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The End Game in Insolvency for Hedge Funds: Special Case or No Favoured Treatment? – Part Two

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As the international financial crisis regarding sub prime financial instruments seems increasingly unresolved, Part Two (Volume 5, Issue 1) focuses on some of the historical instances of financially distressed firms including hedge funds, and how the current crisis may be resolved. This builds upon Part One's (Volume 4, Issue 6) focus on the core dimensions of preventing and containing such financial crisis within the context of an international regulatory framework with significant holes as to dealing with hedge fund regulatory and insolvency issues. Part Three (Volume 5, Issue 2) addresses the above credit crisis through 1 September 2007.

V. Hedge funds and regulation: *de jure* and *de facto* basis for treatment in the event of large scale insolvency

A. Reasons for concern: old remedies for a new age?

As recent events have shown, the concern about systemic risk is the most critical challenge that regulators face today.[80] Add to that, the desire of many policymakers not to let matters get out of hand, and, the risks posed by derivatives we can quickly see how there are major issues that are of concern. This is especially true given the lack of a carefully integrated systematic crisis resolution framework (as Part I demonstrated).

Indeed, prior to the most recent August Quant 2007 crisis, the current public response of the relevant US and UK officials could be summarised thusly: trust us. Some work behind the scenes has clearly been taking place, as systemic risk was unquestionably an important concern of the relevant high-level officials.

Secretary of the US Treasury, Henry Paulsen has led through an interagency group to look into the issue of crisis co-ordination, in part focussed on hedge funds.[81] Further, as previously mentioned, the Chairman of the US Federal Reserve (Ben Bernanke), the mandarins of the FSA and a special EU working group have reviewed these issues.[82]

Indeed, systemic risk was set forth as a top agenda item in the most recent G8 Summit, reflecting widespread concern, primarily from the European continent, that, these issues require discussion and consensus – before a disaster strikes. However, no co-ordinated action was taken at the Summit.

Those responsible for policy in relation to the relevant supervisory and regulatory issues have been wrestling with the dilemmas posed by hedge funds as they increasingly take up a larger percentage of financial assets. This upsets the traditional schemes of supervision and regulation for the 'old age', as opposed to the new age of hedge funds as well as private equity funds (the latter seeming more and more seem like financial if not operational conglomerates). The enthusiasm for hedge funds is reflected in current and future figures showing asset transfers to hedge funds are increasing, including transfers from more conservative investors as they seek 'alpha'.[83]

B. Have we been warned? The scope of the challenge

Due to typical redemption options provided to investors, many hedge funds could be vulnerable to insolvency arising from exposure related to the sub-prime August Quant crisis. This will entail the usual cycle of asking for money in excess of assets, and indeed (for many parties) wanting bankruptcy: remember there

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80 See Part One of this article published in *International Corporate Rescue* Vol. 4, Issue 6 generally, especially Section I.

81 Testimony of R K Steel, US House Financial Services Committee, 11 July 2007 found at <www.treasury.gov/press/releases/hp486.htfm>.

82 For Bernanke, see *supra* note 10; for the FSA see *supra* note 41; and for the EU see *supra* note 44.

83 Bank Of New York Survey, FT Alphaville, 18 June 2006. 'Alpha' is one of five statistical technical risk ratios used in modern portfolio theory to measure performance on a risk-adjusted basis. 'Alpha' takes the price risk of a fund and compares its risk-adjusted performance to a benchmark index, where excess return of the fund *vis-á-vis* the benchmark index results in the fund's 'alpha'.

are many credit default swaps (CDS) out there where the counterparty is expected to fund the loss. This is critical because insolvency is more attractive than a distressed debt discount to avoid bankruptcy. Why take 80% when you can get 100% by collecting on the CDS? Absent liquidity, the question of going concern or enterprise value in the US bankruptcy context becomes fraught: the first lien cannot be refinanced and neither can the second lien, except at huge discount.

Further, as Part One demonstrated, this is a new era where the question of how increasingly powerful 'non-bank banks' such as hedge funds conduct their affairs in truly global markets is crucial to maintaining systemic financial stability. The recognition that we are in a new age where old rules may not be the best ones for financial regulation is (or at least should be at) the heart of current discussions.

This issue was amply foreshadowed several years ago by the concerns expressed so cogently by Swiss Banking commissioner Eva Hupkes in her seminal discussion of the need to consider reforming how 'non-bank bank' issues and financial conglomerates insolvency should be contained. Of course, the premise that they should be treated the same is a complex issue with many viewpoints, as further elaborated in this Part Two.

Since that discussion, changes in the financial markets mean that, if anything, there has been a concentration of hedge funds holding assets. This has meant hedge funds have become more important due to their size. Further developments have included: an increased dispersion of derivatives; increased cross border activity (this has complex implications, chiefly as to the extent which netting schemes are workable. The increase in activity may even exacerbate crisis); and most importantly, a dramatic shift away from banks as the providers of finance to financial conglomerates which face unprecedented challenges in assessing counterparty risk through their prime brokerage arms.

All of these factors, especially in light of the opacity of hedge fund positions lead to the need for several things. First, serious questions of disclosure which so often dominate the policy agendas of the G8 nations (as well as the financial headlines of the newspapers) should be addressed.

Second, consideration should be given about how to prepare in a co-ordinated way (in a world of information asymmetry between funds and brokers) a more coherent methodology for tackling the issues of unravelling a hedge fund precipitated financial crisis.

The experience of insolvency law must therefore be brought to bear urgently to force, before it is too late, a re-examination of the current impact on financial market stability due to what might be called 'insolvency risk' arising from credit, market, or liquidity risk factors.

An ongoing challenge is presented by the extent to which the power of cross border capital flow can disrupt markets in more than one jurisdiction. This does at least provide a stronger basis for government organisations to engage in international monitoring and surveillance.

At the broadest level, this indicates that now, more than ever, there is perhaps a need for some soft law mechanisms to be implemented vis-à-vis the BIS and the Financial Stability Forum in addition to that of domestic policymakers.[84] These soft law mechanisms might enable the calibration of a careful rather than shrill response to this challenge. More direct action is a matter for the US and UK authorities, especially, but it must be looked at with great care to avoid inducing any market distorting reaction. Domestic US and UK officials are grappling with these issues today. One can expect that the markets will indeed, react.[85]

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84 But see K Alexander, R Dhumale, J Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (OUP, 2005) arguing that Basel II extends and reinforces homogeneous behaviour which in turn reinforces correlation risk and belies the fragile financial stability which financial institutions have exhibited in recent Basel I years

85 I have written about this in my recent article, referenced in Part One. One example of this is the flight to London of public issuance of shares as opposed to New York for foreign-based firms. This clearly reflects the promotion of London as a financial centre of a premier 'knowledge-based economy' whereby the financial market rules are configured to present London as a business location with a competitive advantage over New York, and as to Europe. As a consequence, FTSE firms that must comply with Sarbanes Oxley, do so, while those that may not wish to have access to capital from a large investment pool, without undergoing SEC compliance. Moreover, they also avoid US securities class action threats. Goldman Sachs has launched a private placement based Exchange for non-US issuers to access institutional funds, and to enter the backdoor through the US Regulation S/144A process. It will be interesting to see to what extent this grows and is viewed as a viable option on a cost/benefit basis or even explodes. No doubt, many firms will seek such methods to grow, and continue to avoid the US public markets. London, of course will not be without its challenges from the more regulation minded EU as directives such as MIFID provide the basis for much grumbling as to the compliance costs that London based investment firms must endure after October 2007. The point is: regulations matter, as international capital seeks a home where the costs of regulation are reduced, as compared to the benefits of quality signalling and the like. See John W. White, Sec Staff speech, Corporate Finance and the Foreign Private Issuer Community 2007, New York, 2 May 2007; see also generally E Tafara at <www.pli.com>. To the extent any market for international capital, with a lower cost competitor and similar benefit profile, will attract increased capital. Markets will react to overly burdensome changes that may be imposed if they do not provide corresponding benefits in reducing risk, for example; it is a different matter if institutional investors themselves, such as pension funds, choose a flight to quality to avoid 'lemons' and pick funds to invest in who signal such higher standards of enhanced disclosure or risk aversion. In addition to this, there are other issues of mis-alignment between the funds to the extent the fund managers have incentives to play for beta and take the management fees rather than intelligently seek alpha, (e.g. a classic principal-agent dilemma). Further, many institutional investors are seeking the comfort of funds who agree to the enhanced disclosure requirements of the US 1940 Investment Company Act, for example. However, the question of

