Group on Financial Markets ("President's Group") issued a report ("1999 Report").<sup>97</sup> The principal policy concern arising from the LTCM episode was how to constrain excessive leverage.<sup>98</sup> The President's Group acknowledged, however, that the systemic risk posed by excessive leverage must be balanced with the benefits leverage confers on markets.<sup>99</sup> The report notes that it would be difficult to place direct constraints on leverage because it is unreasonable to require a uniform degree of balance-sheet leverage for all investors, given their diverse exposures to risk and differences in their relationships to other market participants.<sup>100</sup>

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94. *Id.*

95. *Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Servs.*, 105th Cong. 40 (1998) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System), available at [http://commdocs.house.gov/committees/bank/hba51526.000/hba51526\\_of.htm](http://commdocs.house.gov/committees/bank/hba51526.000/hba51526_of.htm).

96. 1999 REPORT, *supra* note 18, at 13-14.

97. *See generally id.*

98. *Id.* at 29.

99. *Id.* at 23, 29 (noting that "leverage can play a positive role in our financial system, resulting in greater market liquidity, greater credit availability, and a more efficient allocation of resources in our economy").

100. *Id.* at 24 ("For any given leverage ratio, the fragility of a portfolio depends on the market, credit, and liquidity risks in the portfolio.") Additionally, the group noted

The President's Group further noted several problems with the risk management procedures practiced by LTCM and its counterparties.<sup>101</sup> Investment banks, which often extend credit to hedge funds, were in such fierce competition for LTCM's business that they tended to offer the fund unusually relaxed financing terms.<sup>102</sup> This led to lower standards in the extension of credit, or leverage, to LTCM, which then achieved extremely high levels of assets under management relative to its equity, which in turn exacerbated the liquidity problems the fund faced when it attempted to exit its positions in 1998.<sup>103</sup>

#### F. The Hedge Fund Rule

The SEC's adoption of the "hedge fund rule" in December 2004<sup>104</sup> is an example of the government's misguided focus regarding hedge fund regulation. The rule required hedge fund advisers to register as investment advisers by February 1, 2006.<sup>105</sup> Hedge fund advisers are now required to register because the definition of "client" was changed under the Adviser Act for purposes of the "private adviser exemption."<sup>106</sup>

The SEC stated that "[t]he rule and rule amendments [we]re designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect [the] nation's securities markets."<sup>107</sup> The SEC cited three reasons for the adoption of the rule.<sup>108</sup> First, it noted the 260% increase in hedge fund assets from 1999 to 2004 and forecasts for the continued expansion of the hedge fund industry.<sup>109</sup> Second, it stated that there had been "substantial and troubling growth in the number of . . . hedge fund fraud enforcement cases."<sup>110</sup> Finally, it expressed concern regarding the

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that a uniform standard for leverage constraints might induce fund managers to pursue riskier speculative trading strategies. *Id.*

101. *See id.* at B-7.

102. *See* LOWENSTEIN, *supra* note 37, at 45-46.

103. *See* 1999 REPORT, *supra* note 18, at 29.

104. Hedge Fund Rule, *supra* note 39.

105. *Id.*

106. *See id.*

107. *Id.*

108. *Id.*; *see also* Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).

109. Hedge Fund Rule, *supra* note 39; Goldstein, 451 F.3d at 877.

110. Hedge Fund Rule, *supra* note 39 (noting that over the preceding five years, the SEC brought "51 cases in which [it] asserted that hedge fund advisers defrauded hedge

growing exposure of smaller investors and other market participants, both indirectly and directly, to hedge funds.<sup>111</sup> The most significant area of increased exposure, according to the SEC, was the number of pension funds and endowments that were increasing their allocations to hedge funds.<sup>112</sup> This increased exposure to risk through hedge funds means that “[l]osses resulting from hedge fund investing and hedge fund frauds may affect the entities’ ability to satisfy their obligations to their beneficiaries or pursue other intended purposes.”<sup>113</sup>

The SEC intended the rule to benefit hedge fund investors by deterring fraud and curtailing losses resulting from hedge fund adviser fraud.<sup>114</sup> It would also benefit investors by disclosing basic information about hedge fund advisers.<sup>115</sup> Perhaps most importantly, the rule was supposed to result in improved compliance controls at hedge funds.<sup>116</sup> The SEC also asserted that the change in registration requirements would benefit mutual fund investors by curtailing illegal conduct that exploits mutual funds.<sup>117</sup>

The new rule would provide a level playing field for hedge fund advisers by requiring that everyone register.<sup>118</sup> The SEC also opined that registration of hedge fund advisers would “enhance investor confidence in a growing and maturing industry.”<sup>119</sup> The SEC acknowledged that the rule would create certain costs for the hedge fund industry.<sup>120</sup> Specifically, the rule would create registration costs and costs for establishing and maintaining a compliance infrastructure for each hedge fund.<sup>121</sup>

The hedge fund rule did not receive unanimous support.<sup>122</sup> Two SEC Commissioners dissented, challenging factual predicates on which

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fund investors or used the fund to defraud others in amounts [exceeding] \$1.1 billion”).

