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HEDGE FUNDS; THEIR ROLE AND INFLUENCE IN TODAY'S FINANCIAL MARKETPLACE

"Hedge Fund" is an often used expression, but surprisingly, one without even a generic meaning. It is a term that has been used to describe an undercapitalized individual trader actively buying and selling new issues for his own account as well as a multibillion dollar limited partnership whose general partner has carte blanche to transact deals for the group, with the intent that he maximize the partnership's profits. Hedge Fund transactions may include the purchase and sale of any form of security or commodity, long or short¹, equity or debt, passively or with the view of taking control. All of the foregoing can be executed in

¹The act of selling a security that is not owned, in the hopes of repurchasing the shares at a lower price at some point in the future.

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almost any combination. This memorandum primarily addresses the most common security oriented, capital pools which are also those receiving the most notoriety.

Hedge Funds come in all sizes and shapes, from the now fledgling Dome Capital Management, currently raising money to do "Day Trading,"² to the \$20 Billion off-shore Quantum Fund, run by George Soros, which does not accept American Investors. There are Hedge Funds that specialize in such esoteric fields as Junk Bonds, Derivatives, Currency Trading, Geographic Areas, and even Hedge Funds whose raison d'etre is the investment of partner's funds in other Hedge Funds.³ A January 21, 1992 article in Financial World points out that the pension funds of Harvard, Stanford, Duke and the United Mine Workers are either invested in Hedge Funds or at least are considering them as AN alternative financial tool.

Contrary to popular regulatory misconceptions, a Hedge Fund does not necessarily have to be a limited partnership

²A securities transaction closed out them same day it is initiated. The only possible motivation for conducting business in this manner would be the lower margin requirements.

³The Institutional Investor pointed out in a January 30, 1992 article that "For the first time in their history, offshore funds are monitored and evaluated and their performance published - by New York's Lipper Analytical Services and London's Micropal - making public and visible what was once a shadowy corner of the investment world. Micropal now follows some 3,000 offshore funds worldwide, up from a total of 850 such entities in 1986. No precise figures are available, but estimates of the assets in all offshore funds run somewhere in the neighborhood of \$250 billion."

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to be recognized as one by "The Street". This inadequate definition is the consequence of insufficient knowledge regarding the scope of activities engaged in by sole proprietors performing similar functions.

The larger Hedge Funds aggressively compete for new dollars, trumpeting their heroics to a cult of sophisticated gamblers looking for the hottest hand in town. The smaller sole proprietorships use their own funds and prefer to blend into the background. Only the brokers receiving their business know who they are and the scope of their operations.

Whether they work alone or in concert, Hedge Funds exert enormous influence over all phases of the financial marketplace, at times creating turmoil unparalleled in the financial world. The earlier a potentially profit making opportunity can be uncovered, the greater the probability of beating the competition to the quarry.⁴ The combined assets of these funds most certainly number in the hundreds of billions of dollars, and because of their unregulated nature, they are able at times to hold large investment banking firms in virtual servitude for past or future favors.

Before proceeding further let us define this amorphous creature that we refer to in this article as a "Hedge Fund",

⁴The exception to this generalization is the area of short selling, in which new victims are gratuitously spooned out, like chum to a circling school of sharks.

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understanding that the term is applied by "The Street" to any entity that acts in mysterious ways. My definition of the term would be: a pool of aggressively managed funds whose scope of investment in financial instruments is limited only by the terms and conditions of its charter (most of the time) and the ego of its management.

Most of the major Hedge Funds will generally not pursue a prospective investor unable to risk seven figures. This is not true of Multimanager funds, which invest their limited partner's assets in a multitude of funds, hoping to both spread the risk and give the "small investor", a chance to play in the big leagues. Because Multimanager Hedge Funds charge very high management fees and levy substantial assessments, they must demonstrate extraordinary performance.⁵ Added to these fees are those charged by the Hedge Fund itself, creating enormous baggage for the investor.