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This includes not only protection against possible abuses such as lack of transparent reporting about hedge fund leverage exposure (notwithstanding allegedly ineffectual rules such as US Regulation T); the lack of real accountability and incentives to enhance the ratings among credit rating agencies (given the special immunity provided to credit rating agencies by the SEC so as not to be deemed experts, as well as other court rulings); concerns about mark to market accounting and its distortions, and the very real problem of poor investor due diligence.

Further, in a speech to the self-regulatory champion for the financial services industry, the ICMA, European 'wise man' Alexandre Lamfallusy noted that, unlike in previous eras, the explosion of complex derivative products means it is almost impossible to know who owns what risk in the current market.[86] For example, in the 1980s the IMF identified in a matter of hours the banks that were most at risk during the Mexican debt crisis. However, such a quick identification would not be possible today. A wider systemic crisis could therefore be more likely, if given the above factors, funds were forced to sell equities or other instruments in order to fund their margin requirements.

The solution Lamfallusy suggests is that '[w]e must have at our disposal a well organized prudential regulatory and supervisory system to make systemic crisis less likely'.[87] This statement summarises the scope of the potential challenge that may arise as well in the hedge fund context.

However, it must be equally said that the challenge of financial innovation poses the requirement that we must first *understand the nature of the threat*. And it seems clear that this has either not been the case among relevant public officials or that there has been insufficient political will to rectify some of these problems. This may be summarised in the aphoristic notion that, what we do not understand we fear; what we fear we regulate.

A proposal that merely provides for enhanced disclosure, and that provides for sharing of such data is an improvement on the current system. But knowing that the car tyre has a flat does not fix it. Someone must have the tools – the remedy – to respond in an appropriate manner. Moreover, political will to address these issues must be expended carefully lest it replace the concerns held over incentives to take excessive risk by counterparties and the limited ways to monitor this on the part of financial institutions (not to mention supervisors). A well-calibrated response is essential.

But there are other issues that should be addressed, such as the role of the gatekeepers – the credit rating agencies – in helping to lead some counterparties to take risks that were not well understood because of the complexity of the financial products, in a reprise of the concern over the role of gatekeepers in the Enron scandal.

Further, there is some concern over to what extent the central bank may wish to explore Bagehot's suggestion that it may buy up collateral. In a current financial situation where many highly leveraged institutions may be viewed as 'too complex to fail', the central banks should contemplate becoming market makers themselves.

Indeed, an interesting question is whether the US central bank has taken up Bagehot's suggested approach in the event of banks in financial distress. The answer: Bagehot's three-pronged solution is to lend liberally but at a penalty rate, and take collateral as security.[88] The US central bank partially took up Bagehot's suggested remedy by allowing for the pledge of collateral (much of which could possibly be illiquid) but provided banks with capital at concessionary rather than penalty rates.[89] The UK central bank has provided such penalty funding to Barclays in its own stigmatised discount window at 100 basis points over the normal lending rate (although only 12 basis points above other possibly available private facilities). It is further suggested, interestingly that banks should be market makers of last resorts as to any illiquid securities such as CDO's, SIV's or SIV lite's as a means of setting a floor and re-selling them in the market.[90]

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whether such disclosure is *sufficient* is another matter. And, importantly, the question of whether enhanced disclosure remedies the issue of mis-aligned manager incentives to maximise investor returns remains. Moreover, at the other extreme, the fact that a fund may burn out and a manager may start up again with another pool of capital raises the issue of survivor bias generally as to the industry and its indices. See 'Who'll take the Toxic Waste' found at <www.glynholton.com>.

86 S Jones, 'Banks don't know what they are doing', 31 May 2007, found at <www.iflr.com>. S. Fleming, 'Crisis would test new bank rules', 8 February 2007, found at <www.europeanvoice.com>.

87 Id. at Jones, p. 1. See also argument of BIS economist William White that a new macro-prudential framework is needed to provide the right conditions for financial stability and that Basel II is imperfect, found at <www.europeanvoice.com/archive/article.asp?id=27323>. Finally, on the consultation process as to transparency and structured financial products for the Committee of European Securities regulators (CESR) go to <www.cesr-eu.org>.

88 W Bagehot, *Lombard Street* (1873), cited in J H Wood, 'Bagehot's Lender of Last Resort', found at <www.independent.org/pdf/tir/tir_07_3_wood.pdf>.

89 *The Economist*, 'What would Bagehot do?', 16 August 2007.

90 See W Buiter and A Sibert, 'The Central Bank as Market Maker of Last Resort I-IV', found at <maverecon.blogspot.com/2007/08/central-bank-as-market-maker-of-last.html>. The question of how effective this may be as a remedy under current or future circumstances is discussed in Part Three of this article, to be published in *International Corporate Rescue* Vol. 5, Issue 2.

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C. Current initiatives and concerns

As indicated above, even though there is evidence that the Secretary of the US Treasury has long amassed an interagency group to address these issues, there is no clear statute or set of rules that appears to address how such issues would be resolved in an orderly fashion. There is certainly a high level of awareness from certain staff members of the New York Federal Reserve.[91] Whether this constitutes preparedness and sound stewardship is another matter and is difficult to determine in the absence of more detailed statements on how potential hedge fund insolvency would be resolved.

Rather, from the case studies considered below it would seem that such an event would be handled on an *ad-hoc* basis with a first initial assessment as to the extent of the risk to the financial system, thereby providing a basis for some involvement of the government authorities; a second process of monitoring and surveillance as to the impact on the prime broker; and a review and analysis as to whether it is to be left to the private market solution of corporate insolvency processes, articulated in Part One. Alternatively, perhaps because of the nature of the issues, including the possibility of systemic risk, it may be that the remedy involves utilising some of the traditional methods of banking insolvency. This appears to be the present situation, and may be workable but it does raise questions as to whether further clarity on this issue would not be desirable.

In the case of the UK, the FSA is as shown below, is more closely monitoring those institutions that would be seemingly problematic, due to their asset size. Leverage levels have gone down according to FSA surveys. This, however, may be misleading as taking risks that exceed certain levels onshore to an offshore unit (perhaps affiliated with the fund), or re-characterising transactions in a clever manner offer ways to 'game' the risk based frameworks.

Importantly, there may be an alignment of interests as to the prime broker and as to the hedge fund itself as they are able to raise more fees or engage in riskier transactions with more leverage than 'value at risk' (VAR) models might prudently suggest. This does not mean that hedge funds or investment banks do not have an incentive to maintain strong standards as to risk; rather it is to suggest that risk-taking funds may be able to undertake these transactions in a relatively opaque manner, without undue scrutiny.