111. *See id.*

112. *See id.*

113. *Id.*

114. *See id.*

115. *See id.*

116. *Id.*

117. *Id.*

118. *Id.* There were some advisers who registered voluntarily before February 2006, who prior to the rule, were at a disadvantage to those who were not registered. *Id.*

119. *Id.*

120. *Id.*

121. *See id.*

122. *See generally* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).



the rule was based and the wisdom of the rule.<sup>123</sup> Phillip Goldstein, a hedge fund adviser, also challenged the rule,<sup>124</sup> arguing that the SEC misinterpreted § 203(b)(3) of the Advisers Act.<sup>125</sup> In June 2006, the D.C. Circuit Court of Appeals struck down the hedge fund rule<sup>126</sup> in *Goldstein v. Securities & Exchange Commission*, reasoning that it was too arbitrary.<sup>127</sup> The court reasoned that the rule's new definition of "client" strayed too far from the definition in the statute, and therefore went beyond Congress' intent when it passed the Advisers Act.<sup>128</sup> The SEC declined to appeal the ruling.<sup>129</sup>

*G. Investor Protections and the "Moral Hazard"*

The focus of the government in creating the hedge fund rule was misguided. The rule was "designed to provide the protections afforded by the Advisers Act to investors in hedge funds."<sup>130</sup> While investor protection regulations are important, they do not adequately reduce systemic risk.<sup>131</sup> In fact, the government's new rule might have exacerbated the problem of systemic risk by creating a false sense of security, or "moral hazard," in the financial community.<sup>132</sup> A concern arose that investors might not conduct proper due diligence on funds in which they invested if they had a false sense of confidence in the regulatory scheme.<sup>133</sup> For example, former Secretary of the Treasury John Snow stated that a "government promise to increase scrutiny would create 'a real risk of moral hazard that implies, 'Don't worry. Now the

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123. *Id.* at 878.

124. *Id.*

125. *Id.*

126. *Id.* at 884.

127. *Id.*

128. *See id.* at 883-84.

129. Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, at C1.

130. Hedge Fund Rule, *supra* note 39.

131. Isaac Lustgarten, *De Facto Regulation of Hedge Funds Through the Financial Services Industry and Protection Against Systemic Risk Posed by Hedge Funds*, 26 No. 10 BANKING & FIN. SERVS. POL'Y REP. 1, 1-2 (2007).

132. *See* Craig Torres & Anthony Massucci, *Bernanke Backs 'Light' Regulation of Hedge Funds*, BLOOMBERG NEWS, Apr. 12, 2007 (reporting Chairman Bernanke as saying that heavy regulation after the collapse of LTCM "would have increased moral hazard").

133. *See id.*

government is watching over you and there aren't any problems.'"<sup>134</sup> Leading members of Congress have indicated that future hedge fund regulation will remain primarily focused on investor protection, such as fraud prevention.<sup>135</sup>

It seems the need to protect against the threat to liquidity from excessive leverage outweighs the need to protect against the threat to investors from adviser fraud.<sup>136</sup> Even if the government focused on both liquidity and investor protection, additional regulation runs the risk of overreaching, reducing the flexibility of fund managers.<sup>137</sup> Such regulation could reduce the overall advantages the hedge fund industry offers.<sup>138</sup> Government regulation is too blunt an instrument for this complex problem.

### III. A SOLUTION: PRIME BROKERS, SELF-REGULATION, AND "BEST PRACTICES"

Self-regulation would most likely avoid the excessive and overbroad restrictions, thereby minimizing the impact on the benefits of the hedge fund industry. Self-regulation could effectively address the potential systemic risks hedge funds pose to the world economy. Self-regulation by means of an intra-industry association of prime brokers would strike a proper balance with regard to risk management, credit evaluation, and leverage. Section 15(a) of the '34 Act authorizes this

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134. Kevin Carmichael, *Cerberus's Snow Says 'Lighter' Regulation Best for Hedge Funds*, BLOOMBERG NEWS, Oct. 31, 2006.

135. See, e.g., *Systemic Risk: Examining Regulators' Ability to Respond to Threats to the Financial System: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 1 (2007) (statement of Barney Frank, Chairman, H. Comm. on Financial Servs.) ("We obviously have the concern about systemic risk . . . [a]nd I have been saying that it seemed to me less important than investor protection."), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_house\\_hearings&docid=f:39903.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:39903.pdf).

136. See, e.g., 1999 REPORT, *supra* note 18 at ii (noting that "the principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage . . . [and the resulting] likelihood of a general breakdown in the functioning of financial markets").

