THE OPAQUE AND UNDER-REGULATED HEDGE FUND INDUSTRY: VICTIM OR CULPRIT IN THE SUBPRIME MORTGAGE CRISIS?

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I. INTRODUCTION

It has been argued that hedge funds[1] were among the contributors to the fiscal crisis that arose from the securitiza-

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1. Hedge funds are a challenge to define. U.S. securities law offers no definition. In Spring 2008, the Asset Managers' Committee to the President's Working Group on Financial Markets interpreted the term "hedge fund," as they used it, to mean "a pooled investment vehicle that generally meets most, if not all, of the following criteria: (i) it is not marketed to the general public (i.e., it is privately offered), (ii) its investors are limited to high net worth individuals and institutions, (iii) it is not registered as an investment company under relevant laws (e.g., U.S. Investment Company Act of 1940), (iv) its assets are managed by a professional investment management firm that is compensated in part based upon investment performance of the vehicle; (v) its primary investment objective is investing in a liquid portfolio of securities and other investment assets; and (vi) it has periodic but restricted or limited investor redemption rights." REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, BEST PRACTICES FOR THE HEDGE FUND INDUSTRY, at i, n.2 (Apr. 2008) [hereinafter, REPORT OF THE ASSET MANAGERS' COMMITTEE TO PWG, Apr. 15, 2008], http://www.treasury.gov/press/releases/reports/amcreport april152008.pdf. To complicate matters, there is an investment strategy in

tion of subprime loans.[2] However, it may also be argued that the hedge fund industry did not play a direct precipitating role in the events leading to the financial meltdown.[3] Indeed, there is no single, primary culprit because the crisis arose due to a confluence of inter-related factors fueled, in part, by the deregulated environment in which financial institutions were operating.[4] It is a subject of great debate whether the structure and financial strength of the huge hedge fund industry, with approximately 10,000 funds and $2 trillion in assets under management in 2007,[5] exacerbated the intensity of the

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which hedge funds invest in other hedge funds, which is referred to as "funds of hedge funds." *See* SEC. EXCH. COMM'N, *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, http://www.sec.gov/answers/hedge.htm (last visited Sept. 9, 2009). In addition, other pools of investments that are *not* hedge funds include "venture capital funds, private equity funds and commodity pools . . ." *See* SEC. EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 21 (2003) [hereinafter STAFF REPORT TO THE SEC 2003], http://www.sec.gov/news/studies/hedgefunds 0903.pdf.

2. The securitization of the mortgages, considered one of the root causes of the housing bubble and eventual subprime meltdown, occurred when investment banks pooled prime loans purchased from lenders and issued securities against this pool. *See* John C. Coffee, Jr., *The Securitization Bubble*, NAT. L. J., Mar. 17, 2008, at 14; THE ECONOMIST, *Ruptured Credit*, May 17, 2008, at 6.

3. Those market participants identified as contributing significantly to the "erosion of market discipline" include loan originators, underwriters, rating agencies, sellers of credit default swaps ("CDSs"), and global investors, along with mortgage brokers and others. *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (Mar. 2008) [hereinafter PWG, Mar. 2008], http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf; *see Hedge Funds and the Financial Markets: Before the House Committee on Oversight and Government Reform*, 110th Cong. (2008) [hereinafter *Congressional Hedge Fund Hearing, Nov. 2008*] (testimony of David S. Ruder, Professor Emeritus, Northwestern University School of Law), http://oversight.house.gov/story.asp? ID=2271.

4. *See* Tom Hamburger, *In D.C., Few Evade Blame for Calamity*, L.A. TIMES, Oct. 6, 2008, at C1.

5. Reportedly, the holdings of hedge funds have reportedly increased over five-fold to more than $2 trillion over the last decade. *See Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3, (Opening Statement of Rep. Henry A. Waxman, Committee Chairman). In 2007, Hedge Fund Research estimated that there are more than 10,000 hedge funds with more than $1.8 trillion worth of assets under management. *See* Adam Shell, *Hedge Fund Deadline Could Ease Selling*, U.S.A. TODAY, Nov. 14, 2008, at 2B. Assets managed in the U.S. are estimated to account for about 60 percent of the global total.

meltdown (1) by being ready, willing, and able buyers for the collateralized debt obligations ("CDOs") backed by the home mortgage pools; (2) by contributing to the volatility of the market with stock sales to provide the massive amounts of cash required for investor redemptions and to meet margin calls;[6] and (3) by investing in murky credit default swaps ("CDS") market.[7]

These innovative mortgage-backed securities and their progeny found a receptive framework for the structure and model of the hedge fund industry. First, CDOs and CDSs were temptingly lucrative business opportunities to hedge fund managers, known for using complex and aggressive strategies

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The aggregate trading volumes of hedge funds reportedly account for significant shares of total trading volumes in some segments of the financial markets. *Hedge Funds and Systemic Risk: Perspectives of The President's Working Group on Financial Markets: Before the Committee on Financial Services,* 110th Cong. (2007), [hereinafter *Hedge Funds and Systemic Risk hearing 2007*] (testimony of Kevin Warsh, Federal Reserve Board), http://www.house.gov/apps/list/hearing/ financialsvcs_dem/hr0705074.shtml. One survey indicated that the hedge fund industry grew 26 percent in 2006. Press Release, Hennessee Group Releases, 13th Annual Hedge Fund Manager Survey (May 1, 2007), http://www.hennesseegroup.com/releases/release20070501.html. *See* Jerry Strasburg, *Smaller Hedge Funds Struggle as Money Pipeline Dries Up,* WALL ST. J., Oct. 4, 2008, at B1; *see Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3; *see also* U.S. TREASURY, FACT SHEET: ASSET MANAGERS' COMMITTEE BEST PRACTICES SUMMARY (giving a figure of "8,000 hedge funds with close to $2 trillion in assets"), http://www.ustreas.gov/press/releases/reports/amfactsheetfinal.pdf (last visited Aug. 12, 2009).

6. Hedge funds have specific stock redemption windows defined as "the time in which hedge fund investors must notify a fund of their intention to withdraw assets." When the market pressure builds and investors react to the downward spiral of the economy, "funds are forced to sell their positions regardless of price to meet those demands." *High Fund Redemption May Be Key,* NASDAQ (Sept. 28, 2008), http://www.nasdaq.com/newscontent/20080929/hedge_fund_redemption_may_be_key__27345.aspx.

7. Credit default swaps are complex derivative instruments that "act as an insurance policy of sorts where one party must pay another one in the event the bonds lose value." Credit-default swaps played a major role in the failure of American International Group ("AIG") in Fall 2008. *See AIG and the Trouble with 'Credit Default Swaps',* NPR, Sept. 18, 2008, http://www.npr.org/templates/story/story/php?storyId=94748529; *see* JOINT REPORT ON RETAIL SWAPS AS REQUIRED BY SECTION 105C OF THE COMMODITY FUTURES MODERNIZATION ACT OF 2000, BOARD OF GOVERNORS OF THE FEDERAL RESERVE, DEPARTMENT OF THE TREASURY, COMMODITY FUTURES TRADING COMMISSION, SECURITIES AND EXCHANGE COMMISSION (Dec. 2001), http://www.treas.gov/press/releases/docs/rss-final.pdf.

to bring large returns to their institutional and high net worth investors. Second, hedge funds operated in an under-regulated environment,[8] excluded from the public scrutiny of the Securities and Exchange Commission ("SEC") disclosures,[9] exempt from the regulations of the Investments Advisers Act and the Investment Company Act (both originally enacted in 1940),[10] and free to exploit the exclusion of derivatives (such as CDOs) from the Commodities Modernization Act of 2000.[11] An earlier attempt by the SEC to impose regulation on hedge fund advisers was invalidated by the Court of Appeals in *Gold-*

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8. Hedge funds cannot be called "unregulated" because there are some other regulatory restrictions which apply to hedge funds, including restrictions on insider trading, prohibitions against advertising and offers to the public, anti-fraud provisions, and anti-money laundering regulations and customer identification requirements. It is also possible that hedge funds cross the numerical thresholds in the Advisers Act and the Company Act and trigger regulation. *See also* Louise Story, *Hedge Fund Managers to Testify in Washington,* WALL ST. J., Nov. 13, 2008, at B3.

9. 17 C.F.R. § 230.501 (1997) (containing safe harbor provision for high net worth investors) [hereinafter SEC's Regulation D]. It should be noted that "[u]nder authority of section 128 of the Emergency Economic Stabilization Act of 2008, the [Federal Reserve] Board is amending Regulation D," Press Release, Board of Governors of the Federal Reserve System, Board Announces that It Will Begin to Pay Interest on Depository Institutions and Excess Reserve Balances (Oct. 9, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm.

10. *See* Investment Advisers Act 15 U.S.C. § 80b-3(b)(3) (2004) [hereinafter Advisers Act]; and Investment Company Act of 1940 15 U.S.C. § 80a-3 (a)(2)(c)(1)(2004) [hereinafter Company Act]; *see* the safe harbor rule adopted by the Commission in 1985 that "permits an investment adviser to count a legal organization as a single client so long as the investment advice provided is based on the organization's investment objectives rather than those of any owner or owners of the organization" in Section 203(b)(3)-1 of the Advisers Act. 15 U.S.C. § 80b-3(b)(3)) [hereinafter Rule 203(b)(3)]; STAFF REPORT TO THE SEC 2003, *supra* note 1; *see also* William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman, SEC Open Meeting: Registration of Hedge Fund Advisers (Oct. 26, 2004) [hereinafter Donaldson speech 2004]. Although hedge fund investment advisers are subject to other provisions in the federal securities laws, they are not subject to any reporting or standardized disclosure requirements. Consequently, the SEC has only indirect information about these entities and their trading practices.

11. Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1 – 27(f)) [hereinafter Commodities Futures Act 2000]. *See generally supra* note 7 for a brief coverage of credit default swaps.

stein v. SEC (2006).[12] Moreover, the inherent secrecy of hedge funds enabled them to obscure the complexities of the security instruments in which they were investing. In many instances, the hedge funds added still another layer of secrecy by operating through entities legally domiciled in offshore jurisdictions.[13] One author opined that "[b]ecause [hedge funds] are private investment pools, they aren't subject to federal or state regulation and don't have to disclose what they're buying or selling—not even to their own investors."[14]

As a result of their investments during the period immediately preceding the subprime crisis, hedge funds have faced two opposing consequences: accused of fault[15] and of being a victim of a failing financial sector.[16] The first hedge fund "vic-

12. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. June 2006). This case, which was not appealed, invalidated the 2004 SEC rule regulating hedge fund advisers. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) [hereinafter SEC Hedge Fund Rule 2004].

13. The four offshore leaders are Cayman Islands, the British Virgin Islands, the Bahamas, and Bermuda. It is estimated that more than half of the world's hedge funds are legally domiciled offshore. *See* Martin A. Sullivan & Lee A. Sheppard, *Offshore Explorations: Caribbean Hedge Funds, Part 1* (originally published in TAX NOTES, Jan. 7, 2008), http://www.taxhistory.org/www/features.nsf/Articles/35244A221EDD1BF7852573D00071118E?OpenDocument; *see also* Julie Scuden, *What is an Offshore Hedge Fund?*, Apr. 7, 2008, http://www.hedgeco.net/hedgeducation/hedge-fund-articles/what-is-an-offshore-hedge-fund/.

14. Tom Petruno, *Firm's Public Stock Sale Pulls Hedge Funds Out of Shadow* (Back Story), L.A. TIMES, Feb. 9, 2007, at 1.

15. Some accusations of fault have arisen from hedge funds' overly aggressive investments in complex derivatives backed by home mortgage pools and their extensive leveraging in order to provide more money to invest. Partly to blame for their aggressive tactics is their performance-based compensation model, which typically gives hedge fund advisers hedge fund fees of 1-2 percent on assets and performance incentive fees of 20 percent on all profits. There are vast benefits for the adviser on the profit sharing side, but no offset for the downside when performance is poor. This compensation structure negatively affects the incentive for the advisors to protect their investors against possible risks. *See Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3 (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).

16. As evidenced by HFRX Global Hedge Fund Index maintained by Hedge Fund Research, the global hedge fund performance was down from a positive of 9.26 percent in its best year in 2006 to a negative of -23.25 percent in the year 2008—which demonstrates the devastating effect of the economic downturn on hedge funds during 2008. *See* HFRX INDICIES, https://

tims" of the subprime meltdown appeared in the summer of 2007, reminiscent of the Long-Term Capital Management hedge fund collapse in 1998.[17] After investing almost solely in mortgage-backed CDOs,[18] two Bear Stearns hedge funds declared bankruptcy, and to make matters worse, leveraged the funds to make even more investments in the same type of CDOs.[19]

Part II of this Article outlines the relevant history of hedge funds, including the collapse of Long-Term Capital Management in 1998,[20] the legislative basis for exemption from regu-

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www.hedgefundresearch.com/hfrx_reg/index.php?fuse=login&122766 1910. "Credit Suisse now estimates 30% of the roughly 8,000 hedge funds over the next few years will close." *See* Cassell Bryan-Low, *Hedge-Fund Managers Doing Deals to Keep Investors,* WALL ST. J., Oct. 1, 2008, at C2; *see also* Gregory Zuckerman & Cassell Bryan-Low, *More Pressure on Hedge Funds,* WALL ST. J., Oct. 17, 2008.

17. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 10-22 (April 1999), http://www.treasury.gov/press/releases/report3097.htm [hereinafter PWG April 1999].

18. *See Hedge Funds and Systemic Risk Hearing, supra* note 5 (testimony of Kevin Warsh), Federal Reserve Board); *see also* PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME 320 (2008). A collateralized debt obligation ("CDO") originates from a financial institution and is "a security that entitles the purchaser to some portion of the cash flows from a portfolio of assets, which may include [in the pool] bonds, loans, mortgage-backed securities, or other CDOs." For a given pool, CDOs may have tranches (a word of French origin meaning "slice") divided into senior debt, mezzanine debt, subordinated debt, and equity to designate the different levels of risk. The complex CDOs are good examples of Wall Street ingenuity at its best. *See* MARK ZANDI, FINANCIAL SHOCK 118 (2008) (explaining that a CDO is "[l]ike stock mutual funds, which holds stocks from many different companies [for diversification purposes], a CDO buys bonds . . . Although CDOs have a twenty year history, they became a security of choice during the subprime frenzy when CDO originators—mostly investment banks, focused their attention on . . . [credit obligations], including those backed by subprime loans . . . CDOs have the same tranching structure as traditional securitization, with payments going first to senior tranches, and then to mezzanine tranches, and then to an equity tranche that shouldered the most risk."). Additionally, the correct technical term is asset-backed security collateralized debt obligation ("ABS CDO") and their popularity soared (as shown in a bar chart) during the housing boom from approximately $25 billion in 2005 to the issuance of $100 billion around mid-2007. *Id.*

19. Kate Kelly, Serena Ng & David Reilly, *Two Funds at Bear Stearns Face Shutdown Amid Subprime Woes,* WALL ST. J. ONLINE, June 21, 2007, http://www.realestatejournal.com/indinvestor/20070621-kelly.html.