It is not altogether clear how successful such monitoring really is with respect to sophisticated transactions using special purpose entities (never forget Enron). Moreover, even if the FSA's emphasis on extensively and directly monitoring funds of a certain size is useful, as further discussed below, we do not know the extent to which there is a correlation between the size of the fund and the likelihood of operational risk. Indeed, this would seem to present the classic case where it is necessary to monitor the largest funds, but not necessarily sufficient.[92]

A fund may not lie within the largest funds size parameters but due to its investing style, may be more prone to volatility, or it may be weaker due to less well-developed internal controls leading to fraud, for example. The implications for systemic risk of insolvency of a fund that does not meet the top 31 overall asset size threshold in the market as a whole is not necessarily less. This is of course within the context of what has been characterised as a flawed and possibly weak (although this is not the authors view) legal and institutional system for the resolution of bank insolvency in the UK, as previously mentioned. It would therefore appear that further thought about this issue is desirable.

It is not suggested that the FSA and the Bank of England do not have at their disposal various remedies that may be undertaken as to these issues, but indeed whether the lack of meaningful policy prescription is healthy in the event of possible financial collapse. Although it would certainly be a rational expectation that the above parties would act sensibly in the exercise of their discretion to alleviate a potential financial crisis, how useful such actions would usefully be has not been tested in this context. At the very least additional guidance, would be helpful.

Obviously, the Bank of England could exert pressure on banks to assist in providing financing, and could look for other deep pockets. Although as indicated in Part One, the UK regime for bank insolvency is based upon corporate insolvency, and significant amendments to this law have taken place since Barings, the question of how the regime would work with banks and the FSA to assist them in managing a financial crisis of this type would benefit from further public elaboration. No bank would readily offer a 'blank cheque', even if there was some continuing cash flow, unless: (i) it had sufficient collateral (somewhat unlikely); or (ii) if any funds that were exchanged as

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91 Found at <www.economist.com/finance/displaystory.cfm?story_id=9653092>. See Part One of this article for a discussion of policy statements, published in *International Corporate Rescue* Vol. 4, Issue 6, at 323.

92 It is acknowledged that, absent substantive concerns as to investment style it may not be appropriate for the FSA to pin point firms and announce their concerns as to their handling of risk. Such an announcement might effectively promote an exodus of the fund making its capacity to handle risk and indeed its actual performance a non-issue as skittish investors take flight. At least though greater information as to this issue would be made readily available. There are 31 funds that are apparently monitored more closely than the others.

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part of the transaction, were immune to defences which would allow hedge fund creditors to set aside the terms of such a transfer of funds as an avoidance on the insolvent estate.

Moreover, even if a syndicate of banks would provide such contingent credit line financing when the most serious of circumstances as to systemic risk were presented, valuing the losses of a fund would not be quite so easy to do. Therefore pricing any quick sale of a fund would bring with it enormous challenges. This is not to mention the current situation in which large international banks are seeking short term funding themselves, as is the case with the large US banks using the discount window.

Moreover, the issue of to what extent a *rule based* decision making process as to the calculation and resolution of a fund's liabilities as opposed to a *discretionary* one, presents a serious question in which there has always been healthy debate among academics and policymakers.

This debate, fundamentally, has to do with the issue of what specific events should trigger the banking insolvency procedures. For example, what provides the basis for a central bank to either eschew regulatory forbearance, or to perhaps provide the bank with conditions of moral hazard where it means that the bank may engage in riskier behaviour because it knows it will be bailed out (at least practically, in order to gain more time).

So, this brings us to the issue of what are the current mechanisms that are in place for regulation and to what extent should they be upgraded, as the above suggests. An extended review based upon law and practical experience follows.

D. US hedge fund regulation

Some legal commentators have suggested that to speak of US hedge fund regulation is a misnomer; no such beast exists. Some might call it a limited form of regulation with substantial elements of self-regulation in that only those Funds that seek to structure themselves as entities who must fully comply with the Investment Company Act (1940) will have to register with the SEC and provide a higher quantum of financial and operational information. Under the Investment Company Act (1940) those advisors of funds deemed to have '15 clients' or more have additional reporting burdens and are to be treated as fiduciaries.[93] However, some characterise the existing system as an indirect model of regulation as information passed through by prime brokers to banking supervisors provides a basis for the relevant agency (OCC, Federal Reserve, et al.) to keep a watchful idea on the Fund and its risk management practices.

These characterisations reflect a focus on various aspects of financial regulation; but there is no question that it is an area of substantial ferment, with clear signs of possible legislative action providing a basis for stricter regulation and possibly heightened compliance burdens.

Hedge funds are intended to benefit from various rules to avoid certain costs that may be incurred if the fund is not formed in the most tax efficient way possible and so is not eligible for certain key exemptions. These considerations are critical in the area of tax, securities law, and banking.

Legal entities are set up in the US as so-called 'pass through' entities to avoid corporate tax. This is accomplished by having the funds set up as limited liability companies or limited liability partnerships. As such, the fund entity does not pay tax on investment returns, although investors must pay tax on their individual gains. This eliminates double taxation that would occur if the entity was a corporation and paid tax at that level and then on the returns it provided to investors.

There are over 8800 funds accounting for 5% of total assets held but 30% of trading volume in the US.[94] Less than 20% of pension funds and corporate funds are placed with hedge funds.[95] Of those pension and corporate funds, about 5% of assets are invested in hedge funds.[96] However, there is a growing trend for investment in this sector.

About two thirds of endowments invest an average of 18% in hedge funds. Approximately 2500 funds have investment advisors registered with the SEC.[97] There is some evidence that advisors who register may have some preference among endowments and other large institutional investors to the extent that

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93 86 'The Act exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company. Advisers taking advantage of this 'private adviser exemption' must nonetheless comply with the Act's antifraud provisions, but do not file registration forms with us identifying who they are, do not have to maintain business records in accordance with our rules, do not have to adopt or implement compliance programs or codes of ethics, and are not subject to Commission oversight'. This extract is to be found at <www.sec.gov/rules/final/ia-2333.htm>. This was struck down by the Goldstein decision, referenced below.

94 Securities and Exchange Commission, Testimony Concerning the Regulation of Hedge Funds, found at <www.sec.gov/news/testimony/2006/ts072506cc.htm>.

95 Id.

96 Id.

97 Id.

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the increased disclosure requirement applicable to them provide comfort that such enhanced disclosure mitigates fund manager selection risk, and makes due diligence easier.

As earlier mentioned, one of the core drivers of hedge fund formation is exemption from US regulation, specifically the registration requirements under the 1933 Securities Act. Hedge funds therefore issue securities under private placement rules whereby accredited investors (high net worth persons who meet certain asset/income level tests, and likewise, institutional investors) purchase securities on the basis of a prospectus/offering memorandum.[98] However, advisors and funds are still subject to section 10b of the Securities Act (fraud liability) among others, and are subject to securities rules applicable to other market participants. They also owe fiduciary duties to their investors.

Fees are usually based on a 2% management fee and 20% performance fee triggered when a certain hurdle rate is achieved. Redemption periods vary but it is not unusual to be able to withdraw funds with a 45-day, quarterly, or yearly notice period. Funds are not directly regulated as to their use of leverage or other margins that they may keep with prime brokers.

Major concerns have arisen over the extent of market risk which funds may have, based upon the volatility of their positions in the market. Hedge funds are responsible for up to 40% of daily market trading, and 30% of fixed income trading.[99] This represents an enormous amount of market power.

This market power is disproportionate to the small size of the funds relative to other asset mangers in the markets. Notwithstanding this market power, the SEC's capacity to enforce the law as to hedge funds is somewhat more limited than it would be as to a registered securities offering (although registered investment advisors are subject to more rigorous scrutiny).