137. See Carmichael, *supra* note 134.

138. See *supra* Part I; see, e.g., *Judicial Review of Agency Rulemaking*, *supra* note 4, at 1401 (noting that government "legislation will almost certainly fail to anticipate future trends"); David Enrich & Arden Dale, *Hedge Fund, Regulate Thyself—Could Self-Policing Help Avoid More Government Oversight?*, WALL ST. J., Oct. 14, 2006, at B4.

practice.<sup>139</sup> It provides that “associations may register with the Commission pursuant to specified terms and conditions, and authorizes them to promulgate rules designed to prevent fraudulent and manipulative practices; to promote equitable principles of trade; to safeguard against unreasonable profits and charges; and generally to protect investors and the public interest.”<sup>140</sup>

Prime brokers, commonly a division of large investment banks, offer a “bundle of services” to hedge funds,<sup>141</sup> including “providing intraday credit to facilitate foreign exchange payments and securities transactions; providing margin credit to finance purchases of equity securities; and borrowing securities from investment fund managers on behalf of hedge funds to support the hedge funds’ short positions.”<sup>142</sup> They also contribute clearance and custody services, securities lending, financing, technology services, and assistance with capital introductions.<sup>143</sup> The role of prime brokers as counterparties in extending credit to finance funds’ leverage positions and as intermediaries in funds’ securities transactions place them in unique positions both to gather real-time information on the total levels of liquidity in the system and to limit the hedge funds’ ability to overextend themselves.<sup>144</sup>

At most large broker-dealers, the board of directors authorizes a credit management committee to determine risk management policies.<sup>145</sup> Credit departments that are independent of the business units that assume the credit risk execute these policies.<sup>146</sup> In accordance with the general risk management guidelines set by the management committee, the credit department handles the credit approval process for hedge funds on behalf of the prime brokerage units.<sup>147</sup>

Evaluation of a new hedge fund client typically involves the examination of factors such as “character of management, credit history,

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139. 15 U.S.C. § 78o-3 (2006).

140. *United States v. Nat’l Ass’n of Sec. Dealers, Inc.*, 422 U.S. 694, 700 n.6 (1975).

141. 1999 REPORT, *supra* note 18, at 17.

142. *Id.*

143. *See, e.g.*, Morgan Stanley, Prime Brokerage Services, <http://www.morganstanley.com/institutional/primebrokerage/index.html> (last visited Mar. 16, 2008).

144. *See* 1999 REPORT, *supra* note 18, at 25.

145. *Id.* at B-7.

146. *Id.*

147. *Id.*

financial performance, permanence of capital and access to additional capital, liquidity, asset quality, business integrity, experience of fund management, sensitivity to risk, use of leverage, back office operations, and mark-to-market procedures.”<sup>148</sup> Evaluation of the fund’s risk exposure is determined by the liquidity of positions held and the potential amount of leverage employed based on the funds’ proposed investing strategy.<sup>149</sup> Periodic reviews generally occur no less than once annually.<sup>150</sup> If approved, hedge funds then receive internal credit ratings, which are continually adjusted and which establish the level of trading the funds may conduct and the level of collateral required.<sup>151</sup>

Hedge funds are not rated by credit agencies, but banks’ analysts typically use similar criteria to assess funds’ creditworthiness.<sup>152</sup> Unlike public corporations, however, from which the SEC requires detailed disclosures,<sup>153</sup> hedge funds typically provide less disclosure than public reporting companies or registered entities.<sup>154</sup> Thus, their ratings are inherently based on more subjective factors, such as the experience and track record of the hedge fund and its managers.<sup>155</sup>

Once hedge funds are approved for credit and trading, counterparties such as prime brokers continually evaluate performance and may request additional collateral or limit their ability to leverage positions or execute certain trades.<sup>156</sup> Thus, prime brokers, through their dual role as creditors and counterparties, are best positioned to limit hedge funds’ use of leverage.<sup>157</sup> A self-regulatory body consisting of prime brokers would be able to use this position to reduce systemic risk and help maintain proper liquidity in markets.

#### A. “Prisoner’s Dilemma” and Self-Regulation

The implementation of a “best practice” standard at prime brokerage firms must be backed by an independent, self-regulatory body

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148. *Id.* at B-8.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *See generally* 15 U.S.C. §§ 78a-78ll (2006).

154. 1999 REPORT, *supra* note 18, at B-9.

155. *Id.*

156. *See id.* at B-10 to -11.

157. *See id.* at A-1.

that has the authority to levy significant sanctions against firms that fail to abide by the standards.<sup>158</sup> This is because the brokerage market for hedge fund business generally behaves in a manner that, absent enforceable risk management standards, produces a situation similar to the classical game theory concept of a “prisoner’s dilemma.” The prisoner’s dilemma describes a situation in which parties have complete information regarding the consequences of both their choices and their opponent’s choices, but, due to unilateral incentives to deviate from the optimal strategy, the parties end up with a suboptimal result.<sup>159</sup>

The situation confronting financial firms such as brokers resembles a prisoner’s dilemma. The brokers as a group would be better off if each firm abided by mutually agreed-upon “best practice standards.”<sup>160</sup> Absent a regulatory framework, however, each brokerage firm has a unilateral incentive to deviate from the optimal “best practice” standards to overly lax risk management standards.<sup>161</sup> A failure to do so would put the firm at a competitive market disadvantage.<sup>162</sup> As a result, industry standards that are not regulated by a self-governing association will likely fail to impose the necessary changes in risk management procedures at prime brokerage units.