Further complicating the investment decision, unregistered Hedge Funds with less than one hundred investors are exempt from a public reporting requirement. When superior results are attained, the fund management will arrange press conferences to bombard the public with their results. Under-performance is accompanied by evasion and silence. This lack of regulation and selective reporting fosters

⁵During the five years since the advent of these funds, they have in fact shown such performance.

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fraud. One manager broadcast substantial trading profits during a period when he had actually wiped out the majority of the Fund's investors. The "Alice and Wonderland" performance, though unverifiable, continued to attract gullible participants.⁶

1. THE PURCHASE OF NEW ISSUES

The 80's were Wall Street's decade of easy money, large cars, yuppies, and LBOs. The 90's appear to be shaping up as the decade of deprivitizing the LBOs created in the previous decade. Lower interest rates have allowed the refinancing of much junk bond debt at more favorable rates. Superior management along with the elimination of fat has substantially turned many of these companies around. New issues of these only recently private companies are proliferating, fueled by the best new issue environment in market history.

New issues are the financial lifeblood of American Industry. However, their underwritings inherently spark extraordinary conflicts of interest. When the syndicate department of a brokerage house prices a new issue, it is representing both its clients and the issuer.

⁶In a Forbes article of June 24, 1991, quoting Ronald Lake, a consultant to Optima Fund, a Multimanager, "there are some 40 of the vehicles, he figures there is already \$2 billion invested with more on the way."

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In this, the most ephemeral of all financial decisions, there is no perfect way to strike a balance between supply and demand. If the price is perceived to be "too upscale," the issue does not sell. If it is considered undervalued, the securities command a premium, and the issuer concludes that it has given up too much equity for what was received in return. On Wall Street, you are never any better than your last offering. If the Initial Public Offering ("IPO") trades flat or at a discount, the investment banker becomes known as a purveyor of dogs; if the issue appreciates, he acquires a reputation for underpricing and investors will flock to his next offering.

As principal transactions currently represent the most profitable area of Wall Street's business, an unsold or badly placed underwriting can literally ruin a small investment banking firm's reputation, since it effects both the brokerage firm's clientele and the issuer adversely.

Hedge Funds receive preferential treatment in underwritings because they are generally willing to step up to the plate, win or lose. Officially Wall Street is on record as abhorring almost everything the "hedgie" stands for, and ordinary brokers⁷ are advised to avoid them. This is par-

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⁷registered representatives or securities salespeople

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ticularly true in the new issue market, where they are historically perceived not as investors, but as "fast buck artists," whose allocated shares must be repurchased by the investment banker's clients at higher prices. In actuality, the syndicate manager maintains Hedge Fund accounts on his own personal books, thereby covertly controlling the ebb and flow of the IPO. In return for favorable treatment on hot IPOs, Hedge Funds can be counted on to take down chunks of poorly priced, ill-conceived and under subscribed new issues, thus preventing the deal from aborting.

Not all issues trade at premiums, so it must be assumed that either the majority work out favorably, or that there are other incentives persuasive enough to cause these funds to run the transactional risks. During hot new issue markets, the process functions smoothly, with the premium derived from numerous profitable IPOs far outweighing an occasional loss. These Funds function full time only when the new issue market is hot or other considerations can be arranged.

The IPO climate that has existed since 1989 offers an example of such a feeding frenzy.⁸ In breaking down recent record "street" profits the financial press identify IPOs

⁸It should be noted that limited partnerships may not transact the preponderance of "hedge fund" activity in new issues, probably because of the highly sensitive nature of understandings between the participants.

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as their most substantive source. Incentives may be offered in return for purchasing securities that almost assuredly will decline in price. An incisive overview on incestuous relationship that often exists between brokerage firms and their more flexible clients. The details of this type of transaction will receive major press momentarily as the Alan E. Rosenthal trial unfolds. The Government's contention is that Rosenthal exerted control over funds under his management to purchase Drexel Burnham Lambert's (Michael Milken) underwritings that were not being well received by the "Street". In exchange for Rosenthal's generosity, Drexel, it is alleged, arranged \$1.6 million in phony losses for him, thus reducing his income taxes. Although not a Hedge Fund, (\$2 billion pension and benefits fund) the Rosenthal Case will be one of the first substantive public examples of this type of activity.⁹ This form of barter has infinite possibilities, some of which withstand scrutiny, while others might exceed accepted legal and ethical boundaries.¹⁰