The SEC's attempt to expand the scope of its power as to the hedge fund industry by requiring hedge fund managers (with management of over USD 25 million, and 15 clients) pursuant to the Investment Advisors Act 1940 to register by 1 February 2006, and apply risk based methodologies to them was struck down by the *Goldstein v SEC* decision.[100]

In that case the court essentially took the view that the SEC did not have the authority to prescribe the rules in the manner it had. The rule has resulted in increased numbers of registered advisors, and some large institutional investors see registration as a signal of quality. The SEC has been attempting to fashion a workable rule to achieve its objective of heightened scrutiny through enhanced disclosure, and to toughen up its anti-fraud stance (diminished by *Goldstein v SEC*).

On 11 July 2007, the SEC adopted as final, Rule 206(4)-8, which applies to all investment advisers to pooled investment vehicles, even if the advisor is not registered. Importantly, a pooled investment vehicle is defined to include any investment company, as well as any hedge fund or other fund exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act (1940). The new Rule does not allow 'a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements to, or otherwise to defraud, investors or prospective investors in that pool.'[101]

US Federal Reserve Regulation T (12 CFR 220) sets a 50% limit on how much 'margin' a securities broker may allow a security to be purchased with (although there are various mechanisms as a matter of industry practice, which effectively diminish this requirement).[102]

In addition to the above many hedge funds are also commodity pool operators (for example those trading on futures and options, otherwise known as commodity options). Such funds have been subject to certain exemptions from registration (most notably through Rule 4.7 which, the Commodities and Futures Trading Commission (CFTC) provided, to the extent that qualified eligible persons are investors in the fund pool, and it is not otherwise marketed to US investors.[103] It should be noted that margin accounts on commodity products

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98 Sections 3(c)1 and 3(c)7 of the Investment Company Act of 1940 provide the specific exemptions for funds with fewer than 100 investors (a '3(c) 1 Fund'). Funds where the investors are 'qualified purchasers' (a '3(c) 7 Fund') have individuals or institutional investors with over USD 5,000,000 in investment assets. The difference between a 3(c)1 Fund and a 3(c)7 Fund is that the latter can have an unlimited number of investors, while the former is limited to 100 clients.

99 See generally <www.eurekahedge.com/> for background information (proprietary database); See also 'In U.S. Fixed Income, Hedge Funds are the Biggest Game in Town', 20 August 2007, found at <www.greenwich.com/>.

100 *Goldstein v SEC*, No. 04-1434, DC Ct. App (23 June 2006). See also A Peter and M D Kinzman, 'SEC Quest to Regulate Hedge funds hits Seed Bump' found at <gbr.pepperdine.edu/071/hedgefunds.html>. For another good discussion of this issue and its aftermath see <www.eurekahedge.com/news/11_july_Sidley_HedgeFund_Rule_Vacated.asp>. Some hedge funds also sought to avoid registration by using 25 month lock up periods for any investment capital accepted, a technique available to private equity funds.

101 See discussion found at <www.sec.gov/rules/final/2007/ia-2628.pdf>.

102 This may be found at <www.federalreserve.gov/Regulations/#t>. See also Regulation U, 12 CFR 221, relating to Credit by Banks and Persons other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock, and Regulation X, 12 CFR 224, Borrowers of Securities Credit. There is significant criticism that this rule is easy to bypass in many financial blogs, for example.

103 See CFTC Regulatory Brief: CFTC's New Rules Applicable to CPO's and CTA's, 16 October 2003, found at <www.hedgeweek.com/articles/detail.jsp?content_id=9426>.

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often are traded with over 20% rather than 50% margin in Joint SEC/CFTC Rule 400-406.[104]

E. UK hedge fund regulation

'In this, as in all instances of threats to financial stability, it is important to identify the probable transmission mechanism: what would be the process by which the collapse of one or more hedge funds might lead to wider threat to the financial system? After all, the collapse of a hedge fund, unattractive though this is for those who have invested in it, is not of itself a prudential issue. The direct transmission mechanism would be the effect of a hedge fund collapse on the hedge fund's counterparties, and in particular on the prime brokers, so much of whose business is now with hedge funds. It is this which has led the FSA, in the first instance, to seek to assess and address the possible prudential risk of hedge funds, by ensuring that we understand the exposure to, and management of, hedge fund risk by the prime brokers.'[105]

In the UK, hedge funds themselves, under a so-called risk based framework are directly regulated and have been the subject of extensive study as to their core characteristics in an October 2006 survey.[106] The FSA focuses its regulation on the 15 most important prime brokers and the 31 most important hedge funds.[107]

Risk mitigation efforts involve frequent discussions and proactive surveillance (as above). Most hedge funds typically present a low impact risk rating, participating in global forums such as the Financial Stability Forum (FSF).[108] Funds require authorisation typically under FSMA Article 37 managing investments or Article 53, advising on investments. Individual managers are vetted to determine if they are approved persons. Senior managers must follow certain risk based guidelines (SYSC 3.1.1R), as well as conduct of business rules, and market abuse rules. Liquidity risks are discussed as an issue of some concern.[109]

VI. Patterns of response

A. US cases and the UK

There appear to be a limited number of insolvency cases reported involving hedge funds relevant to hedge funds' liability, or issues reflecting large hedge funds failure in the UK (although Cheyne Capital has recently asked for a stay and may otherwise end up in receivership).[110] The US has recently had a greater number of smaller scale failures, although it has some huge past failures such as LTCM and Amaranth. The most important reported cases are further discussed below.

1. Drexel and LTCM

Probably the financial crisis from which the most lessons can be learnt for today's policymakers is the collapse of the Drexel brokerage, followed closely by LTCM. As the main issues surrounding LTCM and its purchase by a group put together by the New York Federal Reserve, have been previously mentioned as well

Notes

104 See Customer Margin Requirements for Securities Customers found at <www.law.uc.edu/CCL/p242/rule400.html>.

105 D Waters of the FSA, 29 March 2007, Regulation of Alternative Investments, found at <www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0329_dw.shtml>.

106 See id. 'hedge funds to which these broker-dealers are exposed are continuing to grow strongly, with assets under management in total (on an equity basis) now US$658bn, an increase of some 33% from our survey in April 2006. This significant increase is partly as a result of the increase in the number of firms reporting global numbers; but even a direct comparison from the figures reported in April shows a 10% increase in the intervening six months;

exposure to hedge funds is concentrated in two prime brokers, which have slightly less than half the business. For detailed reasons I won't go into, we believe this concentration figure probably misrepresents the true position, which is less concentrated;

aggregate leverage (calculated as industry long market positions divided by industry net equity) decreased slightly between April 2006 and October 2006 from 1.86 times to 1.66 times (we have changed our methodology for calculating this headline rate since the April 2006 survey). It is important to note that this only captures leverage through the prime brokerage business, and does not capture embedded derivative leverage. It is worth pointing out that LTCM routinely operated on a long leverage of 25 times, and as it approached crisis, more than 50 times;

average excess collateral increased slightly, from 86 to 91 per cent, representing an increase in the spare capital funds are holding with their brokers;

contrary to the view that funds divide and rule between many prime brokers, only 19 of 154 hedge funds had more than one prime broker;

Multi-strategy funds saw a significant decrease in leverage between April and October; and 5 of 181 individual exposures were on margin call, representing 0.3 per cent of total individual exposures.'

107 Id.

108 Id at p. 15, 18-38.

109 Id. at p. 30-33.

110 S Farrell, 'Cheyne Capital Asks for Stay of Execution', 30 August 2007, found at <news.independent.co.uk/business/news/article2909557.ece>.