The relations between LTCM and its counterparties exhibited the aforementioned behavior. In that instance, Merrill Lynch, Morgan Stanley, JPMorgan, and “just about everyone else” waived their usual requirements for collateral on bond trades with LTCM.<sup>163</sup> In fact, PaineWebber, who refused to relax its standards, got very little business from LTCM.<sup>164</sup> Thus, while smaller firms such as PaineWebber escaped the damage of LTCM’s collapse, almost all of the major Wall Street firms, consistent with the behavior predicted by the prisoner’s dilemma,

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158. See J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 818 (2007).

159. See Robert G. Bone, *Who Decides? A Critical Look at Procedural Discretion*, 28 CARDOZO L. REV. 1961, 1997 (2007).

160. See Philipp M. Hildebrand, *Hedge Funds and Prime Broker Dealers: Steps Towards a “Best Practice Proposal,”* FIN. STABILITY REV., April 2007, at 75, available at [http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud7\\_0407.pdf](http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud7_0407.pdf).

161. See Robert P. Sieland, *Caveat Emptor! After All the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531, 548 (2003).

162. *Id.*

163. See LOWENSTEIN, *supra* note 37, at 45-46.

164. *Id.* at 46.

relaxed their credit standards in their relations with LTCM.<sup>165</sup> Absent any additional regulatory controls, it is likely that financial firms will continue to exhibit this sort of behavior in the future.

*B. Strengths and Limitations of Self-Regulation via Prime Brokers*

Prime brokers can best reduce the systemic threats posed by hedge funds because they would be able to keep proprietary trade secrets confidential while collecting the necessary information for credit evaluators to account for liquidity at risk. As mentioned, hedge funds are largely opaque with regard to the release of information.<sup>166</sup> Investors often have only limited access to their funds' investment positions, and hedge fund advisors enjoy wide latitude to change their investment positions within broad guidelines.<sup>167</sup> Through their roles as counterparties, prime brokers have significant access to hedge funds' credit exposure.<sup>168</sup> Even so, due to the multitude and complexity of trades hedge funds tend to make, a fund's broker may not be fully aware of the fund's exact trading positions, and consequently of the degree of risk present in its overall portfolio.<sup>169</sup> A self-regulatory body of prime brokers could facilitate the collection of information needed to effectively assess the risk of a fund's portfolio, and thereby allow the broker to limit leverage while preserving proprietary trade secrets.

*C. Liquidity: Risks Mitigated by Self-Regulation by Prime Brokers*

Simply put, "market discipline failed [with] Long-Term Capital Management . . . ."<sup>170</sup> Its reputation, initial success, and potential for fees led to intense competition among Wall Street investment banks for

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165. The list of LTCM's partners that participated in the Fed-orchestrated bailout of LTCM as a result of their own exposure included Goldman Sachs, Morgan Stanley Dean Witter, Merrill Lynch, Chase Manhattan, JPMorgan, Lehman Brothers, Salomon Smith Barney, and Bankers Trust. *Id.* at xviii.

166. See Pearson & Pearson, *supra* note 23, at 26.

167. See *Judicial Review of Agency Rulemaking*, *supra* note 4, at 1400. These broad guidelines are usually set out in a fund's prospectus. *Id.*

168. See 1999 REPORT, *supra* note 18, at B-4 n.21.

169. See, e.g., LOWENSTEIN, *supra* note 37, at 155 ("Because none of [LTCM's] banks had the whole picture, none saw that most of its trades were hedged and tended to offset one another . . . .").

170. Torres & Massucci, *supra* note 132 (quoting Federal Reserve Board Chairman, Ben Bernanke).

LTCM's business.<sup>171</sup> As a result, the fund was able to command terms that led to a gradual deterioration of credit evaluation and risk management by the brokerages and banks with which it dealt.<sup>172</sup> Additionally, due to its size, LTCM dealt with many different brokerages and banks.<sup>173</sup> As a result, no individual counterparty could assess "the depth of LTCM's liquidity problems."<sup>174</sup> Essentially, each counterparty (or brokerage) had only a small snapshot of LTCM's risk profile. With such a limited picture it is doubtful the "counterparties were aware of the nature of the exposures and risks the hedge fund had accumulated, such as the [f]und's exposure to market liquidity and funding liquidity risks."<sup>175</sup> Many bankers, when they arrived at LTCM's Connecticut offices to inspect its books at the height of the fund's troubles, were shocked to see the extent of its leverage and the volume of its trading positions.<sup>176</sup>

#### D. Amaranth Advisors

The hedge fund, Amaranth Advisors ("Amaranth"), is another example of the importance of risk management procedures in relation to prime brokers, and the importance of liquidity at risk to a fund's ultimate success or failure. Amaranth was a Connecticut-based hedge fund that suffered billions of dollars in losses within a matter of days in September 2006.<sup>177</sup> Amaranth, like most funds, used leverage to increase its return on equity.<sup>178</sup> It invested in natural gas futures contracts, a highly illiquid commodity.<sup>179</sup> The particular positions Amaranth held in natural gas immediately prior to its fall are unknown.<sup>180</sup> At one point, Amaranth was said to have entered into

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171. See LOWENSTEIN, *supra* note 37, at 45-46.