⁹A June 1, 1992 article in the Wall Street Journal carried an article that is right on target. In a law suit that Drexel Burnham Lambert Group, Inc. has filed against Ivan Boesky it is alleged that \$4.8 million was diverted from Drexel, by Milken, to Boesky, illegally. "The Journal" states that: "In a lawsuit filed in federal court in Manhattan, Drexel and its creditors cite seven instances in which the two men sold each other stocks at artificially high or low prices. The trades, in January 1985, involved warrants, notes and bonds of MCI Telecommunications Corp., MSA Realty Corp., Valero Energy Corp., First Texas Savings, MSA Shopping Corp., Republic Airlines and Itel Corp.

Mr. Boesky allegedly made the trades, outlined in Mr. Milken's guilty plea, through a broker-dealer he controlled called Seemala Corp.

Mr. Milken, the former head of Drexel's high-yield bond department, has said the stock trades were intended as a repayment to Mr. Boesky for money the arbitrageur lost while assisting Mr. Milken in other criminal schemes."

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If a firm errs in pricing, it is almost universally to the disadvantage of the issuer. Further, the process generally results in undue concentrations of original issue shares owned by professionals rather than the public. Hedge funds are often granted generic "puts" against their transactions, and run little or no risk, while the public receives only the scraps in premium issues and is bulldozed by frenetic stockbrokers into purchasing IPOs that institutional investors who have done their homework, perceive as going nowhere at best.

Professionals can invariably gauge the demand for a particular new issue in advance.¹¹ Wall Street Syndicate Departments readily supply this information to valued clients who can then determine the IPO's probable premium or discount, and adjust their activities accordingly. Some Hedge Funds have research staffs that do superb analytical

¹⁰Smaller Hedge Funds operate with much lower overheads, receiving much of their research from the street, while their expenses are often underwritten by host firms in exchange for commissions. Barter of this type results in substantially higher profits to the Hedge Funds.

¹¹IPO Investment Services has a 900 number that many Hedge Fund's use to determine at what price a new issue will commence trading. Their results have consistently been amazingly close to the mark.

¹¹ This section could be titled, "The Purchase and Sale of New Issues". As pointed out in a Baron's article on August 19, 1991, quoting Jonathan Merriman, whose hedge fund is restricted to the short sale of new issues for 50% of his portfolio: "IPOs have performed poorly....studies show that over the past decade, new issues under performed the S & P by 14% and the IPOs tend to trade well below their offering prices after a certain passage of time."

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work and are therefore much better equipped to do business in this arena than the public.¹²

For a sure thing, you can't beat selling naked into a secondary¹³ that is known to be coming at a discount from its current trading levels. This presents a no-lose situation for the underwriter and the Hedge Fund. The issuer and its shareholders will receive either less money for its securities or will have to issue more stock to receive the same amount, thus creating unnecessary dilution. The Hedge Fund for its part is aware that it can cover its short at a discount from its cost price, without commission, by repurchasing the shares in the secondary. The Investment Banker is assured that if the issue is placed with funds having short positions, those securities cannot come back into the market. This is especially important because there will be no residual effect upon the offering allowing the issue to bounce back once the syndicate is closed, thus making the investment banker a hero in his clients eyes. It also places the brokerage firm in a position to make a larger commitment to the issuer. Whatever stock that has been sold short will be repurchased in addition to whatever buying interest the investment banker may garner through normal supply and demand channels.

¹³An additional offering of a security that is already publicly traded.

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Usually this type of agreement is reached substantially before the offering and although a fairly common "Street" occurrence, its illegality does not seem to preclude its use. Some firms avoid this costly step by selling stock in their own deals short and covering in the offering thus eliminating the middleman.¹⁴

2. "DEAL" STOCKS

Many of the largest Hedge Funds trade only in acquisition-oriented tender offers. In this, Wall Street's ultimate arena, the participants only operate with an open throttle at appropriate times.