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as their specific implications for insolvency law, they are not treated here in detail.[111]

One point to note is that the primary concern of the US Federal Reserve was to have the 16 counterparty creditors buy 90% of LTCM with USD 3.6 bn and take operational control to avoid the destabilising effects of unwinding the complex portfolio of derivative contracts in illiquid markets. The concern was that this might have led to cross-defaults, and spill over effects that could not be controlled. A managed resolution was considered to be better than an uncontrolled one.[112]

Drexel was among the pre-eminent US brokers of securities in the 1980s; but when he pleaded guilty to fraud (Michael Millken brought the firm into disrepute) various other events conspired to create a liquidity crisis for its sales of certain bonds. Consequently, as the secondary market dried up, one brokerage part of Drexel had to borrow from an affiliate to keep solvent (with the approval of the SEC and NYSE). However, when banks would not provide a bridge loan, the game was up: it had to file for bankruptcy.

The most interesting aspect was that both the New York Federal Reserve and BOE stepped in to set up a settlement facility to allow trades to settle between other parts of Drexel when there were concerns about: when Drexel would fail; rights of set off; and, other issues that would have created payment dilemmas. The BOE's actions helped stave off a worse crisis and provided a basis for orderly resolution.[113]

2. The Bear Stearns Case I

Probably the most significant case to sharpen the minds of hedge fund watchers is the recent Federal Bankruptcy Court decision of Judge Burton Lifland.[114] The judge determined that Bear Stearns, as the prime broker for the former Manhattan Investment fund, was liable for damages to certain investors, because they crossed the line from being mere conduits for funds to become transferees who knew or should have known that fraud was taking place when transfers between Bear Stearns were taking place to collateralise trades.

The investors had previously sued (and lost) on the basis of an alleged securities law violation whereby Bear Stearns knowingly aided and abetted in the actions of the above hedge fund. But whereas the standard of proof as to the requisite level of material knowledge was not met as to this violation, in view of the Court's decision in the securities law matter, the standard of proof was met as to the bankruptcy action.

This leads to a series of important questions, only some of which will be addressed here: What is the requisite level of knowledge? Should a prime broker know more, consistent with certain legal obligations? Or, perversely, does having more knowledge create a legal risk, thus creating a moral hazard?

Further, what about the role of Managed Funds Association's 'Sound practices for effective hedge fund' management in the US – should they play a role as to the risk based standards that a prime broker should have?

If they did, it would indicate that a professional duty exists. In turn this would effectively establish constructive knowledge on the part of the broker as to his duties. Moreover, to what extent does this present the possibility of regulatory arbitrage where funds may move their activities to the UK, for example, to avoid the implications arising from the Bears Stearns decision, as funds become fearful of liability exposure due to the application of the low 'constructive knowledge standard'?

As the above shows, the Bear Stearns I decision raises a substantial set of serious questions for prime brokers and for hedge funds. For purposes of this analysis, the focus is on understanding the core law and facts of the case, and how investors may have another open door to pursue, when a hedge fund fails.

It will then review the impact this important bankruptcy decision may have in preventing crisis, as well as some of the international ramifications. The author will consider prudent measures to undertake in light of the above and the dilemmas that this decision poses. This section will therefore address these concerns and provide some observation and reflection as to the questions listed above.

First, the impact of the Bears Stearns decision will ultimately depend upon its treatment on appeal. It is likely to be quite contentious and unresolved until the end of 2007, but should be ultimately reviewed no later than 2008. It should be noted, as the decision itself points out, that certain aspects of the case, such as the use of the dominion and control test present conflicting interpretations where confusion has arisen. To the extent that this decision falls within these parameters and is also of substantial public importance, the Supreme Court may exercise its discretion and hear this matter as to this issue.

Bear Stearns' defence has, essentially, been to argue that public policy dictates that it should not be acting as the insurer of the hedge fund. There is no question that this is a view that many in the Wall Street Bar would in-

Notes

111 See *supra* note 36 for LTCM report.
112 See R Herring *supra* note 66 at p. 33-34.
113 Id. at p. 9-14.
114 See J Creswell, Bear Stearns told to pay 160 million, *NY Times*, 16 February 2007; see *Gredd v Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, __ B.R. __, Adv. Pro. No. 01-2606, 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007).

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tuitively have sympathy with. After all, it could well be argued that such a risk was not priced into the services rendered, which reflected just the cost of capital and some other administrative work. If the risk was priced into the services rendered, costs would go up for hedge funds.

If parties such as Bear Stearns were responsible for such risk an effect would be to potentially place investment banks in a position where they were liable for fraud in a situation which they were not really closely monitoring.

Costs for funds are estimated to range from 6 basis points to over 120 basis points for implementation of operational risk safeguards. For smaller funds this is a potentially troubling issue in view of the compliance burdens imposed on them as to records, which presumably they would have to enhance to keep with new requirements that prime brokers would impose to avoid being exposed to constructive knowledge liability.

The standard of proof needed to establish constructive fraud, especially is far lower than that needed for actual fraud. In order to steer clear of such charges substantially more due diligence than appears to be currently undertaken would have to be performed.

Banking and financial services lawyers, used to the defence of disclaimers on their opinions with respect to, would be naturally sympathetic to the greater due diligence required. This is especially true when the standard for establishing that there has been a lack of good faith has been set at the lower level of constructive fraud.

On the other hand, there is no indication of legislative intent to take the broader concerns about this type of conduct, and its potential for inducing cross default, and apply it to this more narrow context. No doubt, appellate lawyers will find in the securities law jurisprudence some further evidence of such legislative intent, but on the case law presented, the narrow view seems the better one. This is also suggested in that Congress, does not appear to have foreseen such activity of stock lending to hedge funds.

In any event, such an extension of a stockbroker's defence appears to run straight into the Court's recital of certain express provisions. In the absence of some argument that such an interpretation is absurd (or trumped by some other means), it is difficult to foresee a persuasive alternative view.

Until final resolution, there will be some uncertainty as to the reach of this decision. Prime brokers would be wise to seek advice and to ask questions regularly of their clients when they could reasonably be deemed on notice of any possible fraud.

Records should therefore be kept well up to date, and at the level described above. A failure to provide such information essentially represents a strong basis for credit to be tightened or even cut off; this may especially cause problems for funds with certain types of style where volatility is high.

Risk may also be heightened and therefore need for greater funds oversight demanded where concentration risk issues are likely to grow, and it is not just a simple discrepancy or circumstances pointing to potential operational risk (fraud) issues.

The SEC rules, NYSE rules, and other actions would clearly not by themselves provide cover in that compliance took place along these lines and nothing further. Adoption of the MFA guidelines would appear to be one solution, provided proper implementation follows. Strong internal corporate governance to prevent the lure and temptation of fee income from hedge funds or too cosy relationships from overshadowing a good bank/client may be quite helpful to prevent Enron-Anderson type conflicts from arising.

Redrafting of contracts and the development of a new boilerplate set of provisions whereby the bank shifts the burden of disclosure to the hedge fund is unlikely to be terribly helpful in shielding the bank for liability: this is, after all, constructive fraud, we are talking about.

To this extent, the above decision may help raise the level of risk management and therefore help prevent insolvency. There could always be a market solution: an insurer. This is already done in a limited fashion by funds of funds, but it is a sophisticated financial product requiring parties to really know how to assess risk, and to purchase said securities only in this light.