20. PWG April 1999, *supra* note 17.

lation,[21] and the SEC's attempts to regulate hedge funds.[22] In Part III, the authors examine the deregulatory legislation of the last three decades that negatively affected the financial marketplace. This period of financial deregulation started from the passage of the 1980 Depository Institutions Deregulation and Monetary Control Act ("DIDMCA")[23] and the 1982 Depository Institutions Act ("Garn-St. Germain"),[24] resulting in the later savings and loan crisis. History repeated itself in 2007 with the subprime mortgage crisis, a repercussion from deregulatory legislation at the turn of the century in which multiple market participants operated with relative impunity due, in part, to a number of regulatory changes. The precipitating legislation included (1) repeal of the depression-era Glass-Steagall Act,[25] amendments to the 1956 Bank Holding Company Act ("BHCA")[26] contained in the provisions of the 1999 Financial Modernization Act ("Gramm-Leach-Bliley");[27] and (2) passage of the 2000 Commodity Futures Modernization Act ("Commodity Act 2000").[28] In Part IV, the authors discuss the role of hedge funds in the collapse of the subprime

21. Advisers Act, *supra* note 10. Company Act, *supra* note 10.

22. SEC Hedge Fund Rule 2004, *supra* note 12.

23. Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.) [hereinafter DIDMCA].

24. The Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (as codified in scattered sections of 12 U.S.C.), amending section 4(c)(8) of the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1994) [hereinafter Garn-St. Germain].

25. The Glass-Steagall Act is comprised of four sections of the National Banking Act of 1933. See §§ 16, 20, 21, and 32 of the Banking Act of 1933, codified as 12 U.S.C. §§ 24, 78, 377 and 378 [hereinafter Glass-Steagall].

26. Bank Holding Company Act, (codified as amended in scattered sections of 12 U.S.C.) (1956) (prohibiting bank holding companies owning two or more banks from engaging in non-banking activities and from buying banks in another state) [hereinafter BHCA].

27. Gramm-Leach-Bliley, Pub. L. No.106-102, 113, Stat. 1338 (Nov. 12, 1999) (codified as amended in scattered sections of 12 and 15 U.S.C.) [hereinafter Gramm-Leach Bliley].

28. Commodities Futures Act 2000, *supra* note 11. The Commodity Exchange Act failed to make it clear that OTC derivatives are excluded from regulation. Thus, Congress followed the recommendations of the President's Group on Financial Markets to specifically clarify the exclusion of derivatives, including credit default swaps. REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS OVER-THE-COUNTER DERIVATIVES MARKETS AND THE EXCHANGE ACT (Nov. 1999) [hereinafter PWG, Nov. 1999].

mortgage market and the effect of the collapse on the hedge funds, arguing that that an under-regulated and opaque hedge fund industry is an undermining factor exacerbating the instability of the financial marketplace. Part V highlights the work of the President's Working Group on Financial Markets, along with focusing on Congressional hearings' attempts to delve into the secretive inner structure workings of the hedge fund industry in an effort to determine whether systemic risks exist. In the conclusion, the authors discuss the government's dilemma in seeking to maintain the delicate balance between the benefits of an unrestrained free market system and the hazards of under-regulation. Recommendations are made for the creation of a meaningful regulatory structure for the hedge fund industry.

II.
BACKGROUND

The SEC's first attempt to impose regulations on the hedge fund industry occurred in 2004,[29] but the rule was invalidated by a 2006 decision of the U.S. Court of Appeals for the D.C. Circuit.[30] Writing for the majority in that case, Circuit Judge Randolph expressed his frustration that "hedge funds are notoriously difficult to define" and went on to note that "even industry participants do not agree upon a single definition."[31]

Hedge funds are typically organized as limited partnerships[32] or similar entities and cater primarily to institutional investors and individuals with high net worth. It is presumed that these types of investors are sophisticated traders who understand the risks being taken and approve of the aggressive and creative tactics used by hedge fund managers in search of higher returns. In the typical arrangement, a general partner manages the fund (or several funds) for a fixed fee plus a percentage of the gross profits from the fund. The limited partners are passive investors who generally take no part in management activities. Hedge funds tend to make liquid invest-

29. SEC Hedge Fund Rule 2004, *supra* note 12.

30. Goldstein v. SEC, 451 F.3d 873 (D.C Cir. June 21, 2006).

31. *Id.*

32. *See* Tom Petruno, *Firm's Public Stock Sale Pulls Hedge Funds Out of Shadows,* L.A. TIMES, Feb. 9, 2007, at 1.

ments, and, unlike private equity funds, they usually permit investors to enter or leave the fund easily.

An important advantage that hedge funds have—differentiating them from many other investment funds, like mutual funds—is exemption from both SEC registration and periodic reporting mandated by the Securities Acts of 1933 and 1934.[33] First, the exemption of hedge funds from filing reports allows their industry to shroud itself in secrecy. Second, given their investor base, they have avoided the need to provide regulatory protection to unsophisticated investors. Thus, the industry has been able to develop relatively unimpeded by the usual regulatory entanglements affecting funds and other investment vehicles.

A. *History of the Hedge Fund Industry*

In 1949, Alfred Winslow Jones, a Fortune magazine reporter, set up an investment partnership which is widely regarded as the first hedge fund. Jones' investment partnership or hedge fund specialized in buying "undervalued" stocks and short-selling "overvalued" stocks as a way to limit risk exposure while increasing returns.[34] A 1968 survey by the SEC identified 140 funds operating at that time.[35] Between 1990 and 2006, however, hedge funds had a meteoric rise, increasing to an almost 3,000 percent global growth with the number of hedge funds,[36] reaching an estimated 9000 funds, and having approximately $1.5 trillion in global assets.[37]

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33. SEC, *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, http://www.sec.gov/answers/hedge.htm (last visited July 7, 2009)

34. FINANCIAL STABILITY FORUM REPORT 8 (Apr. 4, 2000), http://www.financialstabilityboard.org/publications/r_0804.pdf.

35. PWG, Apr. 1999, *supra* note 17.

36. *See generally supra* note 5. *See also Regulation of Hedge Funds: Before the Senate Committee on Banking, Housing and Urban Affairs*, 109th Cong. (2006), (statement of SEC Chairman Christopher Cox), http://www.sec.gov/news/testimony/2006/ts072506cc.htm [hereinafter July 2006 Statement of SEC Chairman Christopher Cox].

37. "Because hedge funds are under few obligations to disclose information, either publicly or to regulators, it is difficult to estimate the size of the industry accurately." FINANCIAL STABILITY FORUM REPORT, *supra* note 34.

1. *Long-Term Capital Management's Hedge Fund Collapse and Rescue by the Federal Reserve*

The failure of Long-Term Capital Management ("LTCM") in 1998[38] is a significant milestone in of the history of hedge funds and establishes the date when hedge funds first gained national attention. Certainly, LTCM's losses were not the first in the hedge fund business, nor the last,[39] but the sheer scale of the fund's activities make its failure a dramatic example of a hedge fund catastrophe. The story of LTCM's fall is well-known throughout the financial world, and reverberations from the fiasco are still felt. Comparisons have been made between the collapse of LTCM and the collapse of Bear Stearns hedge funds in 2007, as well as the collapse of Bear Stearns Companies, Inc., the parent company, in 2008. First, the $3.2 billion in loans by Bear Stearns Companies to bail out its hedge funds constituted the biggest rescue since 1998 when "more than a dozen lenders provided $3.6 billion to save LTCM."[40] Second, the Federal Reserve Bank's direct intervention in the Bear Stearns Companies crisis of 2008 was reminiscent of the level of concern the Fed showed when it informally intervened in LTCM's downward spiral ten years before in arranging a consortium of lenders to avert a general upheaval in the markets.[41]

LCTM opened for business in 1994 as a Delaware limited partnership along with the fund that it operated, Long-Term Capital Portfolio, which was established offshore in the Cayman Islands. LCTM was successful from its inception because of the extraordinary reputation of its principals[42] and because

38. PWG, Apr. 1999, *supra* note 17, at 12.

39. In 2006, Amaranth Advisors, a hedge fund in Greenwich, Connecticut, lost more than $6.6 billion in two weeks because of wrong-way bets on natural gas futures. A reporter for the New York Times wrote, "enormous losses at one of the nation's largest hedge funds resurrected worries that major bets by these secretive, unregulated investment partnerships could create widespread financial disruptions." Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves,*" N.Y. TIMES, Sept. 19, 2006, at C1.

40. Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund,* N.Y. TIMES, June 23, 2007, http://www.nytimes.com/2007/06/23/business/23bond.html.

41. CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN 53 (2008).

42. Long-Term Capital Management ("LTCM") was headed by John Meriwether, a veteran bond trader from Salomon Brothers, the investment bank now joined with Smith Barney and owned by Travelers Group, Inc. He was

of its large initial capital stake.[43] LTCM attracted investors with the promise of an arbitrage strategy that was so sophisticated that it promised to reduce the risk level almost to zero.

For four years, the fund was exceptionally successful and vastly increased the returns to its investors.[44] Unfortunately, when the Russian and other financial markets hit a period of turmoil in 1998, with currency collapses throughout Asia, LTCM erroneously expected the situation to revert to normal and took large positions in the market. When Russia defaulted on its debt, LTCM was holding a significant position in Russian government bonds, causing losses of millions of dollars per day due to miscalculations about the Russian market, as well as a number of other mistakes.[45]

The Federal Reserve reacted to the LTCM collapse in a manner which was similar to the strategy it used during the economic crisis in Fall 2008. It facilitated the establishment of a $3.65 billion private bailout fund from a consortium of major investment banks after it became apparent to the Federal Reserve that LTCM had positions in the market in excess of $100 billion and an equity base of only $1 million.[46] The banks set up a supervisory body that allowed LTCM to survive and to liquidate in an orderly manner without the chaos of a forced bankruptcy.[47] It is widely believed that the Federal Reserve Bank intervened to avoid the level of disruption that a forced sale of the fund's investments would have had on both New York financial institutions and on international markets.[48]

In Spring 2008, Bear Stearns Companies, Inc. found itself in an equivalent predicament to that of LTCM's earlier crisis. Notably, Bear Stearns had refused to participate in LTCM's rescue. As with the LTCM circumstance, the Federal Reserve

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joined by Robert Merton of Harvard University and Myron S. Scholes of Stanford University, both recipients of the Nobel prize for economics. Steven Mufson & John M. Berry, *Wall St. Struggles to Save Big Fund; Collapse Could Rattle Global Markets*, WASH. POST, Sept. 24, 1998, at A1.

43. PWG, Apr. 1999, *supra* note 17, at 10.

44. *Id* at 11. In 1995, the LTCM Fund produced returns, after fees, of approximately 40 percent.

45. MORRIS, *supra* note 41, at 52.

46. *Id.*

47. *Id.* at 52, 53.

48. William Lewis, Richard Waters & Tracy Corrigan, *Huge Hedge Fund at Risk: Long-Term Capital Management Has Lost U.S. $2 Billion this Year as Global Turmoil Starts to Disrupt NY Markets*, FIN. TIMES, Sept. 24, 1998, at 1.

had to intervene on behalf of Bear Stearns Companies in an effort to lessen the negative implications for financial institutions worldwide.[49]

The failure of LTCM created tremors throughout the hedge fund industry, whose players realized that financial regulators' new focus would be on whether the industry should be strictly regulated. However, no attempts were made toward tighter regulations until 2004, when the SEC issued the Hedge Fund Rule.[50] Although the rule came several years after LTCM's collapse, presumably, LTCM was a precipitating factor in the SEC's attempt to attain some level of control over the industry.

2. *Legislative Basis for Exemption from Regulation*

The exemption of hedge funds from most regulatory efforts between 1949 to 2004, at both the state and federal levels, gave the industry a special status within the financial community—a status it was able to maintain after the SEC's 2004 Hedge Fund Rule was invalidated. The funds were able to take advantage of their limited partnership form, which provided the basis for the exemption from both the Investment Company Act of 1940 ("Company Act")[51] and the Investment Advisers Act of 1940 ("Advisers Act").[52]

As a result of this exemption, members of a limited partnership entity are not considered "clients," and a single fund is counted as the single "client" of its investment adviser, regardless of the number of limited partners involved.[53] Furthermore, hedge funds are not considered to be "in the business of investing, reinvesting, or trading in securities" under the provisions of the Company Act (1) if the fund has fewer than 100 "persons" who are beneficial owners of its outstanding securities, (2) if the fund does not offer its securities to the public, and (3) if the outstanding securities are owned by "qualified

49. *See* Kate Kelly, Mike Spector & Randall Smith, *Bear's Final Moment: An Apology and No Lack of Ire,* WALL ST. J., May 30, 2008, at C1; *see also* Liz Moyer, *They All Fall Down,* Sept. 15, 2008, http://www.newsweek.com/ id/159010/ output/print.

50. SEC Hedge Fund Rule 2004, *supra* note 12.

51. Company Act, *supra* note 10.

52. Advisers Act, *supra* note 10.

53. Rule 203(b)(3)-1, *supra* note 10. *See* STAFF REPORT TO THE SEC 2003, *supra* note 1.

purchasers."[54] In addition, hedge fund advisers qualify for an exemption from the registration and licensing requirements of the Advisers Act[55] (1) if they have fewer than fifteen clients during the course of the preceding twelve months, (2) do not hold themselves out generally to the public as investment advisers, and (3) do not advise a registered investment company.[56] In determining the number of clients, the term "client" refers to the limited partnership or fund itself, not to the shareholders or partners.[57] It is rare that even the largest of hedge fund managers handle more than fifteen funds, creating the perfect shield from SEC control and monitoring.

3. *SEC Attempts to Regulate Hedge Funds*

The hedge fund industry was able to avoid most regulation and was traditionally described as under-regulated. Although some restraints on its conduct exist, the fact that disclosure requirements of the securities laws do not apply to hedge funds[58] did not prevent the SEC from filing numerous lawsuits based on alleged misconduct, including insider trading,[59] misappropriation of funds,[60] and misrepresentation of assets and returns.[61]

In an attempt to obtain some control over the industry, the SEC issued the ill-fated Hedge Fund Rule in 2004, which

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54. Company Act, *supra* note 10; *see* U.S.C. § 80a-2(a)(51)(A) (defining the financial threshold to be a "qualified purchaser").

55. Advisers Act, *supra* note 10.

56. *Id.* ("[N]o . . . partner . . . shall be deemed to be a client of such investment . . . as defined in this subchapter . . .").

57. *Id.*

58. *See generally supra* note 8.

59. *See* SEC v. Mitchel S. Guttenberg, Litigation Release No. 20022 (Mar. 2007), http://www.sec.gov/litigation/litreleases/2007/lr20022.htm; *see also* SEC v. John F. Managan, No. 06 Civ. 0531 (W.D.N.C. Dec. 28, 2006), http://www.sec.gov/litigation/complaints/2006/comp19955.pdf.

