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Hedge Funds

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Preface

This paper is a culmination of extensive research conducted during the months between January and May 2008. Since this time frame much has changed within the financial markets of the United States. The timeline in which this paper was written identifies the beginnings of the financial crisis we find ourselves in today. When I wrote this paper I discussed the controversial bail out of Bear Stearns, which conjured up a massive debate amongst many in Washington. However, in recent past we have seen that Bear Stearns was only the "tip of the iceberg".

Many of my conclusions are a far cry from what is the general consensus on regulatory issues amongst Americans today. However, I intend to offer readers a different viewpoint from the general consensus of harsher regulation and would like readers to understand that there are various repercussions that arise as a result of any policy change.

1. Introduction

Within the last decade or so hedge funds have become major players within the United States' capital markets. By attracting large pools of private capital, combined with the use of complex investment tools (with little oversight from regulatory authorities), hedge fund managers have managed to achieve the rates of returns that your average Wall Street investment banker would only dream of. However, in the recent past, with the financial markets in turmoil as a result of the subprime crisis, hedge funds have come under increasing pressure.

Many hedge funds have simply collapsed as a result of bad investment decisions that may have seemed lucrative a couple of years ago, but as a result of the current market turmoil have instigated their demise. The sheer size and the increasing influence that hedge funds have accumulated within the financial markets have spurred a major debate amongst policymakers. The debate concerning hedge fund operations mainly concerns regulation of the industry. Having operated with little oversight/regulation from regulatory authorities for years now, many in Washington are calling for tighter regulation to curb the prospects of future market turmoil, which they believe was a result of reckless investors exploiting loop holes within the current regulatory framework.

This paper seeks to provide insight into what hedge funds really are, how they operate, and the relevant aspects of regulatory reforms being proposed. The paper will provide arguments from various stakeholders within the industry and draw on some conclusions as to the effects and feasibility of proposed regulatory reforms.

1.1 What exactly is a Hedge Fund?

Hedge funds are vast pools of money managed by an investment advisor, the hedge fund manager, who has a great deal of flexibility[1] Hedge fund managers typically have the right to have short positions, to borrow/ use leverage, and to make extensive use of derivatives[2]. Hedge funds are similar to mutual funds in their underlying investment goals; however, the two have several differences. Hedge funds are largely unregulated private pools of capital. Hedge funds have a more limited target market for clients, who are usually high net worth individuals often referred to as "sophisticated investors." Differences between hedge funds and mutual funds will be discussed in more detail later in this paper, but for now it is important to note that the main differences lie in the regulatory requirements, the types of investors, and the types of investment tools used, including leverage, short selling, etc.

Today, in addition to "trading equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments."[3]

1.2 The Significance of the Hedge Fund Industry

Hedge funds have become a topic of great importance over the last decade because of the increasing amount of influence and effect their operations have on the global financial market. Today more than 7,500 funds manage close to $2 trillion in

assets[4]. With the rapid growth of this industry many institutional investors such as Merrill Lynch are seeking to change the ways in which they invest their money. The hedge fund industry has been recognized as a driving force for innovation in the financial markets and has been accepted as the very essence of a capitalistic/ free market economy.

2. An Insight into Hedge Fund Operations

In order to understand the relevance of the hedge fund industry as a significant player in the financial markets, it is crucial to have some insight into the underlying workings of the industry. In this section of the paper, I shall provide some basic understanding of hedge fund operations, the kind of effects their operations can have on the financial market as a whole, and what makes them such an exclusive entity.

2.1 The Differences between Mutual Funds and Hedge Funds

Mutual funds and hedge funds differ in various ways, particularly the “fees charged; leveraging, pricing, and liquidity practices employed; the degree of regulatory oversight to which each is subjected; and the characteristics of the typical investors who use each investment vehicle.”[5] “U.S. mutual funds are among the most strictly regulated financial products on the market. They are subject to numerous requirements designed to ensure they operate in the best interests of their shareholders. Hedge funds are private investment pools, hence, are subject to far less regulatory oversight”[6].

Regulatory Requirements

Mutual Funds

Mutual funds are investment companies that must register with the U.S. Securities and Exchange Commission (SEC), subjecting them to SEC regulation[7]. "Virtually every aspect of a mutual fund's structure and operation is subject to strict regulation under four federal laws: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act."[8] The SEC is responsible for ensuring the mutual fund industry's compliance with these regulations. "The Internal Revenue Code sets additional requirements regarding a fund's portfolio diversification and its distribution of earnings, and the National Association of Securities Dealers, Inc. (NASD) oversees most mutual fund advertisements and other sales materials."[9] In addition, mutual fund directors are responsible for effective oversight of the fund's policies and procedures. "For virtually all funds, at least a majority of their directors must be independent from the fund's management".[10]

"The Investment Company Act is the cornerstone of mutual fund regulation. It regulates the structure and operation of mutual funds and requires funds to safeguard their portfolio securities, forward price their securities, and keep detailed books and records. In addition, the 1933 Act requires all prospective fund investors to receive a detailed prospectus containing specific information about the fund's management, holdings, fees and expenses, and performance"[11]. Appendix A provides a "snapshot" of a mutual fund prospectus with relevant information pertaining to the fund's performance, management, and expense ratio (which are the fees charged by the fund managers).

Hedge Funds

Unlike mutual funds, hedge funds are not required to register with the SEC (although many do in order to enhance their "legitimacy"). Hedge funds issue securities in "private offerings" not registered with the SEC under the Securities Act of 1933. Furthermore, hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934.[12]

Like mutual funds and other securities market participants, hedge funds are subject to prohibitions against fraud, and their managers have the same fiduciary duties as other investment advisers.[13]

Hedge funds, in collaboration with the President's Working Group on Financial Market's (PWG) have established *"Sound Practices for Hedge Fund Managers"* (Appendix B) as "standards for excellence for improved market discipline and enhanced vigilance through collaborative efforts amongst counterparties."[14]

Fees

Mutual Funds

"Federal law imposes a fiduciary duty on a mutual fund's investment adviser regarding the compensation it receives from the fund."[15] In addition, mutual fund sales charges and other distribution fees are subject to regulatory limits under National Association of Securities Dealers (NASD) rules. Mutual fund fees and expenses must be disclosed in detail, as required by law, in a fee table at the front of every prospectus. There is a standardized format for advisers to present their fees and expenses, so that an investor can easily understand them and can compare expense ratios among different funds.[16]

Hedge Funds

There are no limits on the fees a hedge fund adviser can charge its investors. Author Duff McDonald explores this in his 2007 New York Magazine article, "Behind the Hedge": "The typical fee structure is known by the vernacular "2 & 20"—most funds take a 2 percent management fee and 20 percent of any profits."[17] Some managers take far more. James Simons of Renaissance Technologies Corporation, for example, charges a nominally obscene 5 & 44. The result, according to McDonald: "A $1 billion fund posting a 30 percent return delivers a $78.8 million payday for its managers. A $1 billion fund posting a zero percent return can still spread around $20 million to its employees." The best managers do a lot better than breaking even, mind you, and as a result, a handful of hedge-fund kingpins take home more than $500 million in annual compensation. For example, "James Simons earned an estimated $2.8 billion in 2007." [18]

Leveraging Practices

Mutual Funds

"The Investment Company Act severely restricts a mutual fund's ability to leverage or borrow against the value of securities in its portfolio."[19] The SEC requires that funds engaging in certain investment techniques, including the use of options, futures, forward contracts and short selling, "cover" their positions i.e. ensure some specific level of liquidity is available. The effect of these constraints has been to strictly limit leveraging by mutual fund portfolio managers, which as we will see later can be a risky strategy.