Next, the above presents opportunities for firms to simply 'not want to know', because then they could avoid the fact that they would be on notice of the need for inquiry. This is a classic *moral hazard*, and is therefore a potentially perverse consequence of this decision as firms shift the burden to other gatekeepers of compliance (such as accounting firms) so as to 'pass the ball' and minimise their own risk. Setting up such conditions for taking on or maintaining certain status with clients is probably a likely consequence of this as investment firms' seek to intelligently minimise their liability.

Internationally, this presents some opportunities for regulatory arbitrage, from the fund manager's point of view, as it may be prudent for certain transactions to take place in jurisdictions where the notice requirements on brokers are less strict, and or gatekeepers are less regulated as their financial reporting.

What is prudent here? As indicated above, establishing constructive notice places an extremely high burden on prime brokers. Actual notice is perhaps too lax. Finding a mechanism between these two that is well articulated would present a better result than the troubling Bear Stearns decision would (if it is left to stand). It, of course, may be argued that this is not really that problematic; after all the prime broker can just ask the gatekeeper for more information. But the Bear Stearns approach implicitly raises credit standards by tightening the basis upon which a fund may avail itself of a bank's resources. It may also provide the basis for acceleration of certain contracts (a margin call), and could also be quite expensive for a fund needing to

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model its way out of a crisis with its broker. It would also raises concerns as to the efficacy of cross margining in the event of any fraud and insolvency litigation, and this would be an expensive legal defence to mount for a broker.

Of course it could be said that Bear Stearns encourages market discipline as enhanced disclosure provides a basis for dealing with issues earlier, in a more risk-averse context. Rational banks would price the increased risk, and rational hedge funds would not take further risks because it would not want to pay extra basis points.

However, recent crises have suggested that this will definitely create conditions for increased liquidity risk as to the funds, at an early stage, thereby possibly facilitating more fund dissolution. Whether this does create sufficient incentives to avoid *even greater liquidity risk* through this mechanism is at the heart of deciding the impact of Bear Stearns I.

3. Amaranth – September 2006

Bankrupt Amaranth Advisers was a US managed fund that sought to take advantage of pricing 'anomalies' in the market, energy trading, merger arbitrage, and usual stock trading. Amaranth lost nearly 50 percent of its value, or USD 5 billion *in one week* from its previous USD 9 billion level.

Why the losses? Amaranth essentially bet that a hurricane or other natural disaster would happen and that they could benefit by trading on the spread in the price of natural gas futures, on margin. Essentially, if there was bad news, then the demand for liquid natural gas would be expected to rise, fuelling a price rise as to certain future deliveries. Although trading on margin on stock exchanges normally requires 50 percent capital as collateral (Regulation T), trading on margin in options and futures typically requires only 20 percent capital as collateral, unless a suitable mechanism can be found to decrease the collateral. This is highly leveraged: gains or losses are magnified (Amaranth was reportedly leveraging 8:1)

A total of USD 6.5 billion was lost, forcing a transfer of the portfolio to third parties by 20 September, suspension of trading by 29 September, and a liquidation process that would begin by 1 October. To investors familiar with Barings and the case of Nick Leeson it should have been obvious that if the strategies used lead to massive profits, that they may also go in the other direction, unless appropriate controls are put in place. Here, it was obvious that here they were not.

The most interesting aspect of this insolvency was that it had no broader impact and no government efforts were undertaken to bail out the fund. Market reaction was muted in the sense that there was little if any broader impact on liquidity, for example.

Systemic risk was not an issue, in contrast to the only other large scale hedge fund collapse, LTCM, where such worries were clearly at the heart of the government's efforts to restructure the fund.

4. Bear Stearns II and Bear Stearns III – insolvency dimensions

Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear-Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. filed highly publicised insolvency liquidation proceedings in the Cayman Islands on July 31, 2007. This was due to a massive devaluation of their subprime mortgage-based asset backed portfolios and inability to meet trade counterparties' margin calls. The funds asked the US courts for recognition of the foreign proceedings in the US under Chapter 15 of the Bankruptcy Code when the Cayman liquidation proceedings began.[115] The core claim was that the foreign main proceedings were in the Caymans, or alternatively that they were at least foreign non-main proceedings, which could be the basis of discretionary protection.

Judge Burton R. Lifland, disagreed with both these arguments. There would therefore be no automatic stay in the US for Bear Stearns creditors. The core point was that since the fund did most of its day to day business in New York it was based in New York (despite no registration). It could not be credibly argued that the Fund's centre of main interest was in the Caymans when the designation there as an exempt company compelled it to transact business overseas. He also said that there was no business establishment in the Caymans, such that it could not even be deemed a foreign non-main entity. However, a temporary stay was issued to allow the Funds to file an involuntary Chapter 11 petition decision.

What this means is the funds who counted on overseas proceedings providing some protection against US creditors, as well as the use of foreign courts for resolution of such disputes, is in doubt (if the decision stands – the parties have 10 days to appeal).

The impact of this will be felt in the US as well as globally in that this is one of the first tests of recognition under Chapter 15, and similar issues will arrive in the UK under its UNCITRAL based cross border banking insolvency rules.[116]

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115 <www.nysb.uscourts.gov/opinions/brl/158969_24_opinion.pdf>.
116 See <www.mofo.com/news/updates/files/12713.html>.

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B. Possible responses under the US regulatory regime: overview and application of UNCITRAL cross-border insolvency model law through Chapter 15

There have been a number of well-known cases where fraud and insolvency issues have arisen. The most well known among these are the LTCM matter and the case of Amaranth. Recent cases, pending in the Cayman Islands will present issues as to the application of Chapter 15 to offshore funds whose centre of main interest (COMI) would appear to be in the US, thus effectuating jurisdiction of the dispute relating to this issue to be transferred back to the UK.

There is also the issue of what role hedge funds play when a business collapses. In this regard, we can see a number of interesting issues, which have arisen, as to how hedge funds themselves have changed the rules of the game as to corporate insolvency.[117] Further, hedge funds themselves, such as in the recent ABN-AMRO matter have become activist investors and have sued companies in which they have invested as shareholders when they feel aggrieved.

The above cases although they do not represent all of the issues arising from hedge fund insolvency represent among the most significant matters; and, at a minimum, as hedge fund collapses have recurred over time, show that there is no rush to intervention on the part of Federal authorities. Although the collapse of Amaranth did not precipitate a financial risk of a systemic nature, it does provide further evidence that the need for a rapid response system in the event of such failure is desirable, in the event of a more significant crisis. In a generally benign global economic climate, where the usual 'business cycle' has not reflected a recessionary element for many years, it is somewhat more likely that the future will be more turbulent.

Among well-known legal commentators, there is the expectation that causes of action will be undertaken containing allegations of fraud and aiding and abetting in securities fraud actions; as well as avoidance issues such as in the Bear Stearns I matter. Moreover, claims in negligence for breach of professional standards against fund managers, have also sprung up (e.g., the well-known Chicago Art Museum and failure of due diligence case). When things go bad, it is to be expected that more of these suits will be filed, as investors seek someone to blame who has deep pockets in order that they can be compensated for their losses.

The clear expectation is that as most funds are located offshore, the first issue for resolution will be which locations are relevant for the purposes of the insolvency jurisdiction.

C. Implications for resolution of crisis and insolvency law

There are certain critical observations that can be made here as to what steps need to be in place. The first is that there appears to be an absence of an adequate crisis response mechanism that would handle a truly global financial crisis, although the formation of the work of the Trilateral Hedge Fund Review Group (TFHRG) represents a significant step forward. Further the work of the G8 represents welcome attention to a timely issue. One former IMF head has addressed the broader issue of the role of risk by asking 'Has Financial Development Made the World Riskier?'[118] The issue is on the minds of some of the best economic, financial, and legal minds in the world.