60. *See* SEC v. CMG Capital Management Group and Keith Gilabert, Case No. CV 06-2595 GAF (Ex) (C.D. Cal.), Litigation Release No. 19680, (May 2006), http://www.sec.gov/litigation/litreleases/2006/lr19680.htm; *see* James J. Eccleston, *SEC Continues to Seek to Protect Hedge Funds Investors*, http://www.financialcounsel.com/Articles/Investment/ARTINV0000290-HedgeFundInvestors.asp (last visited Aug. 12, 2009).

61. SEC v. Kirk S. Wright, Int'l Mgmt. Associates, Civil Action No. 1:06-CV-0438 (NDGA Feb. 27, 2006), Litigation Release No. 19581, Feb. 28, 2006, http://www.sec.gov/litigation/litreleases/lr19581.htm; *see* Eccleston, *supra* note 60.

required registration of hedge fund advisers, among other requirements.[62] This attempt at regulation was apparently initiated by the SEC in response to harsh criticism of the agency following the Enron debacle.[63] At the time of the implosion of Enron, WorldCom, and several other high-profile companies, the SEC was widely rebuked for "being asleep at the switch."[64] The public outcry regarding these corporations' transgressions and the lack of accountability of the Enron era pushed the SEC firmly in the direction of more aggressive regulation[65] after the agency was criticized for not doing more to prevent the underlying causes of the corporate scandals. In 2004, as the number of hedge funds and assets controlled by the funds grew rapidly, fears about another "Enron" probably provided the impetus for SEC Chairman William H. Donaldson to promulgate the Hedge Fund Rule.

In Fall 2008, the SEC took action to halt short-sale transactions, one of the strategies used by hedge funds. As described in a SEC press release, short-sales are problematic for the following reasons:

> In an ordinary short-sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price). But in an abusive naked short transaction, the seller doesn't actually borrow the stock, and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.[66]

62. SEC Hedge Fund Rule 2004, *supra* note 12.

63. The well publicized implosion and ultimate bankruptcy of Enron Corp. was the result of numerous accounting manipulations that caused tremendous losses to stockholders and employees. This same kind of improper conduct was mirrored, at least in part, by large corporations, such as WorldCom. *See* JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS FROM ENRON TO REFORM 13 (2006).

64. *Id.*

65. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, U. ILL. L. REV. 975 (2006).

66. *Id.*

As a result, the agency issued back-to-back emergency stopgap measures aimed at temporarily banning the controversial short-sales by hedge funds.[67]

a. *SEC Hedge Fund Rule (2004)*

In 2004, under the leadership of its then Chairman, William Donaldson, the SEC made its first attempt to regulate the industry by issuing the Registration Under the Advisers Act of Certain Hedge Fund Advisers Rule ("Hedge Fund Rule"), requiring registration of hedge fund managers,[68] so that the Commission could gather "basic information about hedge fund advisers and the hedge fund industry" and "oversee hedge fund advisers."[69] The Commission acknowledged its inability to "deter or detect fraud by unregistered hedge fund advisers."[70] After public notice and hearings, the final Hedge Fund Rule was issued in December 2004 and became effective February 2005.[71] The SEC's decision to impose reporting requirements on hedge funds was "primarily directed toward investor protection in the sense of remedying information asymmetries and rooting out fraud."[72] To justify the need for regu-

67. *See* SEC Release No. 58591, Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments (Sept. 18, 2008); SEC Release No. 58711, Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to respond to Market Developments (Oct. 1, 2008); SEC Release No. 58723, Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to respond to Market Developments (Oct. 2, 2008) [hereinafter SEC Emergency Short Sales Rules].

68. SEC Hedge Fund Rule 2004, *supra* note 12. Two of the five SEC commissioners dissented and "disputed the factual predicates for the new rule and its wisdom." *See* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. June 2006); *see Hedge Fund Rule Moves Forward,* N. Y. TIMES, July 15, 2004 (reporting that two of the five commissioners voted against issuance of the Hedge Fund Rule), http://query.nytimes.com/gst/fullpage.html?res=9507E6DB173AF936A25754C0A9629C8B63.

69. SEC Hedge Fund Rule 2004, *supra* note 12; *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,059.

70. *Id.*

71. SEC Hedge Fund Rule 2004, *supra* note 12.

72. Paredes, *supra* note 65; *see* Donaldson speech 2004, *supra* note 10; *see also id.* at 69 Fed. Reg. 72,061.

lation, the SEC stressed recent fraud in the industry,[73] as well as the development of "funds of hedge funds," which made hedge funds more widely available to a broader class of investors.[74]

The Hedge Fund Rule required hedge fund advisers—persons and firms who advise others about securities—to register, subject to the exemption that excluded private advisers that (i) had fewer than fifteen "clients" during the preceding twelve months, (ii) did not hold itself out to the public as an investment adviser, and (iii) did not advise registered investment companies.[75] The private adviser exemption was not different from the Advisers Act. However, conflict arose about whether there was a misinterpretation of the rule that established how "clients" should be counted.[76] The investment fund managers had been counting each hedge fund as one client and the threshold of fourteen clients was not reached unless a firm had fifteen or more funds. The SEC's position, as expressed in the Hedge Fund Rule, was that, for the purpose of the Advisers Act, "investment advisers must count each owner of a private fund towards the threshold of fourteen clients, that is each shareholder, limited partner, member, or beneficiary of the private fund." This requirement would have the effect of removing the vast majority of hedge funds from their previously exempt status.[77]

In the interest of gaining some control over the hedge fund advisers who had been acting in the absence of regulation, the Hedge Fund Rule triggered certain regulations that applied only to registered advisers. Most importantly, in a move aimed at transparency, the SEC required registered advisers to open their records to the Commission upon re-

73. *Id.* Chairman Donaldson noted at a meeting in which the SEC commissioners were considering the adoption of the Hedge Fund Rule that there was an "increased incidence of fraud perpetrated by those [hedge] funds."

74. SEC Hedge Fund Rule 2004, *supra* note 12, n.34.

75. *Id.* at 69 Fed. Reg. 72,070. It should be noted the SEC issued an interpretation of Rule 203(b)(3)-2 in the SEC Hedge Fund Rule 2004 that a hedge fund adviser did not have to count itself as a "client" regardless of the form its ownership in the pool takes and excluded other "insiders."

76. Goldstein, 451 F.3d 873; *see* Rule 203(b)(3)-1, *supra* note 10.

77. SEC Hedge Fund Rule 2004 , *supra* note 12, at 69 Fed. Reg. 72,070.

quest.[78] Furthermore, in contrast to the exemptions granted in the Advisers Act, the new rule included a prohibition against charging performance fees unless the investment advisers were dealing with "qualified" clients,[79] reflecting the ongoing controversy surrounding performance fees.

Opponents to regulation argued that requiring funds to register would make starting a new hedge fund "onerously expensive because of the costs associated with registration—including legal fees, staffing costs and other related expenses."[80] Further, issues were raised about the effectiveness of SEC registration in protecting investors against fraudulent managers, since there were abuses that resulted in legal action against hedge funds already registered with the SEC.[81]

i. *Invalidation of Hedge Fund Rule: Goldstein v. SEC (2006)*

Philip Goldstein, a shareholder activist who managed a hedge fund with assets of about $200 million, was highly critical of the SEC in its issuance of the Hedge Fund Rule.[82] In comments made to CNN/Money, Goldstein argued that "a ruling forcing hedge funds to register with regulators should have come from Congress—not the regulators themselves."[83] He followed with a lawsuit petitioning the court to review the SEC's regulation of hedge funds under the Investment Advisers Act of 1940, claiming that the SEC exceeded its regulatory authority in issuing the rule, and seeking to have the rule vacated.[84] The case was argued before the U.S. Court of Appeals

78. *Id.* at 69 Fed. Reg. 72,072, 72,073.

79. *Id.* at Fed Reg. 72070, 72071, and 72076. An example of a "qualified client" includes an investor who is a natural person or company (1) who has assets worth at least $750,000 under management by the hedge fund adviser or (2) that has a net worth of more than $1.5 million. *See* 15 U.S.C. § 80a-2(a)(51)(A) (defining the financial threshold to be a "qualified purchaser"); *see* Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains or Capital Appreciation of a Client's Account, Securities and Exchange Commission, 18 C.F.R. § 275 (Rule 205-3-(a)) [hereinafter SEC Rule 205-3(a)].

80. *See* Amanda Cantrell, *Government Catches Up with Hedge Funds,* CNN/MONEY, at http://money.cnn.com/2006/02/01/markets/hedge_registration/ (Feb. 1, 2006).

81. *Id.*

82. *Id.*

83. *Id.*

84. Goldstein, 451 F.3d 873.

in December 2005 and decided by the court in Goldstein's favor on June 23, 2006.[85]

Goldstein charged the SEC with misinterpreting the intent of the Investment Advisers Act by changing the definition of "client" for the purpose of calculating the fifteen-client exemption to fit its need for stricter regulation.[86] In this regard, the structure of hedge funds as limited partnerships became an issue in the case. There are competing legal theories on how partnerships are treated: Sometimes, the law treats a partnership as an aggregate of individuals (the "aggregate theory"). Other times, the law treats a partnership as an entity ("entity theory") so that a hedge fund partnership entity would be treated as a single client for the purpose of the exemption.[87] In arguing that the definition of "clients" depends on the context in which it is used, the SEC relied on Section 203(b)(3) of the Investment Advisers Act, meaning that the aggregate theory (described above) applied so "clients" meant investors in the hedge funds rather than the hedge fund themselves.[88] However, the court rejected the SEC's contention that the term "client" should have one meaning when counting the number of clients and another meaning when determining the obligations owed by the adviser to its clients.[89] Further, the court stated that the Commission had not "adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter."[90]

In response to the questions raised by the plaintiff in terms of the scope of the SEC's authority, the court relied on precedent: "An agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency's authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute . . . "[91] The court vacated the

85. *Id.*
86. *Id.* at 8
87. *See id.* at 19.
88. *Id.* at 9.
89. *Id.* at 8.
90. *Id.* at 17.
91. *Id.* at 13 (citing Aid Ass'n for Lutherans v. United States Postal Serv. 321 F.3d 1166, 1174, 1177-78 (D.C. Cir. Mar. 2003) and Am. Library Ass'n v. FCC, 406 F.3d 689, 699 (D.C. Cir. May 2005).

Hedge Fund Rule as an unlawful exercise of the SEC's authority and thereby restored the traditional definition of "client."[92] The court explained that "[a]t best it is counterintuitive to characterize the investors in a hedge fund as the "client" of the adviser."[93] The decision forced the SEC to return to its pre-Hedge Fund Rule position of regulating only the activities of fund managers that fell outside the Advisers Act's exemption, i.e., where there are fifteen or more separate investment entities. As a result, nearly all hedge funds that registered with the SEC and remain registered under the provisions of the Hedge Fund Rule do so voluntarily.

The SEC chose not to appeal the federal court's decision. Significantly, Chairman Donaldson left the Commission in the Summer of 2005, and the newly appointed Chairman, Christoper Cox, chose not to pursue an appeal after he began his term of office in August 2005.[94] Commenting on the SEC's stance post-*Goldstein* decision, Chairman Cox noted:

> Let me make very clear that notwithstanding the *Goldstein* decision, hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws. We will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated.[95]

After Chairman Donaldson's departure in 2005, there were no further attempts by the SEC to regulate the industry until the recent Short Sales Rules in 2008.[96] Further regulations will surely result from the economic crisis that began in the Fall of 2008.

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92. *Id.* at 19

93. *Id.* at 14.

94. Press Release, Securities and Exchange Commission, Christopher Cox Sworn in as SEC Chairman, 2005-2007 (Aug. 3, 2005), http://www.sec.gov/news/press/2005-107.htm.

95. Joshua Pantesco, *SEC Chairman Says Congress May Need to Reinforce Hedge Fund Regulation* (July 26, 2006), http://jurist.law.pitt.edu/paperchase/2006_07_26_indexarch.php.

96. SEC Emergency Short Sales Rules, *supra* note 67.

b. *Curbing Short-Sales (2008)*

A short-sale is one of hedge funds' favorite strategies to increase profit, but it is argued that such transactions increase the havoc in a volatile market. Consequently, at the height of the credit crisis in Fall 2008, the SEC imposed new emergency rules to temporarily reduce short-selling abuses until a Congressional bailout bill could be passed.[97]

The emergency bans on short-sales were lifted after approximately one month but were followed by the issuance of the Interim Final Temporary Rule.[98] The new rule ended the emergency bans prohibiting short-sales, instead requiring certain types of disclosures to the SEC. Even though there is no reference in the rules to hedge funds, the industry is an obvious target because hedge funds fit the description of having a "manager" who exercises "investment discretion" over securities having an aggregate fair market value of at least $100 million.[99]

Effective October 18, 2008, the Interim Final Temporary Rule was in force until August 1, 2009. The rule required certain disclosures on a weekly basis to the SEC regarding short-sales by investment managers who oversee more than $100 million.[100] Although it was mandatory for hedge funds to report weekly to the SEC any new short positions, those positions were not disclosed to the public.[101] Almost immediately, the new rules drew strong criticism from the hedge fund industry and there were threats of a lawsuit "just as the industry did two years ago [in the Goldstein case] to reverse a rule that put them on a tighter leash."[102]

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97. *Id.*; *see also* Tom Lauricella, Kara Scannell & Tennille Tracy, *SEC Extends 'Short' Ban as Bailout Advances,* WALL ST. J., Oct. 2, 2008, at C1.

98. The emergency rules were followed by the Interim Final Temporary Rule, which extended until August 1, 2009, during a period for public comment. *See* Disclosure of Short Sales and Short Positions by Institutional Investment Managers Release No. 58795 (Oct. 15, 2008), http://www.sec.gov/rules/final/ 2008/34-58785.pdf [hereinafter SEC Interim Final Temporary Short Sales Rule].

99. *Id.*

100. *Id.*

101. *Id.*

102. Reference to the lawsuit "two years ago" is to the case, *Goldstein v. SEC,* which was decided by the Federal Court of Appeals in 2006 in which the Hedge Fund Rule was overturned. *See Hedge funds fear new rules to rattle*

During testimony before the Congressional Committee on Oversight and Government Reform (titled "Hedge Funds and the Financial Market)" in November 2008, many witnesses from the academy and the hedge fund industry emphasized the positive results associated with short-selling activities.[103] For example, one argument in favor of short-selling is that "academic studies almost universally find that short-selling makes markets more efficient by bringing the price of stock closer to its true, fundamental value."[104] Essentially, the assertion is that when hedge funds short-sell the stocks of unhealthy companies, they help to divert capital from companies that are fundamentally unstable.

The SEC's one-year open comment period for its Interim Final Temporary Rule on short-selling provided adequate time for the regulators and Congress to examine the impact of any future rules. Moreover, by the end of the year, adequate opportunity was provided to compare the extreme measure of an emergency ban on short-sales, implemented for a short time during Fall 2008, to the special types of disclosure rules imposed during the new rule's test period ending August 1, 2009. This gave the SEC sufficient time to examine the results of experimentation with banning short-sales versus requiring levels of disclosure, while also soliciting thoughtful public comment, in making a decision about whether any regulation of short-selling is necessary.