Hedge Funds

Leveraging and other high-risk investment strategies have become a constant feature of hedge fund management. Hedge funds were "originally designed to invest in equity securities and use leverage and short selling to "hedge" the portfolio's exposure to movements of the equity markets."[20] Today, however, hedge fund managers use a wide variety of investment strategies and have become very active traders of securities.

Pricing and Liquidity

Mutual Funds

Mutual funds are required to "value their portfolios and price their securities daily based on market quotations that are readily available at market value and others at fair value, as determined in good faith by the board of directors. In addition to providing investors with timely information regarding the value of their investments, daily pricing is designed to ensure that both new investments and redemptions are made at accurate prices. "[21] Furthermore, mutual funds are required to allow shareholders to redeem their shares at any time.[22]

Hedge Funds

There are no specific rules governing hedge fund pricing. Hedge fund investors may be unable to determine the value of their investment at any given time. Hedge fund investments are usually illiquid, with most investments made on a long term basis, so investors are usually aware of this and hence daily fluctuations in the market are not of great importance.

Investor Characteristics

Mutual Funds

"The only qualification for investing in a mutual fund is having the minimum investment to open an account with a fund company, which is typically around $1,000, but can be lower. After the account has been opened, there is generally no minimum additional investment required, and many fund investors contribute relatively small amounts to their mutual funds on a regular basis as part of a long-term investment strategy".[23]

Mutual funds generally target a wider base of prospective customers. They are more retail oriented and there are no restrictions on advertising of their products. Generally mutual fund products are made for easier accessibility for "average people".

Hedge Funds

A considerably larger investment is required from hedge fund investors. Under the Investment Company Act of 1940, certain hedge funds may only accept investments from individuals who hold at least $5 million in investments. This measure is intended to limit participation in hedge funds and other types of unregulated pools to sophisticated investors. [24] "Hedge funds can also accept other types of investors if they rely on other exemptions under the Investment Company Act or are operated outside the United States."[25]

More recently, with the rapid growth of the hedge fund industry, hedge funds have begun attracting more institutionalized investment (for example from firms such as Merrill Lynch, etc.).

2.2 Leverage

Hedge funds try to deliver the most attractive rates of return possible. In their ongoing quest to maximize their returns, hedge funds utilize investment tools that enable them to take advantage of opportunities in the market. Leverage is one such tool that has been used widely amongst hedge funds, and has had varied results, from facilitating exponential returns on investments to causing the collapse of many hedge funds.

Leverage can be defined in numerous ways. "As a general matter, however, leverage, can be viewed as a means of potentially increasing an investment's value or return without increasing the amount invested."[26] Leverage is the practice of using borrowed money to make investments in order to maximize returns.

Leveraging (i.e. buying on margin) is like taking out a mortgage to buy a house.[27] Mortgage lenders are typically willing to lend 80% or more of the value of the house. In the securities business, brokers will typically lend about 50% of the value of stock to be purchased. However, the broker will not lend funds against stocks that are viewed as "risky".

Buying on margin involves interest expenses and has the ability to enhance both gains and losses. In "All about Hedge Funds", author Robert Jaeger provides a basic example to illustrate the use of leverage in enhancing both gains and losses:

> "Suppose that you have $100,000 in a brokerage account, and you want to buy $200,000 worth of IBM stock. Suppose further that IBM trades at $100 per share, so $200,000 is 2000 shares. So you borrow $100,000 from the broker, pledging the 2000 shares of stock as collateral, and the full account, including both assets and liabilities, as shown in Table 1. Here the value of the asset fluctuates, but the value of the liability is fairly stable. The liability may increase slightly as you begin to incur interest expenses on the borrowed $100,000. If you want, you can add those charges to the liability. So you begin with assets worth $200,000 and a

> liability of $100,000, which results in net equity of $100,000, you begin 200 percent invested; that is, the ratio of assets to net equity is 2:1. Suppose the broker charges you 5 percent interest (annually) on the borrowed funds. If IBM goes up by 20 percent in the course of the year, then you earn $20 per share on your 2,000 shares, for a profit of $40,000. But you owe $5,000 in interest on the borrowed $100,000. So the net profit is $35,000, on a net investment of $100,000."[28]

By using leverage you have effectively earned 35 percent in the account, even thought IBM stock only went up by 20 percent.

Table 1 - Structure of a Leverage Long Position

Assets		**Liabilities**	
2000 shares of IBM	$200,000	Margin debt	$100,000
Net Equity	**$100,000**		

Source: Jaeger, 2003 "All about Hedge Funds" pp.134

On the other hand, however, if IBM goes down by 20 percent, then the $40,000 gain becomes a $40,000 loss, but you still owe $5,000 in the interest. So the combined loss will be $45,000, on a net investment of $100,000, effectively a 45 per cent loss.

The IBM example is a very basic example of leverage at work. In the hedge fund industry, the volume of trading and the amount of money being used to leverage investments is much higher than in the given example. However, this example makes it easy to see how hedge funds may use leverage to maximize returns, and also how using leverage can be a risky strategy that may lead to bankruptcy for some.

Although leverage historically was obtained primarily by purchasing securities with borrowed money, today futures, options and other derivative contract options may be used as a major source of leverage.[29] As illustrated earlier, the use of leverage may

have a significant impact on investment results because, while it may enhance investment gains, it may also magnify potential losses. Leverage also increases the risk caused by holding assets that are illiquid or whose full value cannot be realized in a quick sale.

We can apply the earlier IBM example to more recent turmoils in the financial markets to illustrate just how risky leverage can be. Many of the hedge funds that have collapsed as a result of the subprime mortgage crisis were highly leveraged and holding collateral (in most cases in the form of mortgage backed securities) that were losing value at a steady pace as a result of the downturn in the real estate market. As a result it became increasingly difficult for these highly leveraged funds to sell off their illiquid holdings and make payments due for borrowed funds. Therefore, funds started recording large losses and write offs. With no apparent sign of an upturn in the market in the near future many of these funds had no choice but to declare bankruptcy. A recent example of a fund that collapsed as a result of holding such illiquid assets is Bear Stearns.

It is clear to see just how risky leveraging can be. While the market for your assets are up, leveraging can be an effective way to maximize your return; however, should the market take a turn, leveraging can also magnify your losses and cause your downfall.

The use of leverage also exposes counterparties to a significant amount of risk. In the simplest sense counterparties may be commercial banks or brokerage firms. Funds that borrow heavily from counterparties may also expose these counterparties to risks should the funds leveraging strategy result in losses, because it becomes increasingly difficult (sometimes impossible) to repay the borrowed amount. Counterparty risk is a significant issue and has been studied extensively because of its increasing influence on

the performance of the financial markets. For the purpose of this paper counterparty risk will be discussed under regulation as a significant policy issue.