However, the capacity to identify the issue is distinguishable from the capacity to find a mechanism whereby there is political will to respond *ex ante* to any truly systemic risk. In this regard, it is hoped that it does not take a crisis for democratic governments to respond; a financial hurricane of Katrina proportions would expose many social and economic problems.

Rather, as indicated above one positive step is for the BIS, through the Basle Committee on Banking Supervision, to take the lead in developing, in cooperation with the Financial Stability Forum, a co-operative mechanism whereby the mechanisms to prepare for such financial shocks, and the protocols for how to deal with them are in place so that a credible, rapid response may take place.

The Financial Stability Forum has already engaged in significant work and has essentially indicated that the benefits of providing liquidity must be balanced by improving on the lack of transparency about counterparty risk. They have therefore issued five core recommendations, which are set below in summary fashion:

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117 These include, for example, cases whereby the Trustee allows the Hedge Fund to participate in the bankruptcy process due to its 'long' exposure when it actually has its risk offset and would not otherwise really be involved in the process; concerns as to whether non-fiduciary distressed investors are provided with informational advantages which they may be able to capitalise on; whether hedge funds as lenders have breached confidences when acting as insiders, thus taking advantage of the informational asymmetry to commit fraud, and further concerns as to increased litigation generally including inter-debtor conflicts, valuation, vote designation, holdouts, new lender liability theories, and other critical liability concerns.

118 See <faculty.chicagogsb.edu/raghuram.rajan/research/#intfin>, advocating that the government play a role but eschews a 'heavy hand'. Providing incentives for financial intermediaries to be discouraged from excessive risk taking is identified as the critical issue for government institutions.

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'1. Supervisors should act so that core intermediaries continue to strengthen their counterparty risk management practices.

2. Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity.

3. Supervisors should explore and evaluate the extent to which developing more systematic and consistent data on core intermediaries' consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts.

4. Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information.

5. The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.

The FSF underscores the importance of ongoing cooperation among financial authorities in taking forward these recommendations and in spreading good practices.'[119]

Similarly, the Trilateral Hedge Fund Review Group comprised of the FSA, New York Federal Reserve, and the SEC is working on information sharing and co-ordinating responses to shared risk management concerns. And, there is no question that the perceived threat and need to be vigilant on the part of these agencies is present. As SEC Commissioner Al Nazareth more generally observes: 'As hedge funds' importance to financial markets increases, their potential systemic impact also increases.'[120] She also points out that in light of the President's Working Groups on Counterparty Risk Management that strengthening in this area is a matter of ongoing concern.[121]

The core agenda is summarised below, but it is the development of broad based political will that leaders should act prudently to help steward the global economy in times of market failure which is crucial. This does not mean that issues of moral hazard and its impact on the resolution of financial crisis will go away. This is an ongoing and enduring debate; but at a bare minimum it would seem that consensus should be developed, subject to the discretion of senior decision makers.

At this time, a light touch is clearly better than a heavy handed approach, and seems preferable to a hands-off perspective. The recommendations below follow from the discussions in Part One and Part Two that have exposed the core elements of concern in causing and then limiting the damage from hedge fund insolvency.

1. *Enhanced Information to further market discipline as well as facilitating appropriate public responses by financial authorities*. During financial crisis, providing clarity as to the condition of financial institutions is crucial. Such information is readily available to bank supervisors, as a condition of licensing. Accordingly, the central banks and/or financial regulators can determine which policy instruments are appropriate if financial stability is truly threatened and there is a systemic threat to global financial systems. Commissioner Nazareth's concern that enhanced disclosure of counterparty risks is a grave issue. Whether this takes place in a direct manner as the UK typically tends to do or in the manner that it is undertaken in the US through prime brokers, is less important than effective implementation of sound, risk based guidelines that provide the basis for an early warning system as to risks that may have implications for the global financial system. Informational issues should be looked at carefully and a debate on the extent to which and how informational asymmetries exist should be carefully considered in order that, if appropriate, proposals are presented for reducing this.

2. *Strong prudential standards for direct as well as prime broker regulation should be globally reviewed and strengthened*. This includes consistent implementation and development of best practices such as those that the MFA has for hedge funds. Such guidance would provide for a defined set of criteria as to how to manage risk through effective collateral requirements, clear standards as to margins and cross margins, requirements similar to those from the Basle Committee for financial institutions as to back testing and enhanced risk measurement in the valuation of portfolios for various risk elements, including counterparty risk. This is already done through the use of credit risk, market risk, counterparty risk, and other risk metrics. It is facilitated through the EU Directives as to the Supervision of Financial Conglomerates, Consolidated Banking supervision, and of Consolidated Supervised Entities in the US regime and should be further extended.

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119 See FSF Press release 19 May 2007. This report builds upon prior reports issued by the Basle based FSF as to Highly Leveraged Institutions (HLI) issued in the wake of the LTCM debacle

120 See Remarks of Commissioner Al Nazareth at PLI Hedge Funds Conference, 6 June 2007, New York, found at <www.sec.gov/news/speech/2007/spch060607aln.htm>.

121 Id.

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If the provision of enhanced information is the first step through some direct or indirect mechanism, then having a basis to more quickly and effectively determine the risk is the second step. A review of how risk is re-allocated and to what extent brokers may have to adjust their collateral requirements so as to limit the real exposures of the clients may take place to some extent if Bear Stearns I is upheld, as it will be a wake up call of sorts. However, reconsideration of the optimal methodology by which to judge risk, based upon quantitative studies and policy analysis, along with real consequences, is needed. The Bear Stearns I case also points out that the issue of when a prime broker may be deemed to be on notice such that it will be liable is urgently needed. The point at which credit must be cut off is essential for all parties to be aware of to avoid legal risk as to insolvency proceedings

An example of a problem area is the use of 'side pockets' whereby hard to value assets may be segregated making it difficult for valuations of the fund and the true extent of illiquidity to be known. Even if there are limits as to this activity, it presents some special challenges in times of illiquidity. This is especially true as the manager may have a conflict of interest as to valuation of any such side pocket when redemptions are based 45 days, quarterly, as opposed to being locked up for at least a year.

3. *Insolvency, Transparency, and HLIs*. The proliferation of derivatives makes this essential, and this solution is therefore coupled with the need for enhanced risk based disclosure, so that the risk is not transferred to counterparties who may not be able to cover their positions. The days when financial intermediation took place through banks have disappeared; one can bypass the banks directly and purchase various types of financial products in the OTC market, for example. The level of risk that the prime broker undertakes as to credit issues generally and as to counterparties specifically should be priced into the risk already, but the question of remedies available if this breaks down is fundamental. A discussion of whether some of the elements of resolution that work in the context of banking insolvency should be directly as opposed to indirectly applied to hedge funds should begin to be discussed. It may well be that providing assistance to financial institutions who then provide liquidity to affiliates and allowing funds to benefit from such injections of capital is a good enough partial solution. Further, it is sometimes the case that a firm is not better off as a going concern but rather that it should fail. However, seeing how some of the advantages of banking insolvency may be integrated into the resolution of hedge funds insolvency should be revisited, and empirical studies undertaken as to its impact as compared to corporate insolvency regimes.