III.
THE BUILDUP TO THE 2008 FINANCIAL CRISIS: AN OVERVIEW OF THE DEREGULATED ENVIRONMENT OF FINANCIAL INSTITUTIONS SINCE 1980

Deregulation alone did not cause the financial system to crumble in 2008, nor did a series of active or passive regulatory failures. The recent history of large financial institutions' collapses—from the fight to salvage the savings and loan industry in the passage of the DIDMC in 1980 and Garn-St. Germain in 1982—evinces a series of mistakes, missteps, carelessness, and

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their business, REUTERS, Sept. 19, 2008, http://www.reuters.com/article/americasPrivateEquityNews/idUSN1948265220080919.

103. *Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3.

104. *Id.* (testimony of Houman Hadab, Senior Research Fellow, George Mason University).

greed by both private industry and government. For instance, Alan Greenspan, who became Chairman of the Federal Reserve Board in 1987 and who had a strong commitment to the free market system, never exercised the authority granted him by the Home Ownership and Equity Protection Act of 1994 to ban financially irresponsible mortgages, such as subprime loans.[105]

The momentum toward deregulating financial institutions was reflected in a spate of legislation at the close of the last century. In 1999, Congress passed the Financial Modernization Act ("Gramm-Leach-Bliley"), which included repeal of Glass-Steagall and amendment of BHCA. Gramm-Leach-Bliley was immediately followed by the Commodities Act of 2000. Signed into law by President Bill Clinton during his last weeks in office, it excluded investment vehicles, such as credit default swaps, from regulation. Deregulation created an environment of lax governmental oversight and control, which permitted recklessness in the financial sector during the highly-charged business atmosphere of the early 2000s.

A. *History Repeats Itself: Lessons Not Learned from Deregulating the Savings and Loan Industry in the Late 1980s*

In 1990, the S&L (or "thrift") crisis was described as the "biggest financial debacle since the Great Depression," with a price tag estimated at $500 billion.[106] However, the present financial crisis, beginning with the failure of the Bear Stearns' hedge funds, has had greater ramifications, both within the U.S. and globally. There are many similarities between the savings and loan industry's implosion in the late 1980s and the present subprime crisis, including the effect of deregulation, as well as the collapse of so many venerable and established financial entities. Arising from the commonality of an environment of deregulation, the thrift industry's failed investments in junk bonds and real estate in the 1980s parallel the catastrophic consequences suffered by financial institutions in 2007 with respect to subprime mortgages.

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105. Home Ownership and Equity Protection Act, 15 U.S.C. § 1639(l)(1), (2) [hereinafter Home Ownership and Equity Protection Act].

106. James Risen, *S & L Cleanup Estimate Rises to $500 Billion,* L.A. TIMES, Dec. 7, 1990, at D2; *see* Maria Boss & Gary Watson, *The FDIC's Special Defenses: Before and after FIRREA,* 29 AM. BUS. L. J. 309 (1991).

1. *History of Deregulation Preceding the Collapse of the S&L Industry (1980 – 1989)*

The S&L crisis has been characterized as "a signal demonstration of the importance of regulatory oversight of lending institutions in modern financial markets."[107] An environment of deregulation existed due to extensive legislation, which struck down and amended old restrictive rules and eliminated regulatory barriers for S&Ls and, in general, reduced the level of regulatory supervision at the federal level. The impetus for the decade of deregulation that preceded the 1989 S&L crisis was skyrocketing interest rates, which reached an all time high of 20 percent in 1980,[108] creating massive problems for S&Ls. The interest rate cap of 5.25 percent at thrifts led savers to look elsewhere for higher returns.[109] The S&Ls responded by pressuring the government for (1) higher deposit insurance to stimulate investment and (2) deregulation so that the thrifts could expand their investment opportunities. The government responded by creating a climate of deregulation through a legislative overhaul that struck or amended old restrictions, eliminated regulatory barriers for S&Ls, and generally reduced the level of supervision by the federal government. However, in their effort to save the thrift industry, state and federal legislators unwittingly created a structure that permitted fraudulent activity to occur without regulatory safeguards to protect investors and the American public.

a. *Depository Institutions Deregulation and the Monetary Control Act (1980)*

Congress's legislative overhaul occurred in a piecemeal fashion, beginning in 1980 with passage of the Depository Institutions Deregulation and Monetary Control Act ("DIDMCA"),[110] followed two years later by the Depository Institutions Act (also known as "Garn-St. Germain").[111] DIDMCA

107. MORRIS, *supra* note 41, at 29.

108. Norman N. Bowsher, *Rise and Fall of Interest Rates*, FED. RESERVE BANK OF ST. LOUIS, Sept. 1980, at 16, http://research.stlouisfed.org/publications/review/80/08/Rise_Aug_Sep1980.pdf.

109. *Lift for Savers*, TIME, June 4, 1979, http://www.time.com/time/magazine/article/0,9171,946264,00.html.

110. DIDMCA, *supra* note 23.

111. Garn-St. Germain, *supra* note 24.

aimed to solve the problems caused by the interest rate controls established under Federal Reserve Board's Regulation Q,[112] requiring the phase out of these controls by 1986.[113]

In addition, S&Ls were given greater flexibility to generate revenue. Just as the level of federal deposit insurance coverage was recently increased by the Emergency Economic Stabilization Act of 2008,[114] DIDMCA raised the limit from $40,000 (originally $5000) to $100,000 to make depositors more secure.[115] The goal was to bolster the S&L industry through a federal guarantee protecting individuals' deposits in an effort to encourage investment. While designed to protect middle and working class savers, institutional investors and high net worth individuals quickly realized that the government would also insure their deposits, which resulted in the "brokered" money market.[116]

b. *Depository Institutions Act / Garn-St. Germain (1982)*

Contributing to the freedom enjoyed by S&Ls during early 1980s was the passage of the Depository Institutions Act, also known as Garn-St. Germain, in 1982, which significantly transformed the composition of the S&L industry from small, local home lenders to sophisticated, multi-billion dollar financial companies.

The statute and the multiple regulations promulgated thereunder affected many areas of operation. After the passage of Garn-St. Germain, the brokered money market injected companies' assets with relatively astronomical sums.

112. Reg. Q, 12 C.F.R. 217.

113. DIDMCA, *supra* note 23. Although, once again, S&Ls could entice customers to invest money at a competitive interest rate, problems persisted because all S&Ls were restricted to the home mortgage business and had the same low margin of profit.

114. Press Release, House Committee on Financial Services, Emergency Economic Stabilization Act of 2008, H.R. 1424, (Sept. 28, 2008.).

115. Depository Institutions Act, Pub. L. No. 96-221, § 308, 94 Stat. 147 (1980).

116. A thrift engaging in "brokered money" advertised high interest rates, which attracted brokers to place amounts of money in certificates of deposit ("CDs") and savings accounts. However, this strategy was an unreliable means of quickly acquiring very large infusions of cash, since the brokers were constantly searching for institutions paying higher interest rates into which to electronically transfer the money. *See* STEPHEN PIZZO ET AL., INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS 22 (1989).

One of the critical components of the Act permitted S&Ls to invest twice as much of their assets (from 20 to 40 percent) in nonresidential real estate lending.[117] This increased nonresidential lending authority was coupled with a provision of DIDMCA allowing thrifts to engage in acquisition, development, and construction ("ADC") loans, as well as a provision of Garn-St. Germain to put up 100 percent of the project's financing in exchange for a percentage of the profits.[118] Prior to enactment of this legislation, S&Ls required developers to put their own equity at risk, but the new policy meant that developers had no risk, and consequently little motivation, to ensure successful completion of their projects.

c. *Additional Regulatory Changes*

Between 1980 and 1983 a number of other regulatory changes were made, each of which further eroded important protections. For example, a 1980 regulation allowed institutions to make real estate loans anywhere, rather than limiting lending to local markets, as had previously been required.[119] Another significant change eliminated the requirement that a thrift have 400 stockholders with no one owning more than 25 percent of the stock; instead, under the new standard, a single shareholder could own a thrift, thus attracting an entirely different kind of entrepreneur.[120] The Federal Home Loan Bank Board ("FHLBB"), a regulator that is no longer in existence, authorized a questionable accounting scheme that permitted S&Ls to count the difference between the market value of assets acquired and the value of liabilities assumed as goodwill.[121]

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117. *Id.* at 12.

118. HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 176, http://www.fdic.gov/bank/historical/history/contents.html (last viewed June 5, 2009) (containing in Chapter 4 a study prepared by the FDIC's Division of Research and Statistics).

119. Bert Ely, *Savings and Loan Crisis,* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html (last visited June 4, 2009).

120. PIZZO, *supra* note 116, at 173.

121. Ely, *supra* note 119. The FHLBB's scheme offers an example of what can happen when accounting rules are altered to provide temporary relief, similar to the pressure put on the SEC in 2008 to use its authority to suspend "mark-to-market" accounting which "pegs the value of assets to their current market price, rather than the price paid for them." *See* Elizabeth Williamson

d. *The Collapse of the Savings and Loan Industry (1989)*

Many thrifts invested in either real estate or junk bonds[122] or a combination of the two investment strategies that turned out to be mistakes. Under Garn-St. Germain, federally chartered thrifts could invest up to 11 percent of their assets in high yield, high risk junk bonds, and the regulations that implemented the Act allowed thrifts to invest up to 10 percent of their assets in commercial loans, including junk bonds.[123] This was the period when Michael Milken, of Wall Street's now defunct investment bank, Drexel Burnham Lambert, aggressively promoted junk bonds to the S&Ls and others as "a new way to finance business, promising that phenomenal interest rates would offset greater risks."[124] When the economy precipitously spiraled downward in the late 1980s, so did junk bonds, real estate, and the S&Ls.

& Kara Scannell, *Momentum Gathers to Ease Mark-to-Market Accounting Rule*, WALL ST. J., Oct. 2, 2008, at A6. Financial Accounting Standards Board ("FASB") Rule 107 required that companies disclose the fair value of what they own, with further clarification in FASB's Statement of Fair Accounting Standards in 2008 in FASB Rule 157. Financial Accounting Standards Board, Rule 107 (1991). By specifically restating the power of the SEC to suspend the application of mark-to-market accounting and requiring that the SEC conduct a study of it in the provisions of the Emergency Economic Stabilization Bill of 2008 (also known as the Bailout Bill), §§ 132, 133, Congress impliedly sent a message to the agency to re-evaluate its position on it, i.e., take a more lenient approach or do away with the rule completely. Although the practice was adopted in response to abuses discovered during the S&L collapse in the 1980s and played a large role in the Enron abuses, free market advocates have not stopped pressing for an end to the rule. Banks have complained that strict application of the rule has forced them to write down billions of dollars worth of mortgage-related securities. *See Breakdown of the Final Bailout Bill*, WASHINGTONPOST.COM, Sept. 28, 2008, *at* http://www.washingtonpost.com/wp-dyn/content/article/2008/09/28/AR2008092800900.htm; *see also* Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., OCT. 4,-5, 2008, at A1.

122. Richard W. Stevenson, *California's Daring Thrift Unit*, N.Y. TIMES, May 25, 1987, http://query.nytimes.com/gst/fullpage.html?res=9B0DEFD6113CF936A15756C0A961948260.

123. DAVITA SILFEN GLASBERG & DAN SKIDMORE, CORPORATE WELFARE POLICY AND THE WELFARE STATE: BANK DEREGULATION AND THE SAVINGS AND THE SAVINGS AND LOAN BAILOUT 45 (1997).

124. Paul M. Barrett, *Wall St. Staggers*, BUS. WK., Sept. 29, 2008, at 30, 31.

In 1989, Congress passed the Financial Institutions and Recovery and Enforcement Act ("FIRREA")[125] and created the Office of Thrift Supervision (thus eliminating the Federal Home Loan Bank Board) to govern an industry reeling out of control at ever-increasing peril and expense to American taxpayers.[126] Congress had already authorized the sale of $20.8 billion to cover the losses of the Federal Savings and Loan Insurance Corporation ("FSLIC") in 1987 but returned in 1989 to authorize approximately $125 billion to buy the bad assets.

B. *Review of Regulatory Changes Leading to the Recent Financial Crisis that Began in 2007*

1. *Effect of the Repeal of the 1933 Glass-Steagall Act and Amendments to the 1956 Bank Holding Company Act included in the Provisions of the Gramm-Leach-Bliley Act (1999)*

Just as in the S&L crisis, there was a pattern of deregulation preceding the tumultuous economic period starting in 2007. In the wake of a federal bailout plan for America's top investment banks in Fall 2008, historical and political pundits search for reasons why the most recent financial crisis occurred. In the same way that the S&L crisis has its roots in the passage of Garn-St. Germain, the present financial crisis begins with the repeal of the Glass-Steagall Act and amendments to the Bank Holding Company Act ("BHCA") in 1999.[127] Repeal of Glass-Steagall comprises one section of the Financial Modernization Act of 1999, known as the Gramm-Leach-Bliley Act ("Gramm-Leach-Bliley" or GLB Act").[128] Also included in

125. Paredes, *supra* note 65.

126. Jenny Anderson, *As Lenders, Hedge Funds Draw New Scrutiny*, Int'l Herald Trib., Oct. 17, 2006, at 15.

127. BHCA, *supra* note 26. The Gramm-Leach-Bliley Act amended section 4 of the BHCA of 1956.

128. The repeal of the Glass-Steagall Act is only a minor part of Gramm-Leach-Bliley and is covered at the beginning of that statute in §101 in which §§ 78 and 377 of the Banking Act of 1933 were specifically repealed. *See* Gramm-Leach-Bliley, Pub.L.No.106-102, 113 Stat. 1338 (Nov. 12, 1999) (codified as amended in scattered sections of 12 and 15 U.S.C.). Primarily, the GLB Act removed the barriers that separated commercial banking from investment banking and some other kinds of banking activities by permitting the "common ownership of the nation's largest banks, insurance companies, and securities firms." Gramm-Leach-Bliley, 12 U.S.C. § 1843 (Supp. 5 1999).

Gramm-Leach-Bliley was an amendment to BHCA, which was originally passed to prevent banks from controlling a non-bank company and from conducting insurance underwriting or insurance agency activities.[129]

Glass-Steagall was a legacy of Depression Era legislation, where it was included in a small part of the omnibus 1933 Banking Act.[130] Its repeal was significant because of the Act's historical importance as an emergency legislative response to the failure of nearly 5,000 banks during the Great Depression[131] after commercial banks were accused of taking too much risk with depositors' money. Glass-Steagall was passed by Congress to separate investment banking from commercial banking activities,[132] thus insulating depositors from the risks of a stock market collapse.[133] The statute prohibited banks from owning full-service brokerage firms, kept commercial banks from underwriting corporate securities, and in turn, kept captive pools of bank deposits out of the reach of investment banks.[134] The act also established the Federal Deposit Insurance Corporation ("FDIC") and strengthened the Federal Reserve's control over credit.[135]

Beginning in the mid-1980s, there was an increased movement toward repealing Glass-Steagall. On several occasions, Congress unsuccessfully attempted to lift major restrictions,[136] and in 1987, the Federal Reserve Board voted to ease regulations under Glass-Steagall against the opposition of its Chairman, Paul Volcker.