2.3 The Short-Long Strategy

Short selling has become a trademark investment strategy of the hedge fund industry. The ability to "short" the market is one of the major differences between hedge funds and mutual funds. As we now know, mutual funds are not permitted to use short selling as an investment tool, whereas hedge funds are. Hedge funds have used short selling to "bet against" the market in order to exploit inefficiencies in the pricing of securities.

Short selling is the mirror image of buying on margin (leveraging). When you buy on margin, you buy stock that you cannot afford. So you make some sort of down payment, and then borrow the cash that you need to make a purchase. When you short sell, you sell a stock that you do not own. You borrow the stock, pledging cash or some other asset as collateral for the loan. Then you sell the stock, in the hope that you will buy it back in the open market at a lower price, at which point you can return the borrowed stock to the lender and make a profit.[30]

In general, "short selling is utilized to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand or to hedge the risk of a long position in the same or a related security."[31]

Jaeger provides another good example to illustrate how short selling can be used and its effects:

"Suppose that, during the height of the Internet bubble in 1999, you begin to feel that Amazon.com is overvalued. You short Amazon at $100; then you cover your short at $50 in the middle of 2000. You've made $50 per share without ever owning the stock."

"First, you must deposit some money or securities into a margin account. Then you use that money as collateral to borrow the Amazon shares. This requires that somebody be willing to lend you their Amazon shares. The prime broker arranges the borrowing. Therefore, hedge fund managers usually look for prime brokers who have, amongst other things, excellent access to stock available for borrowing."

"The next step is to sell the borrowed shares, and that sale produces real money, which is called the "proceeds of the short sale". The proceeds go into an account at the prime broker, where they earn interest. The interest is split three ways; lender of the shares earns a lending fee, broker earns a fee for arranging transaction, and short seller earns remainder of the interest."

"Let's assume that you open the account with $100,000 and you sell short 1000 shares of Amazon.com at $100 each. Then the assets and liabilities in the account are shown in Table 2. The account has total assets of $200,000 and a liability that is originally valued at $100,000. So net equity is exactly $100,000, which was the starting amount. We added a new asset, a new liability, but the net equity remained the same. Let's suppose that Amazon.com goes from $100 to $50, so the value of the liability goes from $100,000 to $50,000. This $50,000 decline in the value of the liability boosts the net equity in the account by

$50,000. Now you can "cover the short" by taking $50,000 from the original deposit, buying Amazon in the open market, and then using the newly purchased shares to pay back the original borrowing of stock. At the end of the day there is $150,000 in the account, and no liabilities. Sold high and bought low."[32]

Table 2 - Structure of a Short Position

Assets		Liabilities	
Original Deposit	$100,000	1,000/sh Amazon.com	$100,000
Proceeds of short sale	$100,000		
Net Equity	**$200,000**		

Source: Jaeger, 2003 "All about Hedge Funds" p.140

If Amazon shares go up to $120 (from $100), then the value of the liability goes to $120,000, assets are still $200,000, so net equity goes to $80,000. As the price of the stock goes up the broker may begin to worry about getting paid back, and at some point he will make a margin call. If you cannot put more money into the account, the broker may ask you to cover the short at current prices, and you will incur a loss.[33]

Short selling can provide the market with important benefits, including supplying liquidity into the market and enhancing pricing efficiency (for overvalued securities). Market liquidity is provided through short selling by market professionals, such as hedge fund managers and financial advisers, who offset temporary imbalances in the supply and demand for securities. Short sales effected in the market by securities professionals add to the trading supply of stock available to purchasers and thus may reduce the risk that the price paid by investors is artificially high.[34]

Short selling can also contribute to the pricing efficiency of the markets. "Efficient markets require that prices fully reflect all buy and sell interests. When a short

seller speculates on or hedges against a downward movement in a security, the transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise or in order to hedge against such an increase."[35] The strategies "differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security." [36]

"Although short selling serves useful market purposes, it also may be used to manipulate stock prices. An example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest."[37] Unrestricted short selling can also put added pressure on a declining market in a security by eliminating bids and causing a further reduction in the price of a security by creating an appearance that the price is falling for fundamental reasons[38].

2.4 Systemic Risk and Hedge Funds

"Systemic risk is commonly used to describe the possibility of a series of correlated defaults among financial institutions, typically banks that occur over a short period of time, often caused by a single major event."[39] However, since the collapse of a large hedge fund, Long Term Capital Management (LTCM) in 1998, it has become apparent that hedge funds are also being implicated in systemic risk exposures. "The

hedge fund industry has a symbiotic relationship with the banking sector, and many banks now operate their trading units that are organized much like hedge funds. As a result, the risk exposure of the hedge fund industry has a significant impact on the banking sector, resulting in new sources of systemic risks." [40]

One of the biggest concerns of hedge funds increasing systemic risk is to do with their extensive use of leverage. Figure 1 illustrates the increasing number of hedge funds readily using leverage as an investment strategy aimed at maximizing returns.

Figure 1 – Increasing Amount of Investors Using Leverage

Source: http://seekingalpha.com/wp-ontent/seekingalpha/images/HedgeFund.GIF

The use of leverage exposes counterparties who provide hedge funds with funding to significant illiquidity risks, as the adverse effects of a downturn in the market will make it increasingly difficult for them to get their money back. With lower expected returns in the near future, the aspects of systemic risk are increasing and counterparty exposure is becoming a major concern.

In March 2005 the National Bureau of Economic Research provided some conclusions as to the effects of hedge funds on systemic risks:

- The hedge fund industry has grown tremendously over the last few years, fueled by the demand for higher returns in the face of stock-market declines and mounting pension-fund liabilities. These massive fund inflows have had a material impact on hedge-fund returns and risks in recent years, with reduced performance spurring increased illiquidity in the market.
- The banking sector is exposed to hedge-fund risks, especially smaller institutions, but the largest banks are also exposed through proprietary trading activities, credit arrangements and structured products, and prime brokerage services.
- Due to the dynamic nature of hedge-fund investment strategies, and the impact of fund flows on leverage and performance, hedge-fund risk models require more sophisticated analytics, and data that are not readily available yet.
- A highly volatile financial market is a contributing factor for the aggregate level of distress in the hedge-fund sector. Furthermore, increasing liquidity problems for hedge funds implies that systemic risk is on the rise.