172. See *id.* at 46.

173. See *id.*

174. 1999 REPORT, *supra* note 18, at 14.

175. *Id.* at 14-15.

176. See LOWENSTEIN, *supra* note 37, at 169-70.

177. *Judicial Review of Agency Rulemaking*, *supra* note 4, at 1394.

178. See *Lessons from Amaranth Helpful for Clients*, INV. NEWS, Oct. 2, 2006, available at 2006 WLNR 17341763.

179. See Maggie Shea, *Commodities Growth: The Good, the Bad and the Blowups*, HEDGEWORLD DAILY NEWS, Feb. 14 2007, available at 2007 WLNR 2945725.

180. See Ludwig B. Chincarini, *The Amaranth Debacle: A Failure of Risk Measures or a Failure of Risk Management?* 2 (Apr. 5, 2007) (unpublished working paper), available at <http://ssrn.com/abstract=952607>.

contracts “representing more than 50% of the monthly demand for natural gas in the United States.”<sup>181</sup> Some estimates indicate that at one point the fund held forty percent of the positions on the New York Mercantile Exchange (“NYMEX”).<sup>182</sup> Other experts concluded that Amaranth held up to eighty percent of the total open interest for natural gas futures on the NYMEX.<sup>183</sup> Regardless of the actual percentage, Amaranth’s massive market share in natural gas futures contracts was a significant factor in its inability to liquidate its assets in the market.<sup>184</sup> When natural gas prices failed to drop as the fund’s head energy trader expected, Amaranth was forced to sell its portfolio to JPMorgan (its prime broker), and Citadel Investments (another large hedge fund).<sup>185</sup>

#### *E. Liquidity at Risk, Self-Regulation, and Prime Brokers*

Brokers for LTCM and Amaranth ultimately failed to account for liquidity risk when they extended leverage to the funds.<sup>186</sup> Although “[m]odels for liquidity risk are not as common place as models for market risk,”<sup>187</sup> financial firms have begun to improve their models for evaluating value at risk.<sup>188</sup> Without information on the total trading levels, positions, and leverage of a fund, especially in relation to the total market, prime brokers and other counterparties are in danger of critically ignoring liquidity risk.<sup>189</sup>

Information regarding the total liquidity and trading levels in markets would allow brokers to establish certain warning levels regarding a hedge fund’s positions so as to allow the broker to limit

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181. Complaint at 4, San Diego County Employees Ret. Ass’n v. Maounis, No. 07-CV-2618 (S.D.N.Y. Mar. 29, 2007).

182. See Press Release, Senate Comm. on Homeland Sec. & Governmental Affairs, Investigations Subcomm. Releases Levin-Coleman Report on Excessive Speculation in the Natural Gas Market (June 25, 2007), available at [http://hsgac.senate.gov/index.cfm?Fuseaction=PressReleases.View&PressRelease\\_id=1493&Affiliation=R](http://hsgac.senate.gov/index.cfm?Fuseaction=PressReleases.View&PressRelease_id=1493&Affiliation=R) [hereinafter Levin-Coleman Report].

183. Chincarini, *supra* note 180, at 25.

184. See *id.* at 28.

185. See *id.* at 2. Experts concluded that Amaranth’s “fire sale” had an extremely adverse effect on natural gas prices in the United States in 2006. See Levin-Coleman Report, *supra* note 182.

186. See Chincarini, *supra* note 180, at 20, 28.

187. *Id.* at 23.

188. See *id.* at 23-24.

189. See *id.* at 25-26.



excessive leverage and the potentially disastrous liquidity problems that could follow. A self-regulating body comprised of prime brokers could gather information on trading levels and positions, while establishing procedures to maintain the proprietary trading secrets of hedge funds. They could then consolidate and analyze this information to measure the total liquidity at risk.<sup>190</sup> Credit evaluation committees are already separate from the business units within the bank that extends leverage,<sup>191</sup> and reasonable measures could be implemented to maintain the confidentiality of information within the credit management and/or risk management areas of financial firms.<sup>192</sup>

Fines or similar monetary penalties would be the easiest and most effective methods of enforcement. Ultimately, the industry must develop standards and specific penalties for all infractions. Whatever the penalty, it must be severe enough to overcome the collective action problem presented by the prisoner's dilemma situation that currently exists among brokers.<sup>193</sup> In other words, the penalty for an infraction, such as overextending leverage, must exceed the potential short-term gain a broker could realize by relaxing its credit terms.<sup>194</sup>

Undoubtedly some concerns may arise regarding the confidentiality of the information.<sup>195</sup> The fear of losing business, however, gives

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190. In the case of a fund that uses multiple prime brokers, the self-regulatory organization could either provide each prime broker with the necessary information to evaluate liquidity at risk, or evaluate a fund's liquidity at risk at the self-regulatory level and then inform the broker if the fund's risk profile exceeded acceptable standards.