The GLB Act also has sections covering the protection of the privacy of consumer information held by financial institutions. *See* 15 U.S.C. §§ 6801-6809 and 6821-6837 (1999).

129. BHCA, *supra* note 26.

130. Glass-Steagall, *supra* note 25.

131. *Glass-Steagall Act 1933,* N.Y. TIMES, Nov. 12, 2008, http://topics.nytimes.com/top/reference/timestopics/subjects/g/glass_steagall_act_1933/index.html.

132. Glass-Steagall, *supra* note 25.

133. *Id.*

134. *Id.*

135. *Id.*

136. *See* Leslie Wayne, *Shaping a Colossus: The Politics; Deal Jump-Starts a Stalled Banking Bill,* N.Y. TIMES, Apr. 8, 1998, http://query.nytimes.com/gst/fullpage.html?res=9B03E1D71F3AF93BA35757C0A96E958260&sec=&spon=&pagewanted=all.

The final step toward repealing Glass-Steagall emerged from impediments to the Citicorp–Travelers Group merger in the late 1990s.[137] Shortly before the deal was announced, Congress had shelved its latest effort to repeal Glass–Steagall.[138] However, in 1999, Congress passed and President Clinton signed into law the Financial Services Modernization Act, also known as the Gramm-Leach-Bliley Act, which included a provision that finally repealed Glass-Steagall[139] after eleven attempts in two decades,[140] thereby removing the last barriers to the separation of commercial and investment banking and opening the floodgates of "structural conflicts of interest."[141]

In the deregulated environment that followed Glass-Stegall's repeal, the new inter-relationship between commercial and investment banking allowed commercial banks to enter the investment banking business. This shift fostered the environment that eventually led to the subprime crisis—commercial banks sold their mortgages to Wall Street and, in turn, invested in the mortgage-backed securities issued by those very same investment banking firms.[142] Hedge funds invested disastrously in the derivatives and other products that were available from investment banks based on those mortgage backed assets.

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137. In 1998, Travelers Group (owner of the former investment house Salomon Smith Barney) and Citicorp announced merger plans, to create the world's largest financial services concern. Acting as impediments to the transaction were Glass-Steagall and BHCA regulations established to prevent this type of combination of insurance underwriting, securities underwriting, and commercial banking. In their proposal, Travelers and Citicorp structured the merger so that it conformed to existing interpretations of Glass-Steagall and BHCA. However, Citigroup would have two years to divest itself of Travelers' insurance business unless Congress changed relevant laws and relaxed relevant restrictions. The overall plan was that Congress would finally change the law before the company had to divest. Meanwhile, the merger was approved by the government. In 1999, Glass-Steagall was repealed. *Id.*

138. *Id.*

139. Gramm-Leach-Bliley, *supra* note 27.

140. Wayne, *supra* note 136.

141. Repeal of Glass-Steagall has caused the Subprime Crisis, Before the H. Comm. on Financial Services, 110th Cong., (Oct. 2, 2007) (statement of Robert Kuttner, economics and financial journalist), http://www.electionnews2008.com/glass-steagall-repeal-caused-subprime-disaster.htm.

142. Maria Bartiromo, *Bill Clinton on the Banking Crisis, McCain and Hillary,* BUS. WK., Oct. 6, 2008, at 19.

2. *Effect of the Passage of the Commodities Futures Modernization Act (2000)*

After passage of the Gramm-Leach-Bliley Act, Senator Phil Gramm (R-Texas) returned in 2000 to spearhead additional legislation in the form of a 262-page last minute amendment of an omnibus appropriations bill,[143] called the Commodity Futures Act of 2000 ("Commodity Act 2000").[144] To date there had been neither federal legislation nor regulation covering derivatives, and in November 1999, the President's Working Group on Financial Markets—comprised of Lawrence H. Summers, from the Department of the Treasury, Alan Greenspan, Chairman of the Federal Reserve Board, Arthur Levitt, Chairman of the SEC, and William J. Rainer, Chairman of the Commodity Futures Trading Commission—made a strong recommendation to provide legal certainty for OTC derivatives by excluding them from regulation.[145] Congress complied with the recommendations, and the Commodity Act 2000 was enacted to make clear that over the counter ("OTC") derivatives, such as credit swaps, were excluded from regulation so long as the parties were large institutions or wealthy individuals.[146] Of course, this legislation further extended the era of financial market deregulation and paved the way for unimpeded growth

143. *A Bill That Was No Midnight Surprise,* WASH. POST, Oct. 10, 2008, http://www.washingtonpost.com/wp-dyn/content/article/ 2008/10/09/AR 2008100902695.html?nav=hcmodule.

144. Commodity Futures Act 2000, *supra* note 28. Also, the Commodity Futures Act 2000 exempted online energy and metals trading from regulatory oversight, which, according to Senator Dianne Feinstein (D-Calif.), created an enormous loophole for energy companies (like Enron) to exploit. *See* Press Release, U.S. Congress, Statement of Senator Dianne Feinstein on Legislation (July 10, 2002). This legislation provided companies such as Enron, the Texas corporation well-known for its implosion in 2001, the freedom needed to engage in highly risky securities ventures and sheltered an Enron Internet trading platform from regulation. *See* MARKHAM, *supra* note 63.

145. *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (Nov. 1999), http://www.treas.gov/press/releases/reports/otcact.pdf [hereinafter Commodity Exchange Act PWG Report 1999].

146. *See U.S. Urges Against Derivatives Regulation,* L.A. TIMES, Nov. 10, 1999, at C4; *see also Greenspan Urges Congress to Fuel Growth of Derivatives,* N.Y. TIMES, Feb. 11, 2000, http://query.nytimes.com/gst/fullpage.html?res= 990CEED7 103EF932A25751C0A9669C8B63.

of the exotic securities that became the bedrock of the subprime market.[147]

IV.
THE UNDER-REGULATED HEDGE FUNDS AND THEIR ROLE IN THE SUBPRIME LOAN MELTDOWN

According to the Mortgage Bankers Association, during the third quarter of 2008, when the effects of the recession were beginning to have an impact, about 6.99 percent of mortgage loans in the U.S, were delinquent and another 2.97 percent were in the foreclosure process—the highest level since the survey was established in 1979.[148] In the first quarter of 2009, Mortgage Bankers Association reported that foreclosures were at a record high of nearly 1.4 percent of all first-lien mortgages.[149] How did this happen and what role did hedge funds play in the home loan mortgage crisis that triggered the financial meltdown?[150] To understand the role of hedge funds in the housing market disaster, it is necessary to first explain how the subprime mortgage implosion occurred.

A. *The Hazards of Subprime Loans and Securitization of Mortgages*

In mid-2007, the financial markets took center stage when they reacted with unexpected intensity to "home foreclosure data, several hedge fund problems, and ominous projections

147. However, at the time of passage, the Commodity Act 2000 was heralded by Senator Richard Lugar (R-Ind.), the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry, and one of the supporters of the legislation, along with Senator Phil Gramm, as a way to "ensure that the United States remains a global leader in the derivatives marketplace and that these markets are appropriately and effectively regulated." *See* Press Release, U.S. Congress Senate Banking Committee, Lugar, Gramm Praise Completion of Commodities Futures Modernization Act, (Dec. 14, 2000), http://banking.senate.gov/prel00/1214comm.htm; *see also* Matthew Philips, *The Monster That Ate Wall Street,* NEWSWEEK, Oct. 6, 2008, at 46.

148. Renae Merle, *Mortgage Troubles Rise to Record Level,* WASH. POST, Dec. 6, 2008, at D1. http://www.washingtonpost.com/wp-dyn/content/article/2008/12/05/AR2008120501323.html.

149. Carrick Mollenkamp, *Subprime Resurfaces as Housing-Market Woe,* WALL ST. J., July 9, 2009, at C1, C3.

150. *Housing: Frank talk from Barney Frank,* MONEY MAGAZINE, Sept. 2008, at 97.

of further foreclosures and price declines to come."[151] Accusations of blame were quick to follow. The House Committee on Oversight and Government Reform held hearings on "The Financial Crisis and the Role of Federal Regulators."[152] In his opening statement at the hearings, Representative Henry Waxman (D-Calif.), Chairman of the Oversight Committee, said "[t]he list of regulatory mistakes and misjudgments is long, and the cost to taxpayers and our economy is staggering,"[153] admonishing the SEC, Offices of Thrift Supervision, the Comptroller of the Currency, the Justice Department,[154] and Alan Greenspan, former chairman of the U.S. Federal Reserve Board, who was blamed for creating the environment for the subprime crisis.[155] Greenspan defended himself against the accusations that he helped to create the environment for the subprime mortgage crisis by arguing that "the securitization of home loans for people with poor credit not the loans themselves were to blame . . . "[156] Also criticized for his role in the financial debacle was Treasury Secretary Henry Paulson, who declared that the "responsibility for the current credit crisis rests firmly with mortgage lenders,"[157] and ultimately proposed a massive overhaul of the U.S. regulatory structure.[158]

Professor John C. Coffee, Jr., an expert on securities regulation at Columbia Law School, noted that "[n]ew empirical studies appear to indicate that the best causal explanation for the housing bubble is that securitization undercuts the incen-

151. KEVIN PHILLIPS, BAD MONEY 3 (2008).

152. *Hearing on The Financial Crisis and the Role of Federal Regulators, Before the H. Comm. on Oversight and Government Reform,* 110th Cong. (2008), [hereinafter *Hearings on Financial Crisis*], http://oversight.house.gov/documents/20081023100359.pdf.

153. *Id.* (Statement of Rep. Henry A. Waxman Chairman, Committee on Oversight and Government Reform).

154. *Id.*

155. Tom Bawden, *Fed Chief Blamed for Stoking US Sub-Prime Loans Crisis,* THE TIMES (LONDON), Dec. 19, 2007.

156. Jane Wardell, *Greenspan Defends Subprime, Sees Some Early Signs of Easing in Credit Crisis,* AP FINANCIAL WIRE, Oct. 1, 2007; *see also Investors, Not Fed, to Blame for Crisis—Greenspan, Apr. 7, 2008,* http://www.reuters.com/article/marketsNews/idUSL074242252008040.

157. *Paulson Points to Sub-Prime Blame,* Sept. 13, 2007, http://news.bbc.co.uk/1/hi/business/6992773.stm.

158. David Cho & Jeffrey H. Bimbaum, *Opposition to Treasury's Blueprint Gains Steam,* www.washintonpost.com/wp-dyn/content/story/2008/03/31/STT2008033100743.html.

tives of the originating banks to screen or monitor their borrowers."[159] In other words, securitizing mortgage debt took the risk off the banks originating the loans, but at the same time, securitization should have served as a warning that there needed to be increased vigilance on the part of the investment banks purchasing these loans. Instead, the investment banks proceeded to repackage and sell the new financial instruments to hedge funds and other clients without concern for the underlying assets.[160] Investment banks that bought the mortgages from the commercial banks "would take good mortgages, bad mortgages, subprime mortgages, put them all together, slice them up, dice them, and ship them off to a hedge fund that buys them . . . and no one knew what was in them."[161]

1. *Sequence of Events Leading to the Subprime Crisis of 2008*

A detailed sequence of events leading to the subprime mortgage meltdown appears below, highlighting important deregulatory actions by Congress and the prominent role of securitization, which permitted hedge funds to flourish but ended with the housing bubble bursting and the ensuing financial disaster:

- Failure of Federal Reserve Board Chairman Alan Greenspan to implement the provisions of the Home Ownership and Equity Protection Act of 1994, which sought to prevent irresponsible mortgage practices, such as subprime loans, at the loan origination level.[162]
- Repeal of the Glass-Stegall Act in the Gramm–Leach–Bliley Act in 1999, which permitted a previously prohibited inter-relationship between commercial banks and investment banks.[163] As a result, commercial banks

159. Coffee, *supra* note 2,

160. *Id.*; *see also Housing and Hedge Funds*, N.Y. TIMES, June 28, 2007, at A22.

161. THE ECONOMY, 110TH CONGRESS DEB. S. 2212 (Statement of Senator Byron Dorgan (D-No. Dak.) (Mar. 31, 2008)), http://www.govtrack.us/congress/record.xpd?id=110-s20080331-13&bill=s110-2212.

162. Home Ownership and Equity Protection Act, *supra* note 105.

163. Gramm-Leach-Bliley, Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999). The Glass-Steagall Act, which was repealed by the GLB Act, prohibited underwriting by banks, as well as affiliations between banks and companies that were principally engaged in securities activities. *See* Glass-Steagall, *supra* note 25.

were able to sell their mortgages to Wall Street investment banks; in turn, the commercial banks invested in mortgage-backed securities issued by the same investment banking firms.[164]

- Passage of the Commodities Futures Act 2000, which clarified the exclusion of OTC derivatives from regulation, allowing the sophisticated credit default swaps to be used without questions being raised regarding their legitimacy.[165]
- In the early 2000s, interest rates on home mortgages reached a 40-year low of 1.25 percent—and, for a short period in 2003, 1.0 percent—as a result of Federal Reserve Chairman Alan Greenspan's response to the collapse of tech stocks in 2000 and to the post-9/11 recession.[166]
- With the real estate boom and the prospect of securitizing mortgages, loan originators invented new loan products "for people that historically had little access to standard forms of credit."[167] The securitization process meant that mortgage lenders no longer held the mortgages, thus eliminating the traditional ongoing relationship between originator and borrower. Consequently, the original lenders no longer had a vested interest in ensuring that borrowers had a reasonable long-term certainty of paying back the loan. In a climate of deregulation, low interest rates, and pro-homeowner policies, subprime mortgages flourished. Pressure to enforce affordable housing goals for low-income and minority homebuyers from Congress, the Department of Housing and Urban Development ("HUD"), and the enforcement of the Community Reinvestment Act[168] on

164. *See* Maria Bartiromo, *Bill Clinton on the Banking Crisis, McCain and Hillary,* BUS. WK., Oct. 6, 2008, at 19.

165. Commodity Futures Act 2000, *supra* note 28.

166. *See* Russell Roberts, *How Government Stoked the Mania,* WALL ST. J., Oct. 3, 2008, at A21; *see also Investors Not Fed, To Blame for Crisis—Greenspan, supra* note 156.

167. ZANDI, *supra* note 18, at 14.

168. Community Reinvestment Act, Pub. L. 95-128, tit. VIII, 91 Stat. 1147, 12 U.S.C. § 2901 *et seq.* In 1995, the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), and the Director of the Office of Thrift Supervision ("OTS") made major changes to their respective regula-

Fannie Mae and Freddie Mac,[169] as well as on loan originators, created added incentives to sell subprime mortgages.[170] No-down-payment, low-down-payment, interest-only loans, and affordable adjustable-rate-mortgages ("ARMs")[171] were offered to prospective homeowners.[172] Hundreds of thousands of formerly ineligible potential homebuyers were offered their chance to "acquire the American dream" with subprime mortgages now offered by mainstream banks and financial institutions.[173]

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tions implementing the Reinvestment Act [*105] of 1977 ("CRA"). *See* Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,177 (May 4, 1995) (codified at 12 C.F.R § 25; 12 C.F.R. § 228; 12 C.F.R. § 345; 12 C.F.R. § 563e).