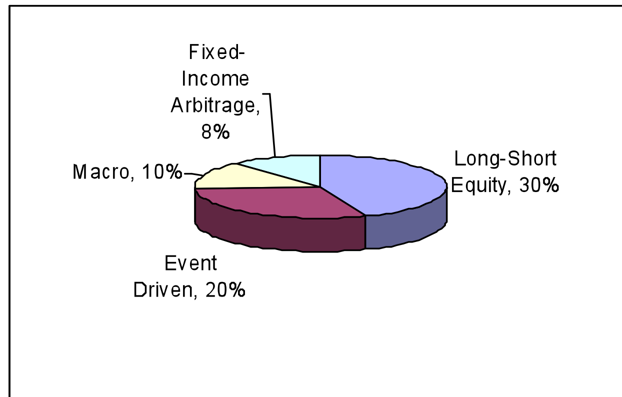
2.5 Investment Style Categories

"Investment in a hedge fund is a bet on the skills of the manager to identify profit opportunities."[41] Managers may use complex strategies to make the most out of their investments. Managers have an incentive to make it difficult to communicate their strategies to the typical investor. The main incentive not to communicate too much is to

ensure that otherwise smart investors do not figure out how to duplicate a manager's strategy, in which case a smart investor may not need the manager anymore.[42]

Rene Stulz, Chair of Banking and Monetary Economics at Ohio State University identifies the most popular hedge fund investment strategies:

Figure 2 – Popular Hedge Fund Investment Strategies by Size



Constructed by Ashish Patel: Data Source: Stulz, 2007

- **<u>Long-Short Equity Hedge Fund:</u>** This strategy takes both long and short positions in stocks. These funds tend to hedge their positions against market risks. For example, a hedge fund of this type might have only long positions in stocks but use options and futures contracts so that fund returns will be unaffected by changes in the market as a whole i.e. hedge against the risk of a market downturn .[43] A typical strategy involves identifying undervalued and overvalued stocks, and going long for undervalued stocks and short on overvalued stocks.

- **<u>Event-driven hedge fund:</u>** This strategy attempts to take advantage of "opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, reorganizations, bankruptcies, and other extraordinary corporate transactions. Event-driven trading involves attempting to predict the outcome of a

particular transaction as well as the optimal time at which to commit capital to it." [44]Skeptics have argued that event driven hedge funds can be tempted to use insider trading in order to exploit opportunities presented in corporate transactions.

- **Macro hedge fund:** This strategy identifies mispriced valuations in stock markets, interest rates, foreign exchange rates and physical commodities, and makes leveraged bets on the anticipated price movements in these markets. "To identify mispricing, managers tend to use a top-down global approach that concentrates on forecasting how global macroeconomic and political events affect the valuations of financial instruments." [45]

- **Fixed-income arbitrage hedge funds:** This strategy seeks to find arbitrage opportunities in the fixed income markets.

Other smaller strategies include "emerging markets funds, funds that trade futures contracts, and convertible arbitrage funds (convertible debt is debt convertible into stock and these funds exploit mispricing in the debt relative to the stock)."[46]

3. The Bear Calamity

The recent collapse of investment bank Bear Stearns has been a focal point for discussion amongst senior policymakers in Washington. The "Bear calamity" as I have termed it, is of great relevance to this paper as the root cause of Bear Stearns' problems began with the failure of two of its hedge funds last year (June 2007). The unprecedented actions that followed by Chairman Ben Bernanke have sparked of major debate as to the Fed's "new role" in the financial market.

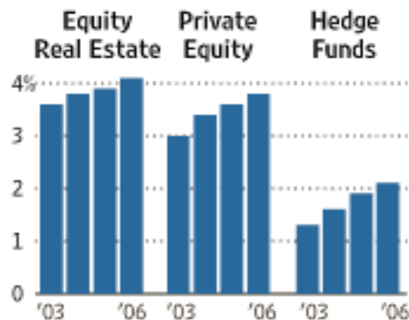
In this section of the paper I shall provide a brief overview of the main issues that led to the "Bear calamity" and provide an analysis of the Fed's "bail out" of Bear Stearns.

3.1 Main Issues Leading to the Collapse of Bear Stearns

In June 2007 two of Bear Stearns's hedge funds; High-Grade Structured Credit Strategies Fund and High-Grade Structured Credit Strategies Enhanced Leverage Fund ran into some serious financial difficulty when a downturn in parts of the housing market hurt the funds' bets on complex securities backed by subprime mortgages, or home loans to borrowers with troubled credit histories.[47] The main cause of their strife was that they were heavily invested in illiquid assets that were difficult to sell off. The Bear Stearns funds were part of a growing industry in investment vehicles that specialized in illiquid assets such as exotic securities.

The major problem with this new niche of investment vehicles was that these hard to trade investments that they were dealing with could suddenly turn south and set off a larger market downturn.[48] Figure 2 illustrates this growing trend of investment vehicles dealing in illiquid, hard to trade investments.

Figure 2 – Increasing Trend in Illiquid Investments



Source: Lahart & Lucchetti June 25, 2007, Wall Street Journal Online Edition

Bear Stearns's funds began to run into trouble when a downturn in the housing market hurt the funds' bets on complex subprime mortgage backed securities. These securities trade infrequently making it hard to sell them quickly without incurring steep losses.[49] The funds were heavily leveraged, which means they were trading with borrowed money. As we now know leverage can maximize returns but it can also amplify losses. In the case of the Bear Stearns funds, when their bets on the mortgage backed securities took a downward turn, their losses became far greater.

The problem at the Bear Stearns funds prompted the firm to lend one of its hedge funds approximately $3.2 billion in a bid to rescue it. The issues of the Bear Stearns's funds highlighted that hedge funds bent on short term gains can go bust when the assets they are holding cannot be easily traded. This problem has plagued many investment banks in the past. "In 1994, hedge funds run by Askin Capital Management sustained huge losses on leveraged bets on infrequently traded mortgage-backed securities. The collapse of Long-Term Capital Management, which shocked markets around the world in 1998, was sparked by its inability to unwind leveraged bets. In the fall of 2006,

commodity hedge fund Amaranth Advisors LLC lost about $6 billion when it couldn't easily exit esoteric trades that went against it." [50] Last year, Bank of Montreal lost more than 600 million Canadian dollars (US$560 million) with a bad bet on natural-gas volatility.[51]

Bear Stearns's funds were a victim of the same kind of calamities that struck some of the funds mentioned above. When the funds began to record large losses, their lenders may have demanded more collateral or even repayment of their loans. To meet these demands, the funds, whose losses were already magnified by leverage, could have been forced to sell their investments well before the market could recover: "With funds that use leverage, it doesn't take a sharp move in a market to create a sharp drop in a portfolio's value."[52]

Bear Stearns's problems only began with the collapse of its two hedge funds. With an increasing amount of their investments being backed by hard to trade, illiquid assets it became very difficult for them to service their obligations to their lenders. It was in the context of intensifying financial strains that, on March 13 2008, Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funding became available.[53]

3.2 The Fed's Reaction

In light of the events surrounding the collapse of Bear Stearns, the Federal Reserve stepped in and sought to facilitate a rescue package that would provide Bear

Stearns some source of funding in order for it to avoid bankruptcy. The actions of the Fed have been deemed as a “bail out” in the media and amongst policymakers in Washington. The purpose of this section of the paper is to provide some insight into the rationale behind the Fed’s actions and also to make some conclusions as to whether using the term “bail out” is appropriate.

In order to understand the underlying rationale for Bernanke’s actions, we must apply what we know about systemic risk. Due to the fact that the plight of Bear Stearns was a result of it being highly leveraged, there are various other counterparties such as brokerage firms, commercial banks, pension funds, all entities that financed much of Bear Stearns’s investments that would be directly/ indirectly affected by its collapse. In this case containing systemic risk was the main concern for officials at the Fed. An adverse effect of Bear Stearns filing for bankruptcy would have been exposing these counterparties to a significant amount of systemic risk, and triggering a potential “domino effect” that would have roiled the entire financial market.