As referenced in Part One of this article, the EHYA has articulated substantial concerns about, for example, UK corporate insolvency legislation as to its efficacy in promoting rescue as opposed to liquidation for corporate firms. Given the presence of similar complexity for hedge fund insolvency, it is apparent that UK insolvency reform as to hedge funds should be considered as well. However, by this the author is not suggesting that the EYHA is necessarily correct.[122]

4. *Cross border monitoring and surveillance, regulatory arbitrage, and insolvency issues must be increased, especially as to issues pertaining to fund managers who may place assets in various jurisdictions.* (A recent case involving a private equity fund in the UK illustrates that under EU Insolvency administration the centre of main interest has been moved from Luxembourg to the UK for insolvency purposes, notwithstanding that it would ordinarily apply to the place of incorporation.) The cases taking place, such as the further Bear Stearns cases should be looked at for any impact that they will have on insolvency practice. The differences in the UNCITRAL Model Law as implemented in practice are important to assess in terms of their possible potential for arbitrage among internationally oriented fund managers.

5. *Netting*. A systematic comparison of whether the current netting regimes are optimal given the experience of various cases, should be undertaken. This is an important finding of Professor George Kaufman's recent research, and must be addressed. (This is especially the case as multi-strategy asset class funds use strategies in which cross-margining strategies may be pursued to offset certain exposures.)

6. *A review of the* application *of mark to market accounting is clearly an area of concern*, to the extent there are incentives to inflate values, without any downside. Accordingly, one of the most important concerns is to provide the funds with a strong audit function where there are sufficient incentives to discourage taking aggressive valuation positions. Looking at what has worked vis-à-vis Sarbanes Oxley and the Turnbull

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122 The incentive of hedge funds when they buy debt at discount may provide them with an incentive to liquidate quickly. Those creditors who have collateral (which may include hedge funds) will perhaps be most inclined to wait it out in a possible insolvency process such as administration. High yield bondholders may be the last in line to be repaid among many creditors and liquidation puts them in a typically worse off position than still holding the bonds of a restructured company wherein the junior bondholders have had to undergo a significant haircut. Further, the point is well taken that the presence of multiple creditors (such as hedge funds) who have bought bank debt on the secondary market will add complexity to the process as numbers increase. The hold out creditor issue is also important.

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guidance without copying either in its entirety would be a good step.

7. *Corporate Governance must be strengthened so that investor interest is better aligned with managers and agency costs are reduced. To a limited extent disclosure of compensation structures, financial record, and credit rating review of fund of funds, and registration of investment advisors may help achieve this objective, but only indirectly.* However, further reputational risk/compensation incentives for managers so as to avoid excessive risk taking in order to 'game' the financial reporting system, or to generally take undue risks without a strong brake applied by the prime brokers is critical and is worth reviewing. This is made more problematic as large funds have multiple brokers in order to take advantage of capital introduction services, and other aspects of the prime brokerage package.

8. *The Gatekeepers, such as credit rating agencies must have stronger incentives to be cautious with their ratings.* Providing some public information as to the performance of the agencies for problematic funds, and then providing some type of possible certification by the agencies, in the usual absence of any liability may be worth considering. But certainly, exposing firms to the possibility of reputational review is a good step.

9. *The legal (cannot sell), and market based or technical sources of illiquidity (information problems, fear and greed in an atmosphere of uncertainty) should be studied to determine what can be done to better understand the trigger points of illiquidity, and then to systematically consider appropriate remedies.*

10. *The crisis should be viewed as an opportunity to remedy potentially serious deficiencies in the international financial system.*

VII. Concluding observations for the resolution of hedge funds in financial distress

> 'I think regulators will clearly need to engage with certain key hedge funds more holistically and more directly than in the past.'[123]

It is important to remember how the bail out process functioned when it involved a non-bank bank – the hedge fund LTCM potentially threatened large-scale crisis due to its bond trading mishaps. It seems apparent here that intervention was justified because of the impact on the banks through their prime brokerage operations, not the hedge fund itself.

But what of other failing hedge funds – should they not be bailed out too? Is it rational for LTCM to be the beneficiary of some financial relief, while Amaranth is treated as a different case?

Is this justifiable from a legal perspective? One answer to that would be that yes, it is. The whole point of discretion is that it is applied judiciously.

Some commentators have suggested that the LTCM bail out was product of serving interest groups such as the large banks, even though it produced a positive externality – maintaining public confidence in the markets. But this view belies the reality that the US Federal Reserve is charged with oversight of large banks, and to the extent that they can find solutions, albeit indirect ones, such as: helping arrange a distressed asset sale; to assist them in maintaining confidence; and reducing pressures on liquidity. Bail out can be a win-win situation, not inconsistent with its role as bank supervisor.

The empirical evidence as is less clear as to whether or not that the bail out was undertaken where no broader financial market mechanism was really at risk. It may well be that it was not. Still, it is difficult to argue that it was undertaken without proper legal justification in that it was within the broad powers of the US Federal Reserve to intervene given the possibly broad exposure to the markets, and the Federal Reserve's legal authority, as well as its role as to the prime lenders. Indeed, the approach taken using the classic technique of having a good bank buy out a bad bank or otherwise look for a suitor to prevent further losses, except in this case having one group of investors buy out a fund is likely to be repeated in extreme circumstances.

No systemic financial crisis after this particular credit event did ensue. Indeed, it seems apparent that Amaranth presented no such high level of concern, and it precipitated no threat to the economy and confidence in the markets. This may be viewed as a validation of the discretion of the US Federal Reserve in this case.

However, this does not necessarily illuminate what constitutes the crucial *tipping point* when an impending corporate insolvency is treated like bank insolvency. Arguably the distinction is that in LTCM you had a real threat of bank insolvency and in Amaranth you did not. That may well be the case and provides a justification for the US Federal Reserve's actions.

It therefore appears that it is a two-step process, as indicated above, with a crude decision tree as follows:

One, does the illiquidity threaten the markets. Specifically may banks as prime brokers have losses that could not be covered and might not be withstood. If so, then action is to be taken. If not, then it is to be treated just like any other corporate insolvency.

Notes

123 See Remarks of Commissioner Al Nazareth at PLI Hedge Funds Conference, 6 June 2007, New York, found at <www.sec.gov/news/speech/2007/spch060607aln.htm>. These remarks were made in the context of calling for better review of risk management systems of hedge funds as counterparties, and for increased international monitoring and surveillance through enhanced US/UK regulatory ties.

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For those who are not inclined to historical reductionism about the likelihood of insolvency and the consequent concerns about the proper role of the government in assisting in the resolution of such situation, it is suggested that this issue is likely to increase in importance in global financial markets.

Pascal's wager essentially posits that even if we do not know if God exists we are better off planning for an afterlife with God because the consequences of not planning are far worse.[124] It is this concept that necessitates a review of the history of the most well-known crises and to examine their form of legal and regulatory resolution, or lack thereof.[125] This is especially true as we live in an age of heightened financial complexity.

It is critically important for the Basle Committee to consider strong soft law action as a means of encouraging further thought among key decision makers in order to be better prepared for any financial doomsday scenario. And it is vital for the TFHRG to consider the issues posed by this article, in addition to its focus on preventing and avoiding crisis through the application of better risk metrics and related issues of enhanced supervision and regulation, to think through these scenarios.

The alternative is, simply, unthinkable.

Part Three, consequently, will discuss what is to be done in resolving the current August Quant Crisis, before it becomes a systemic crisis that induces recession or negative economic growth.

Notes

124 For an interesting discussion of this, including the original text, see the Stanford Encyclopedia of Philosophy found at <plato.stanford.edu/entries/pascal-wager/>.

125 Of course, there are certain steps of preventing such crisis well before containing it there are part of any sound risk management framework. But discussion of those risks and their role in addition to the role of prime brokerages and various regulatory capital requirements is the subject of several other pieces by this author, and is not therefore covered given the insolvency focus of this research.

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