169. *Understanding Two Loan Giants,* L.A. TIMES, Sept. 8, 2008, at A18. Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are in the business of buying and guaranteeing loans of lending institutions "to generate more cash for those lenders to make more home loans." They serve a middleman position by buying mortgages from lenders and banks and then holding or reselling them to investment banks. They are considered government-sponsored enterprises, having been initially formed by the federal government. Fannie Mae was created in 1938 under President Roosevelt in the wake of the Great Depression to assure that funds would be available in the housing markets without regard to fluctuation in the marketplace. It became a publicly traded company in 1968. Freddie Mac was created as a publicly traded company in 1970 "so that Fannie Mae wouldn't have a monopoly on government-backed mortgages." The problems encountered by Fannie Mae and Freddie Mac, which caused the federal government to take control of the troubled firms in the Fall of 2008, were endemic in the industry. The companies lowered their standards for loans they would buy, and they backed riskier mortgages. *See* Charles Duhigg, *Pressured to Take More Risk, Fannie Hit a Tipping Point,* N.Y. TIMES, OCT. 5, 2008, http://www.nytimes.com/2008/10/05/business/05fannie.html.

170. Roberts, *supra* note 166.

171. Many of the ARMs had an introductory rate for a specified period of years (e.g., three years) that would reset at a much higher rate after that period.

172. Lee Christie, *Mortgage Resets: A Rude Awakening,* CNN MONEY.COM, Oct. 17, 2007.

173. Although loans to borrowers with low credit ratings had been available for years from companies, such as Aames Home Loan and The Money Store, these loans were not categorized as subprime loans (but were known under such names as "hard money loans") and they were not in the mainstream markets. An example of the way the subprime loans found their way into the mainstream is demonstrated in the civil case filed in June 2009 by the SEC against the former chief officers of Countrywide Financial Corp.,

- Standards of lending were relaxed to such an extent that loans could be obtained by prospective property owners who had risky credit histories and low credit ratings. These mortgages were sometimes described as "ninja loans," i.e., the borrowers had *no* *in*come, *j*ob, nor *a*ssets.[174] There was also a relaxation of the rules for underwriters, such as Freddie Mac and Fannie Mae. Examples of the lower standards[175] in obtaining a loan at a financial institution included: (a) Low Doc/Stated Income/EZ Doc loans, which required borrowers to provide only minimal proof of their stated income and their ability to pay; (b) calculating the home buyer's income as a multiple of the low introductory ARM monthly payment; (c) liberal property appraisals to inflate the amount that could be borrowed against the property; (d) higher loan-to-value of property ratios; and (e) zero down payment loans.
- Wall Street investment bankers recognized that, in an era of easy credit, low interest rates, and surging global investor demand, there existed opportunities for extraordinary profit through transforming simple home loans, purchased from the initial lenders, into complex financial instruments by securitizing and trading those loans. In the securitization process, the mortgages were pooled by slicing them into pieces and repackaging

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one the nation's largest independent mortgage lenders. The case is based on the alleged reckless practices of Countrywide executives in extending subprime home loans. A violation of the federal securities laws was alleged through their acts of deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share. *See* Litigation Release, U.S. Securities and Exchange Commission, No. 21068, June 4, 2009. SEC v. Angelo Mozilo, David Sambol, and Eric Sieracki, (C.D. Cal.), Civil Action No. CV 09-03994 (VBF), http://www.sec.gov/litigation/litreleases/2009/lr21068.htm; *see also* Press Release, SEC Charges Former Countrywide Executives With Fraud; Former CEO Angelo Mozilo Additionally, Charged With Insider Trading, http://www.sec.gov/news/press/2009/2009-129.htm.

174. Coffee, *supra* note 2; *see also Housing: Frank talk from Barney Frank,* MONEY MAGAZINE, Sept. 2008 at 97. Greenspan failed to respond to Congressional authority to ban irresponsible mortgages; Home Ownership and Equity Protection Act, *supra* note 105.

175. Katalina M. Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown,* COMMERCE CLEARING HOUSE 6 (1980), http://business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf.

them as debt securities in the form of CDOs. The CDOs were carved into debt tranches based on the ratings of the credit rating agencies with the highest rated bonds going to the investment banks' best clients around the world,[176] including hedge funds, exempted from regulation by the Commodity Act of 2000. Payments for these debt securities were backed by the cash flow from the mortgage pool. The accounting for these mortgage-backed securities was done through entities called special purpose vehicles ("SPVs") in order to keep them off the banks' balance sheet, frequently forming the SPVs offshore to avoid taxes and regulation.

- From 2004 until the Fall of 2007, home sales boomed[177] with prices peaking during Spring 2006.[178] But housing prices dropped dramatically in 2007 as a result of an economic slump from a combination of factors including the rise in oil prices, the high cost of energy, the wars in Iraq and Afghanistan, the technology bust, the low value of the U.S. dollar on the foreign exchange market, and subsequent inflation.[179]
- With the economic crisis, interest rates increased,[180] and the effect of rising interest rates on mortgages was immediately reflected in the rapid escalation of monthly payments on ARM home loans, since ARM payments are entirely dependent on interest rate fluctuations.[181]
- The drop in housing prices meant that many properties were worth less than the mortgage used to purchase the homes, creating "negative equity" (colloquially known as "being underwater"). Ordinarily, these homeowners

176. MUOLO & PADILLA, *supra* note 18; ZANDI, *supra* note 18.

177. ZANDI, *supra* note 18, at 43.

178. *Id.* The Tax Relief Act of 1997 increased the demand for higher valued property by increasing the capital gains exclusion to $500,000 from $125,000. Pub. L. No. 105-34, 111 Stat. 788 (1997). *See* Roberts, *supra* note 166.

179. Noelle Knox, *Home Sales Plummeted 13% in 2007,* USA TODAY, Jan. 24, 2008, http://www.usatoday.com/money/economy/housing/2008-01-24-existing-home-sales_N.htm.

180. Noelle Knox, *Some Homeowners Struggle to Keep Up with Adjustable Rates,* U.S.A. TODAY, Apr. 3, 2006, http://www.usatoday.com/money/perfi/housing/2006-04-03-arms-cover-usat_x.htm.

181. Christie, *supra* note 172.

would have sold the property or refinanced to obtain an affordable fixed rate, but the developing subprime crisis made refinancing and sale impossible and foreclosure almost certain.[182]

- The increasing rate of foreclosures caused home prices to fall,[183] devastating the cushion of capital of those institutions holding mortgages as collateral. Then, credit rating agencies downgraded their ratings on bonds backing mortgage-backed securities, which immediately and substantially reduced the value of investment-grade subprime mortgage-backed bonds. The downward spiral of the investment banks and other investors, like hedge funds, began.
- The U.S. government intervened in the crisis to sponsor emergency measures.

B. *The Role of Hedge Funds in the Subprime Mortgage Crisis*

A number of factors guaranteed that hedge funds would have an eventual role in the credit crisis. As detailed above, the main issues were the minimal regulation of hedge funds and the secrecy with which the funds did business. Michael Greenberger, former director of the Division of Trading and Markets at the Commodity Futures Trading Commission, commented that "not only are hedge funds lightly regulated but they deal to a large measure in unregulated transactions. It's a daisy chain of risk."[184] Second, hedge fund managers are known for their aggressive investment strategies,[185] driven by lucrative

182. Liz Pulliam Weston, *The Negative Equity Epidemic,* MSN MONEY, http://moneycentral.msn.com/content/Banking/Homefinancing/P148861.asp (last visited June 5, 2009).

183. *Moody's Economy.com: Rising Household Debt, Defaults Straining US Economy,* REUTERS.COM, http://www.reuters.com/article/pressRelease/idUS160626+23-Jul-2008+BW20080723 (last visited June 8, 2009).

184. *See* Kara Scannell & Alistair MacDonald, *Can Anyone Police the Swaps,* WALL ST. J., Aug. 31, 2006, at C1.

185. MORRIS, *supra* note 41, at 109. In describing the broad scope of the hedge funds business, the author observed that "[t]here are few limits on how they invest, what kind of risks they take, and how much leverage they use." To name but a few of the kinds of strategic activity in which hedge funds engage: short selling, trading in derivative instruments, using leverage to enhance the risk/reward profile, investing in commodities and real estate, as well as investing in ordinary stocks. *See* 2008: A Rough Year for Hedge Funds, Sept. 9, 2008, http://secure.foxbusiness.com/story/markets/econ-

compensation schemes,[186] which made mortgage-backed securities an attractive market opportunity. Finally, during the build-up to the subprime crisis, there were a large number of hedge funds with tremendous assets available to invest in CDOs.[187] Wall Street firms encouraged originators to make risky loans to troubled borrowers, which they could securitize and sell to investors, such as hedge funds—among these firms' favorite clients.[188]

1. *Hedge Funds' Duality*

Hedge funds have been placed in the dual position of being one of the exacerbating causes of the subprime mortgage debacle and a cultprit in the campaign to assign blame for the subprime meltdown, while also being a victim and a casualty of the financial crisis through its suffering of great losses. Many of the smaller hedge funds will cease to exist in the declining market.[189] Hedge funds' assets have been depleted by stock market declines, margin calls, and redemptions.[190] However,

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omy/rough-year-hedge-funds. Derivatives essentially include any instruments that derive their value from the underlying asset. MUOLO & PADILLA, *supra* note 18, at 321; *see also* Scannell & MacDonald, *supra* note 184.

186. *See* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance,* 63:4 J. OF FIN. 1735 (Aug. 2008); *see also* Jenny Anderson & Julie Creswell, *In the Race for Riches, Hedge Fund Managers Top Titans of Wall Street,* INT'L HERALD TRIB., Apr. 24, 2007, http://www.iht.com/articles/2007/04/23/business/hedge.php. Another factor that attracted hedge fund managers to invest in the promising mortgage-backed securities is the generous compensation structure of managers. Unlike the usual compensation schemes, hedge fund managers typically receive fees of 1-2 percent on assets and additional performance incentive fees of 20 percent on all profits.

187. *Id.*

188. Using the figures available to the authors, and regardless of the fact that "only a small portion of hedge funds had anything to do with CDOs," an assumption can be made that hedge funds investing in CDOs could have accounted for up to 29 percent of that market—if it is assumed that "hedge funds focused in the fixed income debt markets have been estimated to have leverage of up to 10 times their equity." *Congressional Hedge Fund Hearing,* Nov. 2008, *supra* note 3 (testimony of Houman B. Shadab, Senior Research Fellow, Regulatory Studies Program, The Mercatus Center at George Mason University); *see Housing and Hedge Funds,* N.Y. TIMES, June 28, 2007, at A22.

189. Jenny Strasburg, *Smaller Hedge Funds Struggle as Money Pipeline Dries Up,* WALL ST. J., Oct. 4, 2008, at B1.

190. The HFRX Absolute Return Index, a performance benchmark maintained by Hedge Fund Research Inc., is down by –13.09 percent at the end

the sale of billions of dollars of securities simultaneously contributed to the stock market's volatility.[191] Hedge funds were condemned for making a profit for their clients by taking advantage of the complex and sophisticated mortgage-backed derivatives available in the marketplace. Hedge funds contributed to the subprime crisis because their opaque structure and huge assets under management, functioning in an underregulated environment, permitted advisers to invest in complex financial instruments free of scrutiny.[192]

2. *The Bear Stearns Hedge Funds' Collapse*

a. *Collapse of Bear Stearns Hedge Funds: Initial Indication of the Magnitude of the Subprime Loan Crisis (June 2007)*

One of the earliest signals of the looming danger of subprime loans was the failure of two Bear Stearns hedge funds in 2007. Hedge funds had become so popular and had such huge earnings that Bear Stearns Companies, Inc. created its own internal funds: Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. ("High-Grade Fund") and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leveraged Master Fund, Ltd. ("Enhanced Fund"),[193] both managed by Bear Stearns Asset Management Inc. ("BSAM"). A third hedge fund was in development but did not make much

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of 2008 compared to a positive figure of 7.43 percent at the end of 2006. The Market Directional Index is down –28.70 percent at the end of 2008 compared with a positive figure of 10.45 for 2006. Both performance statistics, i.e., absolute and directional, indicate the negative effect of investor redemptions in reaction to the credit crisis. HFRX INDICES, https://www.hedgefundresearch.com/hfrx_reg/index.php?fuse=login&1227661910. It has been reported that "[w]orried investors are pulling out their money—some $31 billion through September, according to Hedge Fund Research." Also, hedge funds are subject to many more margin calls from lenders during the credit crisis and cash is required to meet those calls, thus necessitating the sale of assets. *See* Matthew Goldstein & David Henry, *The Hedge Fund Contagion,* BUS. WK., Nov. 3, 2008, at 37.

191. *See* Jenny Strasburg & Gregory Zuckerman, *Hedge Fund Selling Puts New Stress on Market,* WALL ST. J., Nov. 7, 2008, at 1.

192. Walter Hamilton & Tom Petruno, *Wall St. Humbled by Hedge Funds,* L.A. TIMES, Aug. 14, 2007, at 1.

193. Barclays Bank PLC, v. Bear Stearns Asset Management Inc., Ralf Cioffi, Matthew Tannin, Bear Stearns & Co. Inc. and The Bear Stearns Companies Inc., No. 07 CV 11400 (S.D.N.Y., Dec. 2007) [hereinafter Barclays' complaint], *available at* http://www.insurereinsure.com/files/upload/Barclays-Bear%20 Complaint.pdf.

progress before the first two collapsed.[194] When the housing bubble burst in the Summer of 2007, two of the firms' major hedge funds collapsed, and Bear Stearns incurred $1 billion in write-downs by the end of the year.[195] As a result of the funds' failures, the SEC filed a civil lawsuit against the fund managers,[196] the Department of Justice filed criminal charges against the same parties,[197] and investors filed arbitration claims.[198]

The unexpected bankruptcy of the two Bear Stearns mortgage hedge funds in the summer of 2007 sounded the alarm for oncoming losses throughout the industry—Bear Stearns' dilemma was shared by many. First, like the Bear Stearns funds, many hedge funds had invested primarily—even entirely—in the securitized mortgage instruments issued by Wall

194. The third investment vehicle was Everquest Financial Ltd. Jody Shenn & Yalman Onaran, *Bear Stearns to Liquidate Bond Hedge Fund, People Say*, BLOOMBERG.COM, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a0LL0_ucig4Q. *See also id.* (in addition to Bear Stearns' floundering dealings with the remnants of its two hedge funds is the fragility of a third hedge fund. *Bloomberg* reports that Bear Stearns halted redemptions from a third fund after a slump in credit markets prompted investors to demand their money back).