Bernanke stated in his April 3, 2008 testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate that the issues raised by the Bear Stearns situation would raise difficult questions of public policy. Normally, the Fed would allow the market to determine which companies survive and which do not. However, the Bear Stearns calamity raised issues that went far beyond the fate of one company. Bernanke stated that the sudden failure of Bear Stearns would have led to a chaotic unwinding of positions in the markets within which Bear Stearns participated and could have severely shaken the confidence of the entire market.[54] "The company’s failure would have cast doubt on the financial positions of some of Bear Stearns’ thousands of counterparties."

Given the exceptional pressures on the global economy and financial system, the adverse effects of a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, a default would not have been confined to the financial system "but would have been felt broadly in the real economy through its effects on asset values and credit availability."

In order to prevent a disorderly failure of Bear Stearns and the severe consequences for the market and the broader economy, the Fed, in consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JP Morgan Chase. JP Morgan agreed to purchase Bear Stearns and assumed Bear's financial obligations supported by a line of credit offered by the Federal Reserve.[55]

The reaction of the Fed drew some varied reactions from various stakeholders within the industry. Some finance experts have voiced concern over what they said was a "bailout" and the risky precedent that may have been set. Furthermore, lawmakers have criticized the Fed's willingness to provide 29 billion dollars in "taxpayer" guarantees in return for collateral from Bear Stearns.[56] Some of the collateral involves mortgage backed securities that have dropped in value.

Paul Volcker, a former Chairman of the Federal Reserve, voiced some concern about the Fed's role in the Bear Stearns deal. In his speech at the Economic Club of New York earlier this month Volcker said "the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices."[57] It is important to note that the Fed could make money from the collateral it purchased, if the securities rise in price. However, it could also lose money if the value were to fall. Some lawmakers are

concerned that the Fed has encouraged securities firms to speculate more aggressively, and expect government assistance if they get into trouble.

Republican senator Jim Bunning of Kentucky even went as far as saying of the Fed's actions "that is socialism, not a free market, and it must not happen again."[58] Bernanke has stood his ground and maintained that the collapse of Bear Stearns would have placed immense pressure on the broader market and the ripple effects would have been impossible to contain. Bernanke's actions have drawn some significant support as well as criticism.

Merrill Lynch & Co Chief Executive Officer John Thain said the Federal Reserve's rescue of Bear Stearns helped avert "systemic risk" to the global financial system posed by the credit market meltdown.[59] Thain said that the move "has given the market a degree of confidence that nothing is going to be systematically damaging."[60] Further support has come from Roland Manarin, founder and president of the Manarin Investment Council asset management firm who said, "Bernanke stopped the house of cards from collapsing, which was the peril, the danger, so I approve of what he did."[61] Jeremy Siegel, a finance professor at Wharton Business School shared similar sentiments to John Thain, and stated, "a generalized credit collapse seems now most unlikely due to the Fed's actions in connection with Bear Stearns. That increasingly looks like the turning point in this financial crisis."[62]

Perhaps the term "bail out" may not be the most appropriate. One must never forget that one of the fundamental roles of the Federal Reserve is to act as a lender of last resort in instances of financial market turmoil. I feel that the adverse effects of systemic risk in the case of Bear Stearns were too apparent to have ignored. The Fed's decision

may have helped prevent a total meltdown of the credit markets and I believe had the Fed not done anything and rather had let the market determine the fate of Bear Stearns we would be seeing a lot more distress in the financial markets and a lot more criticism about why the Fed never stepped in to do something about the situation.

4. Regulation

With the accumulating influence of the hedge fund industry within the United States' financial market, there is emerging a divide amongst many concerned as to the future direction of regulation of the industry. On one side of the divide there are those that are more "traditional" so to speak, and these "traditionalists" are advocating for the status quo, believing that regulation goes against the very essence of a capitalistic society. Furthermore, these "traditionalists" believe that for as long as the United States' capital markets competitiveness takes precedence, there shall be no further constraints placed on an industry that fosters innovation and efficiency within the market.

On the other side of the divide are the more "modern" figures, who feel that throughout the history of the financial sector there have been various changes made to the regulatory framework to keep up with the times. These "modernists" are wary of the increasing influence of the hedge fund industry and feel that the recent events (Bear Stearns, LTCM etc.) are a clear indication that something within the regulatory framework is "broken" and now is the time to fix it in order to prevent future turmoil.

In this section of the paper I shall provide some relevant insight from the perspective of the major stakeholders of the hedge fund industry. My extensive research

provided me the opportunity to interview key players within the industry, the results of which I shall share in this section of the paper.

4.1 The Case For and Against Regulation

The Case For Regulation

The main case for regulation is spawned by the good old question, "who is responsible?" In light of the current turmoil we have Fed officials who are scrambling to contain the damage, financial markets that are reeling, and taxpayers who are bracing themselves to foot the bill for the rescue efforts. What about the Wall Street titans that got us into this mess in the first place?

These have been the major questions being asked by policymakers in Washington. "The Federal Reserve continues to bail out major financial institutions without imposing meaningful conditions to improve their conduct and performance," said Peter Morici, professor at the Smith Business School at the University of Maryland (Farrell, 2008). According to the New York State Office of the Comptroller, "New York securities industry firms paid out a total of $137 billion in employee bonuses from 2002 to 2007" (Farrell, 2008). Wall Street big wigs earned a bonus of $9.8 billion in 2002, $15.8 billion in 2003, $18.6 billion in 2004, $25.7 billion in 2005, $33.9 billion in 2006, and $33.2 billion in 2007.[63]

These were the heydays for hedge fund managers, and private equity titans who created all kinds of complex securities and highly leveraged transactions, such as Collateralized Debt Obligations (CDOs) or Leveraged Buy Outs (LBOs).[64] These

complex securities have been at the forefront of discussions regarding the root cause of current financial market turmoil.

Here lies one of the main issues that does not sit well with policymakers in Washington. Investment moguls preached the free-market gospel and pocketed unheard of amounts of money, yet when times got tough, they called for a government bailout.[65] According to Raghuram Rajan, economist at the University of Chicago Graduate School of Business and former chief economist at the IMF, "markets work if participants are at risk to both positive and negative consequences.[66]" However, on the upside, financial firms insisted not to even think of regulating them, yet when things started to head south they pleaded for help. One of the main arguments for regulation floating around the halls of Congress is that if relatively unregulated entities want help from the Federal Government, then they must play by the same rules as everyone else.

Policymakers advocating for tighter regulation argue that, once the turmoil calms down regulators should step up their scrutiny of the industry, demand more transparency, and require greater accountability among financiers. If investment banks have a line to the Fed in bad times, then the Fed must have authority over the investment banks in good times too.[67]

With the increasing amount of institutional investment in hedge fund operations coming from sources such as pension funds, universities, charities, and endowments, there is an increasing likelihood of retail exposure to hedge fund risk.[68] What this means is that many of the people indirectly invested in hedge funds through their pension funds etc. are exposing themselves to the risks associated with hedge fund operations. Policymakers have called for greater transparency, and more restrictions on marketing

activities for hedge funds, so as to limit retail exposure and ensure that hedge fund investors are limited to that breed of "sophisticated investors" that are aware of higher levels of risk for higher returns associated with hedge fund operations.