191. See 1999 REPORT, *supra* note 18, at B-7.

192. A similar situation already exists with investment banks. The banks are responsible for maintaining a "chinese wall," the purpose of which is to prevent the flow of information between the investment banking and research divisions of the companies (in order to prevent certain conflicts of interest). See Lisa Smith, *The Chinese Wall Protects Against Conflicts of Interest*, INVESTOPEDIA, <http://www.investopedia.com/articles/analyst/090501.asp>. While the SEC and banks are constantly working to improve the systems currently in place, the self-regulatory measures set up by the banks have largely been successful. See, e.g., *Analyzing the Analysts: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs., 107th Cong. 70-72 (2001)* (statement of Laura S. Unger, Acting Chairman, Securities and Exchange Commission), available at <http://financialservices.house.gov/media/pdf/107-25.pdf>.

193. See *supra* Part III.A.

194. The short-term gains brokers receive by relaxing credit terms usually comes in the form of increased financing fees, either through increases in volume of lending, or in total clients.

195. See *Regulation of Hedge Funds*, *supra* note 3 (noting the need to protect

financial firms a strong incentive to maintain confidentiality, and a self-regulatory body would be able to determine an appropriate level of punishment for such a breach. Additionally, since the government could step in to regulate the hedge fund industry,<sup>196</sup> a self-regulatory body has an incentive to maintain confidential information to avoid this alternative. Self-regulation is the most promising way of preventing excessive government regulation by maintaining the necessary risk management controls to address the total liquidity problem. “Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under [U.S.] jurisdiction.”<sup>197</sup>

#### F. Public Relations and Recent Government Efforts

In recent years, political pressure to further regulate the hedge fund industry has increased.<sup>198</sup> Many factors have contributed to this trend: the fact that hedge funds are “open only to the rich;”<sup>199</sup> the industry’s increased profile due to recent hedge fund failures; increased focus on the tax rate of “carried interest,” which makes up a large portion of fund managers’ pay;<sup>200</sup> the industry’s rapid growth;<sup>201</sup> and the rising level of investment in hedge funds by pension funds and endowments.<sup>202</sup> Public opinion already helped push a tax bill through Congress that would more than double the taxes paid by fund managers on “carried interest.”<sup>203</sup>

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proprietary information of hedge fund traders).

196. See Editorial, *Targeting Hedge Funds*, WALL ST. J., Oct. 31, 2006, at A18; Bill McIntosh, *Hedge Funds Work to Address Critics’ Concerns*, HEDGEWORLD DAILY NEWS, Sept. 26, 2007, available at 2007 WLNR 18905748. [hereinafter McIntosh, *Critics’ Concerns*].

197. *Fallen Star: The Testimony; Excerpts from Greenspan Remarks Before Congress*, N.Y. TIMES, Oct. 2, 1998, at C3, available at <http://query.nytimes.com/gst/fullpage.html?res=9B01E6DB1538F931A35753C1A96E958260>.

198. See generally *Targeting Hedge Funds*, *supra* note 196, at A18; Matt Chambers, *Fanning the Flames: An Influx of Hedge Funds is Making Energy Markets More Volatile Than Ever*, WALL ST. J., Oct. 16, 2006, at R6.

199. See *Targeting Hedge Funds*, *supra* note 196, at A18.

200. Raymond J. Elson & Leonard G. Weld, *Carried Interest: What Is It and How Should It Be Taxed?*, 77 CPA J. 46, Nov. 1, 2007, available at 2007 WLNR 22804390.

201. See, e.g., Lartea Tiffith, *Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA’s Lead*, 27 NW. J. INT’L L. & BUS. 497, 498 (2007); Sargon Daniel, *Hedge Fund Registration: Yesterday’s Regulatory Schemes for Today’s Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 253-54 (2007).

202. Tiffith, *supra* note 201, at 517.

203. See David Cho & Tomoeh Murakami Tse, *Managers of Funds May Face Stiff*

Additionally, an increasing number of alternative asset management firms, such as hedge funds, have chosen to tap the capital markets by going public.<sup>204</sup> Such moves have raised awareness of the high compensation hedge fund professionals earn.<sup>205</sup> These factors will continue to place pressure on elected officials to increase regulation. A self-regulatory body approved by the SEC has the potential to “prove a decent hedge of its own against more-intrusive alternatives.”<sup>206</sup>

Recent changes in state law also reflect the increased pressure to regulate.<sup>207</sup> The California Department of Corporations (“CDC”), for example, recently announced its intention to eliminate a registration exemption for certain investment advisers.<sup>208</sup> The proposed amendment essentially mirrors the SEC’s 2004 hedge fund rule by requiring any person who fits California’s definition of an “investment adviser” to register with the CDC.<sup>209</sup> Essentially, the amendment would require registration of those hedge fund managers who are no longer subject to federal registration as a result of the *Goldstein* decision.<sup>210</sup> This type of state action serves as a reminder that “[t]he hedge fund industry must be

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*Taxes; House Democrats Offer Bill; Blackstone Shares Rise in IPO*, WASH. POST, June 23, 2007, at D01.