195. Who Should Police Wall Street (June 24, 2008), http://www.investorprotection.com/blog.

196. SEC v. Cioffi and Tannin, No. 08 2457 (U.S. District Court, Eastern District of New York, filed June 19, 2008), http://www.sec.gov/litigation/complaints/2008/comp20625.pdf. *See* Press Release, U. S. Securities and Exchange Commission, SEC Charges Two Former Bear Stearns Hedge Fund Portfolio Managers with Securities Fraud (June 19, 2008), [hereinafter SEC Civil Cioffi Press Release], http://www.sec.gov/litigation/litreleases/2008/lr20625.htm.

197. Press Release, U.S. Attorney's Office, Eastern District of New York, Two Senior Managers of Failed Bear Stearns Hedge Funds Indicted on Conspiracy and Fraud Charges (June 19, 2008), http://www.usdoj.gov/usao/nye/pr/2008/2008jun19.html [hereinafter Press Release, DOJ indictment].

198. The investors agreed to arbitration as the dispute mechanism in the event of breaches of contract or civil misconduct on the part of the hedge funds. Lawyers for the claimants argue that "Bear Stearns misled investors in Bear Stearns hedge funds about the funds' exposure to subprime risk." Investors also claimed that Bear Stearns gave them the impression that their losses were going to be relatively minor, rather than the virtual eradication of their investments amounting to more than $100 million in losses. Martha Graybow, *Bear Stearns Hedge Fund Investor Files Claim*, Aug. 1, 2007, *at* http://www.washingtonpost.com/wpdyn/content/article/2007/08/01/AR2007080101282.html.

Street investment banks.[199] Second, Bear Stearns' funds borrowed heavily from unrelated third party banks in order to invest in CDOs backed by home mortgage pools,[200] but high leverage meant high risk. With the surge of delinquent loans and subsequent foreclosures, the hedge funds became entangled in the subprime crisis when credit rating agencies downgraded their ratings on the investment-grade subprime mortgage-backed bonds held by the hedge funds.[201] Since banks held the mortgage-backed bonds as security against their loans, the banks wanted Bear Stearns to provide additional collateral, but the funds did not have ample liquidity to cover their debt obligations, so the funds attempted to sell bonds to generate cash.[202] While some of the bonds could be sold to raise money, most were not salable at any price.[203]

Eventually, the two Bear Stearns hedge funds disclosed their financial dilemma to the investors in a communication describing the company as having suffered from "unprecedented declines in the value of securities used to bet on subprime mortgages."[204] Investor losses were more than $1 billion.[205] The hedge funds' primary reliance on an incredibly unstable subprime mortgage market, as well as the lack of transparency that prevented investors from assessing their risk, precipitated the funds' failure and the catalyst for the downfall

199. Robert Lindsay, *SEC Probing Bear Stearns Hedge Funds*, TIMES ONLINE, June 27, 2007, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1995259.ece.

200. Daniel Gross, *Please Don't Feed the Bear*, NEWSWEEK, July 12, 2007, *available at* http://www.msnbc.msn.com/id/19588432/site/newsweek/; Julie Creswell & Vikas Bajaj, *$3.2 Billion Move*, *supra* note 40.

201. Vikas Bajaj, *More Trouble in Subprime Mortgages*, N.Y. TIMES, June 15, 2007, *at* http://www.nytimes.com/2007/06/15/business/15mortgage.html.

202. Vikas Bajaj & Julie Creswell, *Bear Stearns Staves Off Collapse of 2 Hedge Funds*, N.Y. TIMES, June 21, 2007, *at* http://www.nytimes.com/2007/06/ 15/business/15mortgage.html.

203. MORRIS, *supra* note 41, at ix.

204. Yalman Onaran, *Bear Stearns Seizes Assets from Failed Hedge Fund*, BLOOMBERG.COM, July 26, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=a2rP8XvO7WV4&refer=home; *see also* Yalman Onaran, *Bear Stearns Halts Redemptions on Third Hedge Fund*, BLOOMBERG.COM, July 31, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aBuz_1cIZ_EQ.

205. Press Release, DOJ Indictment, *supra* note 197.

of the firm itself.[206] The collapse of the funds began a crisis of confidence in the market from which Bear Stearns Companies, Inc., a key player in the business of packaging subprime mortgages for sale to investors, could not recover. In Spring 2008, Bear Stearns Companies, Inc., an old and venerable institution whose name was synonymous with Wall Street success, narrowly escaped filing bankruptcy,[207] and with no other options, merged with one of its chief rivals, JPMorgan Chase.[208]

b. *Legal Actions Resulting from the Collapse of Bear Stearns' Hedge Funds*

A number of civil actions and prosecutions arose from the collapse of Bear Stearns' hedge funds. However, these legal actions were stalled, though some were re-filed,[209] as a result of Bear Stearns Companies forced merger with JPMorgan in May 2008.[210]

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206. William D. Cohan, *The cases against Bear Stearns,* CNNMONEY.COM, Aug. 4, 2008, http://money.cnn.com/2008/07/31/news/companies/ bear_lawsuits.fortune/index.htm?postversion=2008080410.

207. Andrew Ross Sorkin, *JPMorgan Pays $2 a Share for Bear Stearns,* Mar. 17, 2008, http://www.nytimes.com/2008/03/17/business/17bear.html?pagewanted=print.

208. *Id.*

209. James Quinn, *Barclays to Re-File Bear Lawsuit,* DAILY TELEGRAPH (London), June 13, 2008, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2791579/Barclays-to-re-file-Bear-Stearns-lawsuit.html.

210. Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns,* WALL ST. J., May 27, 2008; *see also* Kate Kelly, *Fear, Rumors Touched Off Fatal Run on Bear Stearns,* WALL ST. J., May 28, 2008, at A1; *see also* Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Days,* WALL ST. J., May 29, 2008. As the mortgage market spiraled down, Bear Stearns' position deteriorated and the possibility of filing a Chapter 11 bankruptcy loomed. The regulators' greatest fear was that Bear Stearns would be forced to declare bankruptcy and trigger a global financial panic. Treasury Secretary, Henry Paulson, a former Wall Street executive from Goldman Sachs, and New York Reserve Bank President, Timothy Geithner, directly intervened to prevent this from happening by helping to negotiate a deal whereby Bear Stearns would sell itself to J.P. Morgan Chase & Co. The first agreement was for a sale of its stock at $2 a share but, facing increased pressure and outcries, the amount was raised to $10 a share.

i. *Barclays Bank PLC v. Bear Stearns Asset Management Inc. (2007 and 2008)*

One of the major lawsuits against Bear Stearns that was re-filed[211] was brought by Barclays Bank, the sole participating shareholder in the umbrella fund that managed the two failed hedge funds. Barclays initially filed suit against Bear Stearns Co. Inc., The Bear Stearns Companies Inc., and Bear Stearns Asset Management Inc. ("BSAM")—the investment manager for Enhanced Fund, one of the two failed hedge funds[212]—in the U.S. District Court, Southern District of New York, alleging fraud, conspiracy, misrepresentation, breach of fiduciary duty, and promissory estoppel.[213] Barclays asserted that BSAM concealed the fund's failing net asset value ("NAV"), not revealing the drop in value and not taking immediate corrective action to minimize the escalating risk.[214] After the merger the suit was re-filed,[215] necessarily naming JPMorgan Chase as a defendant because of its acquisition of Bear Stearns.[216] In February 2009, however, Barclays dropped the lawsuit, with prejudice, against Bear Stearns and all defendants.[217]

ii. *Bear Stearns Hedge Fund Managers: DOJ Indictments and SEC Civil Actions (2008)*

In the late Summer of 2006, Bear Stearns' hedge funds held approximately $1.4 billion of investor money under management.[218] Within a year, those assets were wiped out. The extent of fraud and malfeasance by Bear Stearns' hedge funds' managers is still not known. On June 19, 2008, the Department of Justice ("DOJ") and the U.S. Attorney's Office, Eastern District of New York, announced criminal indictments of two Bear Stearns hedge funds managers: Ralph Cioffi—

211. Quinn, *supra* note 209.

212. *Id.*

213. Barclays Bank PLC v. Bear Stearns Asset Management Inc., No. 07 CV 11400(S.D.N.Y., filed Dec. 19, 2007) *available at* http://www.insurereinsure.com/files/upload/Barclays-Bear%20Complaint.pdf).

214. *Id.*

215. Quinn, *supra* note 209.

216. *Id.*

217. Thom Weidlich, *Barclays Drops Suit Against Bear Over Fund's Collapse,* BLOOMBERG.COM, http://www.bloomberg.com/apps/news?pid= 20601103&sid=aWVopdweC040 (last visited July 10, 2009).

218. Press Release, DOJ Indictment, *supra* note 197.

founder and senior portfolio manager of the two funds—and Matthew Tannin—the funds' portfolio manager—for conspiracy, securities fraud, and wire fraud.[219] Additionally, Cioffi was charged with insider trading resulting from his $2 million redemption activity.[220] The criminal trial is scheduled to begin in September 2009.[221]

On June 19, 2008, the SEC filed a civil action—still pending in mid-2009—against Cioffi and Tannin in U.S. District Court, Eastern District of New York.[222] Filed on the same day, against the same defendants, the Commission's civil suits against the defendants almost mirrors the criminal action by the U.S. Attorney's office. The SEC's complaint seeks the following: (1) to enjoin defendants from engaging in future transactions, practices, acts, and courses of business that violate the Securities Act of 1933, Securities Exchange Act of 1934, and Rule 10b-5; (2) to compel defendants to disgorge, with prejudgment interest, the illegal profits and proceeds they obtained as a result of their actions alleged by the SEC; and (3) to require the defendants to pay civil money penalties.[223]

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219. *Id.* The indictment alleges that in March 2007 the defendants had reason to believe the Funds were in serious risk of collapsing, but failed to inform the Funds' investors and creditors in what appears to be an attempted scheme to stall an inevitable withdrawal of investor funds with the hope that the Funds' prospects would improve and the defendants' income and reputation would remain intact. The indictment also addresses issues of misrepresentations regarding investor redemptions and possible destruction of evidence.

220. *Id.* Tannin erroneously told investors, numerous times, that he was adding to his investment in the funds and, Cioffi, without informing investors, transferred $2 million of his $6 million investment in one of the funds to another successful Bear Stearns hedge fund, which he managed, resulting in an indictment for one count of insider trading.

221. William D. Cohan, *Bear Stearns: a fight over the corpse,* CNN.COM, http://m.cnn.com/cnn/archive/archive/detail/260388/full;jsessionid= EAFE9F8460A93F569AC8F6FE470DAE36.live5i (last visited July 10, 2009).

222. *See* SEC v. Cioffi and Tannin, No. 08 2457 (E.D.N.Y., filed June 19, 2008); *see also* SEC Civil Cioffi Press Release, *supra* note 196.

223. *Id.*

V.
HEDGE FUND REGULATION REFORM: CONGRESS, THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, AND U.S. DEPARTMENT OF TREASURY (2007 TO MID-2009)

At the beginning stages of the financial crisis in 2007, and motivated by the failure of the Bear Stearns hedge funds, Congress began a serious investigation of the risks associated with hedge fund activities. In an effort to address the lack of federal oversight, the President's Working Group on Financial Markets ("PWG") has also become involved.

A. *Legislative Activity and Administrative Proposals*

The U.S. Senate is engaged in an ongoing debate on hedge funds' activities and their role in the subprime loan crisis. Senator Byron L. Dorgan (D–No. Dak.), one of eight Senators who voted against Gramm-Leach-Bliley, has been a vocal critic of the hedge fund industry. At the time of the Senate's vote on the financial rescue plan, he proposed "a system of regulation that would require accountability for the speculative investment activities of hedge funds and investment banks that create and sell complex securities,"[224] but his proposal was not included in the bailout legislation. Previously, Senator Dorgan expressed his frustration that hedge funds are "completely deregulated," that despite attempts by some legislators, Congress had failed to enact any legislation,[225] and that agencies empowered to regulate hedge funds refused to do their job.[226]

Despite their role in the crisis, stricter regulation of hedge funds has been slow to develop. At a Congressional Hearing in July 2007,[227] lawmakers complained about the under-regulation of hedge funds to officials from the Federal Reserve, the Treasury Department, the SEC, and the Commodity Futures Trading Commission. These legislators observed that an unregulated hedge fund market is not a viable solution going for-

224. Press Release, Dorgan Statement on Financial Bailout (Oct. 2, 2008), http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr0705074.shtml.

225. 154 CONG. REC. S2213 (Mar. 31, 2008) (Statement of Sen. Dorgan), http://www.govtrack.us/congress/record.xpd?id=110-s20080331-13.

226. *Id.*

227. *Hedge Funds and Systemic Risk Hearing, supra* note 5.

ward, issuing an indirect call for regulation.[228] In June 2008, the U.S. House of Representatives passed the Alternative Minimum Tax bill, containing a provision that attempted to solve the contentious problem of how much to tax hedge fund managers.[229] The bill was never considered by the Senate, but it would have more than doubled the tax rate on hedge fund managers' profits, and it closed loopholes used by those managers to evade taxation of their overseas incomes.[230]

The Committee on Oversight and Government Reform of Hedge Funds and Financial Markets held an important hearing on November 13, 2008, which examined (1) the role hedge funds played in the financial crisis; (2) whether hedge funds create a systemic risk; and (3) the appropriate level of government oversight and regulation.[231] Along with several witnesses from academia, five hedge fund managers were invited to testify, selected because they were top earners in the previous year, reportedly receiving more than $1 billion each.[232] Some witnesses at the hearing explicitly stated that credit default swaps caused a massive problem in the financial markets and supported the creation of a clearinghouse for these derivatives as a way to "dramatically reduce [systemic] risk."[233] Both the academics and industry professionals generally accepted that there must be some regulation of the hedge

228. Jonathan Peterson, *Panel Targets Hedge Funds*, L.A. TIMES, July 12, 2007, at C3.

229. Alternative Minimum Tax Relief Act of 2008, H.R. 6275 (110th Cong.) (June 25, 2008).

230. *Id.*

231. *See Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3, (Opening Statement of Rep. Henry A Waxman, Committee Chairman).

232. The hedge fund directors who testified at the hearing were George Soros, Chairman of Soros Fund Management LLC; James Simons, Director of Renaissance Technologies LLC; John Alfred Paulson, President of Paulson & Co. Inc.; Philip Falcone, Senior Managing Director of Harbinger Capital Partners; and Kenneth Griffin, CEO and Managing Director of the Citadel Investment Group. The academicians who presented testimony included Professor David Ruder, Northwestern University School of Law; Professor Andrew Lo, Massachusetts Institute of Technology; Professor Joseph Bankman, Stanford University Law School; and Houman Shadab, Senior Research Fellow, George Mason University.

233. *Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3 (testimony of Kenneth Griffin, CEO Citadel Investment Group; testimony of Philip A. Facone, Harbinger Capital Partners Funds; testimony of George Soros, Soros Fund).

funds, such as the special disclosure requirements imposed by the SEC in its Interim Final Temporary Rule on short sales,[234] despite assertions that short-selling is a valuable feature of our markets.[235] Input from these witnesses should provide Congressional leaders with the kind of information they need in deciding whether to regulate hedge funds, and if so, how to construct a framework for that regulation.