Limiting systemic risk is perhaps the main argument for regulation. The extensive use of leverage and the trading of complex derivatives and illiquid assets has been a major source of concern for regulators. As we witnessed earlier, systemic risk has been at the forefront of major policy issues. In the case of the Bear calamity, the Fed's unprecedented actions came as a direct response to containing systemic risk. Policymakers have argued that the Fed and other regulators must act to curb the exposure of the market to systemic risks and avert future turmoil.

The Case Against Regulation

Financial regulation has been an evolving process. Ever since the 1930's the United States has been subject to various different changes/ updates to the regulatory framework. Hedge funds are a new breed of investment animals, and their success can be attributed to the relatively "light touch" regime under which they operate. "The last time right-thinking Americans agreed on the need for more regulation as rapidly as possible, we got Section 404 of the Sarbanes-Oxley Act. Accounting firms were given a vague and onerous mandate and, the next thing anyone knew, New York was losing its financial strength to London."[69] For as long as the might and competitiveness of the United States' financial markets takes precedence there will always be those advocating against what they see as socialistic policies such as tighter regulation.

In order to ensure that the United States' financial markets remain the largest and most competitive, they must be efficient and harness innovation. Hedge funds have long been accredited with fostering innovation and promoting efficiency especially in the pricing of securities. Advocates against regulation argue that financial technology has taken off the same way as information technology did in the early 90's. Financial technology cannot be put back in a box any more than information technology can: This is the culmination of 30 years of innovation starting with the Black-Scholes option pricing model in 1973 which was used to quantify the viability of investment options, but the notion that we can return to 1972, with credit held on bank balance sheets and investment banks just flogging securities on commission, is false.[70]

Advocates against regulation argue that if Congress tried to hinder financial innovation with excessive regulation, then the global investment banking industry, which is currently dominated by the United States, would be driven offshore to London or Zurich, or some other jurisdiction where it could operate in peace .[71] Judging by the fact that in the last few decades the United States has had to relinquish its superiority in other industries e.g. manufacturing, the financial industry is one that is far too important to lose to other countries. Therefore, in order to preserve the superiority of the financial markets, policymakers should consider the consequences of being over zealous with the regulation stick.

According to Chairman Christopher Cox, US Securities and Exchange Commission, "hedge funds contribute substantially to capital formation, market efficiency, price discovery, and liquidity."[72] Tighter regulation may have an adverse

effect of promoting inefficiencies within the market in terms of overvalued securities and so on.

There is of course the more conventional argument against regulation. Financial markets have experienced booms and busts through out their entire history. In particular a "sophisticated and innovative financial system is susceptible to destructive booms; but a simple, tightly regulated one will condemn an economy to grow slowly."[73] The bottom line is that financial crises are endemic. Overzealous attempts to regulate them may do more harm than good.[74]

The Federal Reserve itself has been a key advocate of the market discipline approach. For centuries the markets have determined who survives and who does not. Those advocating against regulation have taken shelter behind a market discipline approach. According to Ben Bernanke's speech at the Federal Reserve Bank of Atlanta, May 2006, the market discipline approach states that the hedge fund industry has four main sets of actors who must assume responsibility to regulate each other:

1. Hedge Fund Investors who have the responsibility to demand the necessary information to ensure that they are fully aware of the operational and risk elements of investing in hedge funds.
2. Creditors and Counterparties who may at any time limit the amount of funding they wish to offer hedge funds to use to buy on margin/ leverage.
3. Regulatory Agencies who should keep track of current market trends and raise the alarm when potentially threatening situations occur.

4. Hedge fund managers themselves, who have a responsibility to practice due diligence, and must abide by some form of code that prohibits reckless behavior.

Investors and creditors can largely regulate hedge funds between themselves. Investors are usually high net worth individuals who (as the argument goes) have access to more resources, are more sophisticated i.e. well versed with complex investment strategies that Mom and Dad have no idea about, have a larger incentive to monitor activities, and demand more information needed to make investments. The externality of this is greater transparency and accountability as hedge fund managers seek to comply with their investor's demands.

Counterparties are also a source of regulation. Large commercial banks and investment banks that provide credit and other services to hedge funds have a large economic incentive to monitor and limit hedge funds' risk taking abilities.[75] The market discipline approach has been at the very essence of this capitalistic society we keep talking about. For those concerned, tighter regulation of hedge funds will mean that the social benefits of this industry will disappear and support for financial and economic innovation would be lost.[76]

4.2 Insight from Within the Industry

I interviewed Jennifer Han, Legal Counsel at the Managed Funds Association (MFA) on Friday March 28, 2008. The MFA is the global voice of the alternate investment industry, mainly hedge funds. Its members include professionals in hedge

funds, funds of funds and managed futures funds (www.managedfunds.org). MFA has been at the forefront of drafting litigation for hedge funds and basically offering the hedge fund industry a voice in Washington. Ms. Han offered me some invaluable insight, which I shall share in this section of the paper.

First, Ms. Han explained to me that the reason hedge funds are considered such an illusive industry is partly because there has been a ban on advertising of hedge fund products, services, or any other activities. This is one of the main reasons they target only sophisticated investors and do not cater for the wider retail audience. The MFA would like to point out that reporters who claim that hedge funds are "unregulated" are often creating a false impression. The SEC regulates the trade of securities, but hedge funds trade in a whole lot of entities, hence, there is no single entity that can regulate them.

The MFA works closely with the President's Working Group on Finance (PWG). The principles and guidelines in Appendix B are a culmination of efforts by the PWG and the MFA. Ms. Han stated that hedge funds dealt with counterparties that were already heavily regulated by the SEC. The regulation of these counterparties should suffice as adequate regulation, because the counterparties can control how much they want to lend to a hedge fund, which in turn helps to reduce systemic risk through limiting excessive leverage.

On the issue of transparency, she stated that the perceived lack of transparency within the hedge fund industry is false. Her argument: That "in order for hedge funds to borrow money from commercial banks and institutional investors, they must disclose a vast amount of information, just because this information does not get out to the general public does not mean that it is not being provided to one regulated entity or another." The

logic being that if information on hedge fund operations was widely available to the general public, then any finance savvy individual might attempt to duplicate the strategies, creating systemic risk due to a convergence in investment strategies and reduced diversity.

The MFA believes that the "sophisticated investors" that invest in hedge funds do not need the government's protection. Therefore, a lot of the regulation that is done for retail investors does not apply for hedge fund investors. "When you have hundreds of millions of dollars, you have a lot of bargaining power and you can negotiate/ demand certain information that your average retail investor cannot," said Ms. Han. This falls under the argument that hedge fund investors can act as regulators themselves by demanding all the information they deem necessary.