204. Becky Yerak, *Citadel Hiring Points to IPO*, CHI. TRIB., Sept. 19, 2007, available at 2007 WLNR 18329808 (noting that “[a]lternative investment firms such as hedge funds and private-equity firms increasingly have been tapping public markets”).

205. See Andrew Dolbeck, *U.S. Legislators vs. Private Equity Firms*, WKLY. CORP. GROWTH REP., July 23, 2007, available at 2007 WLNR 14506913.

206. *Targeting Hedge Funds*, *supra* note 196.

207. See generally J. Matthew Mangan & Alexandra C. Sparling, *California Proposes Rule Change That Will Require Certain Hedge Fund Advisers to Register with the State and Proposes New Rules Affecting Licensed California Advisers Generally*, K&L GATES HEDGE FUND ALERT (K&L Gates, New York, N.Y.), Oct. 2007, [http://www.klgates.com/files/Publication/dae6c307-6dab-4899-b163-36b7bc409c0e/Presentation/PublicationAttachment/c3e67c57-54cc-4bd2-bc23-3a0dd3729ffb/Alert\\_HedgeFund\\_100307.pdf](http://www.klgates.com/files/Publication/dae6c307-6dab-4899-b163-36b7bc409c0e/Presentation/PublicationAttachment/c3e67c57-54cc-4bd2-bc23-3a0dd3729ffb/Alert_HedgeFund_100307.pdf).

208. Donald S. Davidson & Cortney Scott, *California to Require Pooled Investment Vehicle Managers to Register as Investment Advisers and Also Proposes Changes in its Books and Records Rules and Reporting Requirements for Broker-Dealers and Investment Advisers* (Bingham McCutchen, New York, N.Y.), Oct. 15, 2007, <http://www.bingham.com/Media.aspx?MediaID=5960>.

209. See *id.* The definition of an “investment adviser” includes advisers who have a place of business in California or has six or more clients in California, and is exempt from registration under the SEC’s *de minimis* exception contained in § 203(b)(3) of the Advisers Act. *Id.*

210. *Id.*

seen to be taking its responsibilities seriously . . . . If not, others will fill the vacuum.”<sup>211</sup>

*G. Self-Regulation and Legal Liability: Good for Brokers, Too*

The establishment of industry standards, or “best practices,” may be necessary for prime brokers to limit legal liability arising from their contractual obligations to hedge funds. Amaranth,<sup>212</sup> in addition to serving as a warning of the effects of poor risk management, also serves as a reminder that the absence of endorsed, standardized industry practices may leave participants vulnerable to liability without any affirmative defenses to claims of misconduct and fraudulent action. In November 2007, Amaranth sued its broker, JPMorgan,<sup>213</sup> alleging that JPMorgan’s refusal to clear a proposed trade of its energy portfolio to Goldman Sachs breached the two parties’ contract governing their trading relationship.<sup>214</sup> The complaint also alleged that JPMorgan interfered with a proposed sale of the energy portfolio to the Chicago-based hedge fund Citadel.<sup>215</sup> Amaranth alleged that JPMorgan contacted Citadel after Citadel reached an agreement with Amaranth and informed it that Amaranth’s financial condition was worse than the fund had disclosed.<sup>216</sup>

Amaranth’s lawsuit raises important questions about the relationship between hedge funds and prime brokers. While the lawsuit is still in its infancy, and its outcome is unclear, endorsed industry standards would nevertheless help protect the brokerage industry from future allegations by their hedge fund clients of tortious conduct. Such standards would serve as guidelines for balancing brokers’ contractual obligations with their own self-interests. More importantly, industry standards would guide brokers in balancing their contractual obligations to clients, while maintaining standards that help protect against unnecessary systemic risk. If a situation similar to Amaranth’s arises in

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211. McIntosh, *Critics’ Concerns*, *supra* note 196.

212. *See supra* Part II.

213. Summons and Complaint, Amaranth LLC v. J.P. Morgan Chase, No. 603756 (Nov. 13, 1997); Katherine Burton, *Amaranth Sues JPMorgan for Disrupting Transactions (Update 2)*, BLOOMBERG NEWS, Nov. 14, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acglx.akXLhE>.

214. Summons and Complaint, *supra* note 213, at 5.

215. *Id.* at 7.

216. *Id.* at 8.

the future, a prime broker should not have to choose between breaking its obligations to clients and unnecessarily increasing its risk. A self-regulatory body would help brokers to achieve the proper balance of those interests.