At the start of 2009 up to mid-year, there is ongoing activity by both houses of Congress and the Obama administration to regulate hedge funds which includes, among numerous others: the Hedge Fund Transparency Act introduced by Senators Grassley (R-IA) and Levin (D-MI),[236] a series of bills introduced by Representatives Castle (R-DE) and Capuano (D-MA),[237] and the Treasury Department's Financial Regulatory Reform proposals.[238]

B. *President's Working Group on Financial Markets (2008)*

The President's Working Group on Financial Markets ("PWG") plays an important role in recommending policy changes on hedge fund activities. The group was formed by Executive Order on March 18, 1988, in order to "[enhance] the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and [to maintain] investor confidence."[239] There are four members of the PWG: the Secre-

234. *Congressional Hedge Fund Hearing, Nov. 2008, supra* note 3.

235. *Id.* (testimony of Philip A. Facone, Harbinger Capital Partners Funds; testimony of Houman Shabad, Research Fellow, George Mason University).

236. *See* Press Release, Carl Levin, U.S. Senator, Grassley and Levin Introduce Hedge Fund Transparency Bill (Jan. 29, 2009), http://levin.senate.gov/newsroom/release.cfm?id=307481.

237. Hedge Fund Adviser Registration Act of 2009, http://frwebgate.access.gpo.gov/cgi-in/getdoc.cgi?dbname=111_cong_bills&docid=f:h711ih.txt.pdf; Pension Security Act of 2009, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h712ih.txt.pdf; The Hedge Fund Study Act, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h713ih.txt.pdf.

238. Administration's Regulatory Reform Agenda Moves Forward, Executive Summary, http://www.financialstability.gov/docs/regulatoryreform/executive_ summary.pdf (last visited July 10, 2009).

239. PRINCIPLES AND BEST PRACTICES FOR HEDGE FUND INVESTORS, REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, April 15, 2008, [hereinafter REPORT OF INVESTORS' COMMITTEE TO PWG, APR. 2008], http://ustreas.gov/press/releases/reports/investors'committee reportapril152008.pdf.

tary of the Treasury and the chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.[240] In 2007, the PWG sponsored two private sector committees to build upon the principles and guidelines: an Asset Managers' Committee charged with developing best practices specifically for managers of hedge funds and an Investors' Committee charged with developing best practices specifically for those making hedge fund investments.[241]

In March 2008, the Working Group issued a Policy Statement on Financial Market Developments, attributing turmoil in the financial markets to the soaring delinquencies of subprime mortgages in the U.S. The policy statement analyzed the underlying factors that contributed to the on-going market stress and offered a comprehensive set of recommendations to address those weaknesses.[242] Following that Policy Statement, on April 15, 2008, the Investors' Committee and the Asset Managers' Committee of the PWG issued separate reports on hedge funds, specifically. The Investors' Committee report on Principles and Best Practices for Hedge Fund Investors contains both a Fiduciary's Guide and an Investor's Guide outlining the a process for the evaluation, engagement, monitoring, and disposition of hedge fund investments.[243] The Asset Managers' Committee report on Best Practices for the Hedge Fund Industry establishes a set of standards for hedge fund managers to reduce risk and foster investor protection within the hedge fund industry.[244] Notably, neither of these documents offer regulatory solutions to prevent and monitor future calamities at hedge funds. Rather, the reports function as a roadmap for the industry's self-regulation.

Again in January 2009, the Asset Manager's Committee and the Investors' Committee issued separate reports for self-regulation concerning best practices for hedge fund managers and investors "so that market participants may enhance inves-

240. *Id.*

241. *Id.*

242. *Id.*

243. REPORT OF INVESTORS' COMMITTEE TO PWG, Apr. 2008, *supra* note 239.

244. REPORT OF THE ASSET MANAGERS' COMMITTEE TO PWG, Apr. 15, 2008, *supra* note 1.

tor protection and systemic risk safeguard consistent with PWG principles and guidelines."[245]

VI.
RECOMMENDATIONS

The authors recommend changes in three primary areas affecting the hedge fund industry: (1) SEC disclosure; (2) increased taxation on the income of hedge fund managers; and (3) increased regulation of the derivatives market, which may require amending sections of the Commodity Futures Modernization Act of 2000, which has provided the current safe haven for hedge funds.

First, the authors support SEC disclosures regarding investment of funds, leverage levels, and details about complex transactions, although hedge funds object to open disclosure claiming it would reveal investment strategies to competitors. Regulatory oversight is necessary to limit the practices of hedge funds that exacerbate the instability of the financial marketplace and undermine soundness of the market. Moreover, in the last few years, the hedge fund industry has undergone substantial "retailization," expanding its customer base beyond wealthy individuals and institutional investors, particularly through "funds of funds" that rose to public prominence with the Bernard Madoff scandal.[246] Consequently, hedge funds cannot be allowed to continue to operate so opaquely in an under-regulated manner, and greater transparency is cru-

245. The Asset Managers' Committee; The Investors' Committee, http://www.amaicmte.org/ (last visited July 10, 2009); *see* BEST PRACTICES FOR THE HEDGE FUND INDUSTRY, REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PWG, Jan. 15, 2009, http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf; *see* PRINCIPLES AND BEST PRACTICES FOR HEDGE FUND INVESTORS, REPORT OF THE INVESTORS' COMMITTEE TO THE PWG, Jan. 15, 2009, http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf

246. Massive fraud was discovered in 2008 in the hedge fund operation of Bernard Madoff in which unrelated hedge fund managers pooled investors and brought them into his fund. *See* Erin E. Arvedlund, *What We Wrote About Madoff*, BARRON'S, Dec. 22, 2008, at 41 (citing an article that was written by the same author in the May 7, 2001 issue of Barron's, titled "Don't Ask, Don't Tell," in which the Ponzi scheme was not exposed, but questions were raised about the way Bernie Madoff operated his business). Madoff was charged with a $50B securities fraud by running a Ponzi scheme, in which newer investors' money was paid out to earlier ones. Robert Frank & Tom Lauricella, *Financier Created Air of Mystery*, WALL ST. J., Dec. 20, 2008, at A1.

cial to protect investors. Some form of regulation has already been implemented through the Interim Final Temporary (short-sale) Rule, which requires weekly disclosure to the SEC only and not to the general public.[247] The temporary rule could provide Congress with a blueprint for framing future hedge fund disclosure legislation in the way it incorporated disclosure to the SEC but not to the public.

Second, in the interest of fairness and equity, the authors strongly recommend a change in the tax structure governing the income of hedge fund managers. Currently, U.S. tax law permits hedge fund managers to treat the vast majority of their earnings as capital gains with a tax rate capped at 15 percent, rather than the 35 percent maximum for ordinary income.[248] Furthermore, hedge fund firms pay no corporate income tax, and only the income of the individual partners is taxed. Hedge fund managers are typically compensated according to the two-and-twenty model, receiving 2 percent of the fund's assets as management fees, as well as 20 percent of the fund's profits.[249] An average fund manager may earn more than $10 million annually, and top fund managers may earn in excess of $100 million per year, with both levels of income taxed at the 15 percent rate.[250] Congress has considered this issue before and only made minor changes to applicable tax policy,[251] but the matter should be addressed again. As a U.S. Senator in 2007, President Obama was among those calling for all publicly traded partnerships, including hedge funds and private

247. *See* SEC Interim Final Temporary Short Sales Rule, *supra* note 98.

248. The management fee (which is usually 2 percent) of hedge fund managers is taxed as ordinary income, which has a maximum rate of 35 percent. However, the greater amount received is attributable to a profits interest or "carry" compensation (which is traditionally 20 percent) is made at the fund level and is taxed at a maximum rate of 15 percent. "If the fund's profits are from the sale of capital assets held for over a year, the income will flow through to the limited partner investors as long-term capital gain and the amounts paid to the hedge fund managers as carry will also be taxed as long-term capital gain taxed at the maximum rate of 15 percent." *See Congressional Hedge Fund Hearing, Nov. 2008* (testimony of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School), *supra* note 2.

249. *See id.*

250. *See id.*

251. The tax advantage of deferred compensation of management fees was removed in the Emergency Economic Stabilization Act of 2008 as enacted as a part of Internal Revenue Code Section 457. *See id.*

equity firms, to be treated as corporations and taxed at the 35 percent tax rate.[252] Thus, it is reasonable to expect that he will support the progressive taxation of hedge fund managers.

Finally, Congress should amend the Commodity Futures Act of 2000 to allow regulation of the derivatives market. A primary cause for the economic meltdown was a very large credit default swap market in which collateralized debt obligations were supposed to be insured by CDS contracts. Of course, hedge funds were among the market participants investing in this dynamic and profitable market. The authors have concluded that the unregulated status of OTC derivatives, such as CDSs, substantially increases systemic risk, and as such, played a harmful role in the financial crisis, as evidenced in the necessity for the government bailout of AIG.[253] The Commodity Act of 2000 codified the unregulated status of OTC derivatives allegedly to provide "legal certainty" by specifically excluding derivatives, like credit default swaps, from regulation.[254] Instead, the unregulated status of derivatives created legal chaos and financial catastrophe to an unexpected dimension. The U.S. Treasury is advocating greater oversight and transparency on derivatives trading by the SEC and the Commodity Futures Trading Commission.[255] More transparency can be obtained by forcing more of the financial instruments to be traded via standardized contracts and through central clearing houses,[256] but the Commodity Act 2000 must be amended to clearly allow such regulation.

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252. Russell Berman, *Clinton Faces Pressure on Hedge Fund: Edwards, Obama Back Taxes,* N. Y. SUN, July 12, 2007, http://www.nysun.com/national/clinton-faces-pressure-on-hedge-funds/58261/.

253. *AIG and the Trouble with 'Credit Default Swaps, supra* note 7.

254. The proponents of the Commodities Act of 2000 argued that the status of OTC derivatives should be clarified and provided with legal certainty. *See* Committee Letter Regarding Legal Certainty Provisions of the Commodity Futures Modernization Act 2000 to James A. Leach, Chairman, Committee on Banking and Financial Services (July 18, 2000), http://www.newyorkfed.org/fxc/annualreports/ar2000/FXAR00RL.pdf.

255. *See* Press Release, U. S. Department of the Treasury, Regulatory Reform Over-The-Counter (OTC) Derivatives (May 13, 2009), http://www.treas.gov/press/releases/tg129.htm.

256. *See* Press Release, Securities and Exchange Commission, SEC Approves Exemptions to Allow Central Counterparty for Credit Default Swaps (Dec. 23, 2008), http://www.sec.gov/news/press/2008/2008-303.htm.

VII.
CONCLUSION

It has been observed that "regulation is necessary to define acceptable standards of conduct in an amoral world and to ensure that those standards are upheld."[257] Accordingly, many blame deregulation for the subprime crisis, although to make it the sole culprit is inaccurate and naive. Numerous financial institutions, including hedge funds, contributed to the catastrophe.

Just as deregulation played a role in the Savings and Loan crisis of the 1980s, it also fostered the relatively unrestrained free market environment in which subprime lending and mortgage backed securities thrived. Although deregulation and under-regulation alone were not the sole causes of the subprime crisis, laissez-faire approaches to market monitoring facilitated market excesses, permitting market participants to engage in a frenzy of reckless investing in innovative, untested, and unregulated products.[258]

Of course, the hedge fund industry is also a culprit in the crisis—viewed as very large, secretive, under-regulated industry, commanding large amounts of assets, further swollen by leveraging, which aggressively invested in the exotic CDOs and CDSs emanating from the housing bubble. However, with effective regulation, such as the registration requirements of the 2004 Hedge Fund Rule and mandatory disclosure requirements, hedge funds could not have exacerbated the subprime lending and securitization phenomenon through their aggressive investment strategies. Nevertheless, the hedge fund industry is not merely culprit, but also casualty of crisis. Most funds have suffered severe losses in the economic downturn, forcing many to go out of business.

During a period of deregulation in the U.S. financial markets, the under-regulated hedge fund industry flourished. In a

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257. David Lazarus, *The free market's not always the fair and honest market*, L. A. TIMES, Sept. 21. 2008, at C1 (arguing that the free market's not always the fair and honest market); *see also* MORRIS, *supra* note 41, at 31 (noting that "the LBO [leveraged buyout] boom and the S&L debacle demonstrate the dangers of loose financial markets regulation . . . ," and cynically remarking, "[i]n raw markets, the scent of money deadens all other sensory and ethical organs").

258. Hamburger, *supra* note 4.

relatively short period of time, the industry became fully integrated as a major segment of the financial sector. The hedge fund industry continues to pose a continued a substantial risk to the economy because it has such a large footprint in the financial sector. It is inevitable that legislators will impose regulatory oversight, thereby reining in hedge funds' special freedom in the marketplace. Thus far, self-regulation and market discipline have obviously proven insufficient.[259] Both hedge fund managers (who earned an average $1 billion in the prior year) and academics testified at a Congressional hearing that some disclosure process is necessary, although there was no indication they believe that hedge funds create a systemic risk. Furthermore, the industry has a compensation system that incentivizes aggressive investment in various areas, including exotic securities. But, on balance, it is also important that, unlike the broad scope of regulation proposed by the European Commission for EU investment fund managers,[260] Congress and other U.S. government regulators should not completely curb the ability of the funds to use innovative and creative investment strategies. However, beyond a reasonable threshold,[261] hedge funds should be subject to SEC monitoring by

259. *See* REPORT OF THE ASSET MANAGERS' COMMITTEE TO PWG, Apr. 15, 2008, *supra* note 1.

260. Far beyond the scope of regulation being considered in the U. S., the European Commission has proposed a Directive on Alternative Investment Fund Managers ("AIFMs") with the objective to create a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level. Proposal for a Directive on Alternative Investment Fund Managers, (Apr. 29, 2009) http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#proposal; *see also,* Press Release, European Commission, Financial Services: Commission proposes EU framework for managers of alternative investment funds (Apr. 29, 1009), http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669&format=HTML&aged=0&language=EN&guiLanguage=fr. Extensive regulation is proposed, including mandatory registration with national regulators for AIFMs, disclosures to investors as well as to regulatory agencies, setting capital requirements, strengthening the legal responsibilities of depositories who hold assets for funds, and requiring preclearance with regulators before marketing specific types of funds.

261. In order to avoid placing unnecessary burdens on smaller hedge funds, a threshold should be set—much like the proposed directive in the EU which applies only to those AIFM managing a portfolio of "more than100 million euros." *See* Press Release, European Commission, Financial Services: Commission, Apr, 29, 2009, *supra* note 269.

requiring registration of their advisers[262] and by mandating specific disclosures available to the SEC but not available to the public as provided in the SEC Short Sales Rule.[263]

262. The SEC should return to its basic premise of the 2004 Hedge Fund Rule that hedge fund managers must register, which means that it must correct the defects of the 2004 rule so that the registration provisions can withstand judicial scrutiny.

263. *See* SEC Interim Final Temporary Short Sales Rule, *supra* note 98.