One of the major issues that the MFA are concerned with is the outdated and inefficient regulatory framework. According to Ms. Han, the United States' competitiveness is slowly diminishing. The United Kingdom has one sole regulator, the Financial Services Authority FSA. In the United States there are several regulators, the Security and Exchange Commission SEC, the US Treasury, the US Commodity Future Trading Commission CFTC, and the Office of the Comptroller of Currency OCC. All these different entities often have their own different set of requirements, legislations, and codes, which make it very difficult to coordinate operations. In the UK, the FSA can better coordinate with hedge funds because it is the sole regulator. Often US regulatory authorities have duplicative policies which drive up transaction costs, are more time consuming, and are largely inefficient simply due to the fact that hedge funds deal in a wide variety of products making it difficult for them to comply. The MFA has been

advocating for a reduction of duplicative procedures/ policies and would like to see a principle based approach which allows regulators to change with the times. The MFA would like to see the regulatory framework streamlined, so that duplicative and bureaucratic procedures can be eliminated, forging the way for a better coordinated and more efficient system.

The MFA argues that regulation may offer investors a false sense of security. Just because an entity is regulated does not mean it cannot go bust. Some of the hardest hit institutions during the sub-prime crisis have been these large commercial banks that are regulated by the SEC and so on. Hedge funds bring liquidity into the market and survive solely because they generate returns; they also help enhance efficiency by exploiting holes in the market. Ms. Han argued that even after the sub-prime crisis, hedge funds for the most part have faired pretty well, with commercial banks recording some of the largest losses. The argument behind this statement is that in most cases investors have their own money invested in hedge funds; therefore, the risk burden is placed squarely on their shoulders.

My interview with Ms. Han provided me a rare opportunity to explore the sentiments shared by those within the “illusive” hedge fund industry. Her responses highlighted the fact that hedge funds exist solely to service the free market principles that have dictated the course of the United States’ financial markets for decades. The MFA has shunned the prospects of tighter regulation, rather calling for a streamlined regulatory framework that allows for better coordination, reduces unnecessary bureaucracy, and increases the competitiveness of the financial markets.

From within the industry, hedge fund pioneer and investment titan, George Soros, was quoted as saying "I think that hedge funds need to be regulated like all other market participants." [77] Soros stated that hedge funds would be best regulated through the banking system by requiring banks that lend to them to hold greater reserves.[78] Soros claimed that the extensive use of leverage should be a major concern for regulators and that it is the job of the authorities to prevent the system from collapsing.

Influential U.S. Congressman Barney Frank has been one of the strongest advocates for tighter regulation. The US lawmaker, who chairs the House Financial Services Committee, has called for a "financial services risk regulator." Mr. Frank said, "if entities such as investment banks wanted access to emergency cash, they would have to accept supervision of a regulator that could have enhanced tools to receive timely market information from market players, inspect institutions, report to Congress on the health of the entire financial sector, and act when necessary to limit risky practices." Frank said that the Fed should be appointed to act as the regulator or a separate one should be established.[79]

As you can see, there is a divide amongst the major stakeholders with regard to regulation. On the one hand there is the hedge fund industry advocating for smaller changes in the status quo that promote a more efficient, streamlined system that will allow them to be more competitive. On the other hand there are lawmakers asking some serious questions and seeking a change in the status quo towards harsher regulations that they feel will help to avert future turmoil.

4.3 Current Litigation

In response to the current turmoil in the financial markets and increasing pressure from lawmakers in Washington, US Treasury Secretary Henry Paulson outlined a "blueprint" for regulatory reform on March 31, 2008. I shall now identify the relevant aspects of Paulson's "optimal structure" for financial regulation.

The Federal Reserve gets the role of "Super Cop"

Paulson's plan calls for the Fed to be a "market stability regulator" with broad powers to fight threats to the stability of the overall financial system.[80] According to Paulson's plan "the market stability regulator should be responsible for overall conditions of…financial market stability that could impact the real economy. Given its traditional central bank role of promoting overall macroeconomic stability, the Federal Reserve should assume this role."[81] The primary function of the Federal Reserve's market stability role should continue through traditional channels of implementing monetary policy and providing liquidity to the financial system. "In addition, the Federal Reserve should be provided with a different, yet critically important regulatory role and broad powers focusing on the overall financial system."[82] In terms of its new regulatory role, the Federal Reserve should have specific authority regarding the collection of appropriate information from financial institutions, disclosing information, collaborating with other regulators on rulemaking, and taking corrective actions when necessary in the interest of overall financial market stability.[83]

Establishing a Prudential Financial Regulatory Agency

The prudential financial regulator should focus on financial institutions with some form of explicit government guarantees associated with their business operations. In an attempt to protect consumers, explicit government guarantees may often erode market discipline, creating the potential for moral hazard and a clear need for prudential regulation.[84] "Prudential regulation in this context should be applied to individual firms, and should operate like the current regulation of insured depository institutions, with capital adequacy requirements, investment limits, activity limits, and direct on-site risk management supervision."[85] To perform this function, a new regulator, the Prudential Financial Regulatory Agency should be established.

Establishing a Business Conduct Regulator

The Treasury Blueprint suggests that, "The business conduct regulator should be responsible for business conduct regulation across all types of financial firms."[86] Business conduct regulation, in this context, "includes key aspects of consumer protection such as disclosures, business practices, and chartering or licensing of certain types of financial firms."[87] One agency being responsible for all financial products should promote greater consistency in areas of business conduct regulation where overlapping requirements currently exist. "The business conduct regulator's chartering and licensing function focuses on providing standards for firms to be able to enter the financial services industry and market and sell their products and services to customers."[88]

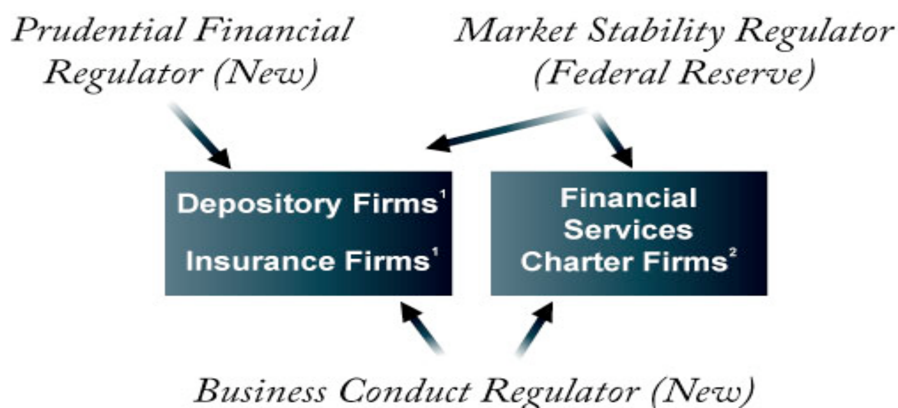
Establishing a Federal Insurance Guarantee Corporation

"The Federal Insurance Guarantee Corporation should function as an insurer for institutions regulated by the prudential financial regulator." Or in other words, the Federal Insurance Guarantee Corporation should possess the authority to set risk-based premiums, charge ex-post assessments, and act as a receiver for failed prudentially regulated institutions.[89]

The Securities and Exchange Commission Remains as Corporate Finance Regulator

"The corporate finance regulator should be responsible for general issues related to corporate oversight in public securities markets."[90] The blueprint lays out the recommendation that these responsibilities should include corporate disclosures, corporate governance, accounting and auditing oversight, and other similar issues associated with corporate activity.[91] The Securities and Exchange Commission would continue to perform this function in the optimal structure.