#### H. Future Trends in the Industry

Recent developments suggest that investment banks that serve as prime brokers to hedge funds have begun to move toward establishing self-regulatory frameworks to govern their dealings with advisers, showing that they may be receptive to the establishment of a self-regulatory body. Morgan Stanley, one of the world's leading providers of prime brokerage services,<sup>217</sup> recently launched LiquidFunds, a hedge fund platform designed to enhance liquidity and transparency for institutional investors.<sup>218</sup> According to one of the program's managing directors, "[t]he LiquidFunds program will help people overcome th[eir] reluctance [in investing] by delivering an alternative range of hedge funds that provide the liquidity and transparency that investors demand, within a self-regulatory regime."<sup>219</sup> Each participating fund must undergo a three-stage due diligence process prior to enrollment in the program.<sup>220</sup> Greenwich Alternative Investments ("GAI") administers the due diligence process.<sup>221</sup> "In the initial screening stage, each prospective manager is screened against static criteria for track record, minimum assets under management and performance."<sup>222</sup> In the second stage, GAI conducts an on-site visit with the investment manager culminating in an assessment of the investment strategy.<sup>223</sup> The third stage involves an ongoing assessment of the fund through monthly reviews of its performance.<sup>224</sup>

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217. See, e.g., *Morgan Stanley Top Prime Broker*, HEDGE FUND DAILY, Oct. 24, 2007, <http://www.institutionalinvestor.com/article.aspx?articleID=1533465> (reporting that *Alpha* magazine named Morgan Stanley best overall prime brokerage for the third year in a row).

218. Bill McIntosh, *Morgan Stanley Launches LiquidFunds with \$200 Million*, HEDGEWORLD DAILY NEWS, Aug. 6, 2007, available at 2007 WLNR 15102398.

219. *Id.* (quoting Ted Hood, managing director of LiquidFunds).

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

Funds participating in the program must comply with specific investment guidelines.<sup>225</sup> Investors have the option to buy and sell their hedge fund positions on a weekly basis.<sup>226</sup> The funds must adopt common corporate governance standards and must issue daily risk reports.<sup>227</sup> The reports must include an “assessment of whether each fund is in compliance with the program’s investment guidelines.”<sup>228</sup> Additionally, Morgan Stanley has retained a risk analytics provider, GlobeOp Risk Services Ltd.,<sup>229</sup> to provide “sensitivity, scenario, stress, and [value at risk] analysis . . . .”<sup>230</sup>

The launch of programs like LiquidFunds represents a positive step by the industry to improve risk management procedures, but more needs to be done. The program’s scope is limited, as it only governs funds that choose to enroll. It therefore fails to adequately address liquidity problems and systemic risk. While such programs are a step in the right direction, they should not be the end goal of the industry. Nevertheless, the hedge fund industry’s movement toward self-regulatory standards on a firmwide level provides hope for the success of a proposal to impose self-regulatory standards on the entire industry.

#### *I. The Limitations of Self-Regulation via Prime Brokers*

An association of brokers that imposes penalties on its members for failure to follow certain standards must avoid the risk of imposing limits on leverage that are too strict, such as prematurely withholding credit or ceasing to execute a fund’s trades.<sup>231</sup> For example, if a fund used new trading strategies or traded in a new type of security, a broker’s model for credit evaluation could exaggerate the actual risk inherent in the fund’s portfolio. Prematurely withholding leverage would result in a situation similar to that preceding the collapse of Amaranth and LTCM, forcing a fund to sell its assets for less than their true market value.

Despite this concern, the benefits of self-regulatory limits on

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225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. In the case of future or derivative contracts, this essentially limits leverage, as the fund would no longer be able to purchase contracts based on the price of an underlying security.

leverage outweigh these potential dangers. Uniform standards, strictly enforced across the industry, would provide advance warning of funds that are approaching hazardous levels of leverage. Additionally, on average, a hedge fund is only leveraged at around twice its asset base.<sup>232</sup> Restrictions and standards governing leverage and liquidity risk should only be used in extreme situations (like an Amaranth or LTCM) and should not impair the vast majority of funds.

Ultimately, an environment that allows the vast majority of funds to operate unimpaired and to maintain total liquidity, thereby drastically reducing systemic risk, would be the most beneficial to the hedge fund industry, brokerages, and the investing public.

#### CONCLUSION

Hedge funds benefit the economy in many ways, but they also present many risk management challenges for the funds, the brokers, and the market as a whole. Maintaining benefits while limiting risks requires a balance among many interests. Current regulations fail to achieve this balance because they inadequately reduce systemic risk. Recent attempts by both federal and state governments have also failed to address this risk, and future government regulation may impose unnecessarily broad rules that would limit the benefits of hedge funds. Self-regulation at the broker level can properly balance hedge funds' risks and benefits by quickly evaluating current market conditions and adjusting accordingly. This regulation must be supported by an organization with the authority to impose penalties for non-compliance, neutralizing participating firms' incentives to unilaterally deviate from industry standards. An association of brokers offers numerous advantages to the participating parties, and is likely to find support in the hedge fund industry.

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232. Adam Shell, *Could Hedge Funds Cause Market Meltdown?*, USA TODAY, May 18, 2005, at 1B, available at [http://www.usatoday.com/money/markets/us/2005-05-18-hedge-funds-usat\\_x.htm](http://www.usatoday.com/money/markets/us/2005-05-18-hedge-funds-usat_x.htm).