Figure 4 – A graphical representation of the "optimal regulatory structure"



Source: Treasury Blueprint, March 2008 p. 142

Paulson's plan has won significant praise from the hedge fund industry. Earlier we learned that the hedge fund industry (through their global outreach firm – MFA) have been advocating for a modernized, streamlined regulatory framework that aims to reduce unnecessary bureaucracy and duplicative procedures. Paulson's "optimal regulatory structure" caters for a streamlined regulatory framework, with each regulatory entity performing an exclusive function, hence, no overlap or duplication.

Skeptics of Paulson's plan argue that the plan does little to address the regulation of hedge funds or private equity firms. As Conde Naste financial writer, Megan Barnett noticed, "In the 212 page Treasury plan, the term "hedge fund" appears only twice and "private equity" only once."[92] Skeptics say that, judging by the language in the blueprint, it is pretty clear that Paulson intends to leave hedge funds and private equity firms lightly regulated.[93] "According to the executive summary, the funds would fall under the purview of a new regulator to oversee business conduct across all financial firms. They would also be subject to information reporting requirements from the Federal Reserve, but its use of that information would only be used broadly when systemic risks in the market emerge."[94]

Many feel that Paulson's plan does little to change the status quo for hedge funds and private equity firms. Indeed there are those that feel that politics may have played a major role in determining the winners and losers of any regulatory changes. However, I feel that these are purely circumstantial arguments. Yes, it is true that hedge funds donate vast amounts of money to various political campaigns and have in recent years been increasing their presence here in Washington; however, to assume that they are powerful

enough to influence the outcomes of a piece of national financial regulation litigation may be a gross misassumption.

On the other hand there are those that feel that Paulson's plan does enough to ensure more stringent capital adequacy requirements for firms using leverage, and that the streamlined approach will allow regulators to be more effective and efficient.

5. Conclusion

Throughout this paper I have provided insight and arguments from key stakeholders. In my conclusion I intend to express my personal view points on the central thesis of this paper – regulation.

I am a strong believer that the emergence of the hedge fund industry has come as a direct consequence of the sheer genius and added innovation by players in the financial markets. The growth of this "exclusive" industry has proved that the very essence of the capitalistic values that have determined this country's path to success, still hold true today.

It is evident that financial crises are endemic and will always continue to be so (for as long as we embrace our capitalistic values). Since the inception of our financial markets we have experienced booms and busts. The current turmoil we face is no different from the ups and downs experienced throughout the very long history of our financial markets. The notion that a world can just regulate its way out of crises is an illusion.[95] I believe that crisis is the price we pay for innovation and governments face a tough choice of embracing this innovation by keeping markets open or regulating and

hampering their innovation. Regulation may provide some form of safety, yes, but it will also destine an economy to a lower rate of growth and even then crisis may strike.

I feel that regulation has never proven to be effective in avoiding market turmoil. Consider that the hedge funds have been amongst some of the least affected entities in this subprime mess. However, the very institutions that recorded some of the largest losses ever have been the Citigroups, the UBSs, the Bank of Americas, the very regulated entities that people want hedge funds to emulate.

I am not an advocate for more regulation of hedge funds but rather better regulation of hedge funds. I do believe that the current framework is "broken" and that changes need to be made to make it more effective. Paulson's plan provides some genuine attempts to make the system more efficient and embrace this financial innovation that hedge funds and private equity firms provide.

Tighter regulation will mean that the social value of these entities will be lost and we will be succumbing ourselves to a more socialistic value chain that is not interested from benefitting from the sheer brilliance and ingenuity that spawns from financial innovation.

APPENDIX A – SNAPSHOT OF A FIDELITY FUND

Morningstar Report | Snapshot Section | Full Report (contains all sections) 11-25-08

Click the print icon in your browser to print this report.

Snapshot
Fidelity FFIDX

Performance more

Growth of $10,000 10-31-08

Fund Current Category Index

	2004	2005	2006	2007	2008
Fund	7.8	7.5	13.7	16.8	-36.2
+/- S&P 500 TR	-3.0	2.6	-2.1	11.3	-3.4
+/- Cat	-2.2	1.6	-0.5	10.7	-2.2
Fund Category	LB	LB	LB	LB	LB

Trailing Returns % 11-24-08

	YTD	3 year	5 year
Fund	-44.19	-9.74	-1.73
+/- Cat	-2.00	1.76	1.16
+/- S&P 500 TR	-3.40	0.85	0.55

Premium Features

Analyst Pick or Pan
Premium

Role in Portfolio
Premium

Key Stats more

Morningstar Category
Large Blend

Morningstar Rating
★★★★

NAV (11-24-08)
$21.40

Day Change
$1.23

Total Assets($mil)
4,984

Expense Ratio %
0.55

Front Load %
None

Deferred Load %
None

Yield % (TTM)
1.49

Min Investment
$2,500

Manager
John D. Avery

Start Date
02-06-02

Analyst Report Summary

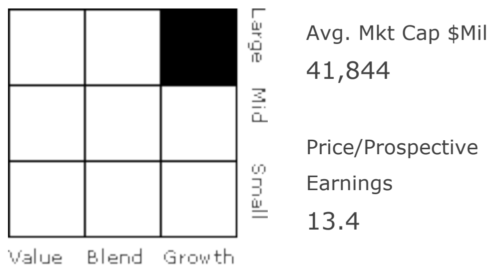
Even after a surprising 2007, we still want to see more from this mutual fund. **Read full analyst report**

Stewardship Grade

A decent steward, but with room for improvement. **See more detail**

Portfolio Analysis more 09-30-08

Morningstar Style Box



Avg. Mkt Cap $Mil

41,844

Price/Prospective Earnings

13.4

Sector Breakdown (% of stocks)

Information	**17.79**
Software	1.76
Hardware	12.11
Media	1.79
Telecommunications	2.12

Ownership Zone

Large
Mid
Small

Value Blend Growth

	% Long	% Short	% Net Assets
Cash	1.2	0.0	1.2
Stocks	98.8	0.0	98.8
Bonds	0.0	0.0	0.0
Other	0.0	0.0	0.0

Industrial Materials	13.57
Energy	14.25
Utilities	2.07

Annual Turnover %	80
% Assets in Top 10	20.21

	Top 5 Holdings Get Price Quotes	Sector	YTD Return %	% Net Assets
⊕	Monsanto Company*	Industrial Materials	-36.75	3.25 %
⊕	Bank of America Corporation*	Financial Services	-62.60	2.29 %
	ExxonMobil Corporation*	Energy	-14.26	2.12 %
⊕	Wells Fargo Company*	Financial Services	-10.08	2.11 %
	Wal-Mart Stores, Inc.*	Consumer Services	12.47	1.99 %

⊕ Increase ⊖ Decrease ☆ New since last portfolio * Analyst Report available

YTD Return through 11-24-08.

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