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¹⁴An article in the New York Post, of May 19, 1992 gives a recent example of this type of activity in the listed shares of ConAgra: "The NYSE investigation began in December 1990 after a lower-level Shearson employee said she was ordered to place a trade lowering ConAgra's stock price.

Shearson had lined up investors to buy 4.4 million shares of ConAgra stock at 33 1/4. (in a secondary offering)

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But at the close of trading on the day the stock offering was priced, a trade pushed up ConAgra to 33 3/8 a share. The new price meant additional money for ConAgra. But Shearson worried it would have difficulty selling the shares at the higher level, especially since it had arranged buyers at 33 1/4." A trade was executed after the NYSE close on the Pacific Coast Stock Exchange knocking down the price. (this trade in itself was probably an illegal short sale. It is interesting to note that Peter J. Dapuzzo, co-head of Shearson's worldwide equity division prior to this incident was highly regarded on the "Street", as a solid professional and was frequently quoted in the press. Shearson has already paid ConAgra \$500,000 in compensation for its actions.

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Tight money for acquisition purposes has caused a severe retrenchment in this group. Such funds assemble blue ribbon staffs, or hire consultants, to perform the highly complex evaluation of every possible contingency. The staff may include lawyers, who advise on Justice Department implications, actuaries, who analyze the demography of the target's stockholders to predict the outcome of the vote on any given proposal, industry research specialists whose sole function is to determine whether the target is, indeed, "in play",¹⁵ and whether a competitor may offer an increased price. Bidders use the rating services to relate the investment grade of the debt issued as part of the bidder's package to its worth in the marketplace. Most importantly, the acquiring Company tends to tacitly co-operate with Hedge Funds, in resolving questions such as whether the bid may be changed or raised and under what circumstances the paramour may lose all interest in its quarry. The Hedge Fund's attorneys evaluate "poison pills", protective state legislation, and the suitor's chances of prevailing over these and

¹⁵A deal is "in play" when, the initial purchase offer has been made for a publicly traded company or negotiations are announced relative to a potential offer. The corporation then can become a universal target. Competition for the original offer may be dictated by considerations such as a competitor's desire to acquire synergistic product lines or to block a competitor. "The Street" often assumes that the bidder knows about values buried either in the balance sheet, or in the depreciation figures. A Street perception that the Company has excess fat, poor marketing or inferior management may be other considerations. Financial engineers also may conclude that the sum of the parts is substantially greater than the whole and by adroitly rearranging the corpus, create a more valuable target. Lastly, many of the more prestigious Investment Bankers will not participate in an unfriendly takeover attempt, but when the "target" is "in play", "White Knights" make competing bids that may be more palatable to current management especially if it protects management's position or insures the opening of their "Golden Parachutes".

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other potentially insurmountable roadblocks. "Golden parachutes" are examined for legality, cost and potential renegotiation.

When all of this esoteric data has been compiled, a mathematical model can be created that quantifies the risks. The model also predicts, within certain parameters, what profit the transaction will produce if it proceeds as anticipated as well as the potential downside, should unforeseen events occur. On the basis of this risk/reward calculation, the bidder can determine whether to buy, sell, short or conclude that the investment is not worth the gamble. ¹⁶

The incestuous relationship between Hedge Funds and the potential acquirers works well for both. Stock ownership quickly flows from investors to speculators. Equity holdings in the target shift from loyal, long-term investors to speculators with an eye on short-term profits measured in days or even hours.

The Hedge Fund model of the stock price of a target company is primarily based on three variables: the likeli-

¹⁵ More often than not, a bidder will purchase shares in an amount that approaches, but does not exceed SEC reporting requirements, (Rule 13D) prior to making its bid, thereby defraying its initial transactional costs, with profits earned in the event of a successful higher offer by another bidder.

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hood that this or another similar transaction will take place, the time in which it will probably occur, and the price at which the transaction could eventually culminate. When the Hedge Fund model coincides with the projected stock price, profits can be predicted with a fair degree of certainty. In view of the nominal holding period, very high annualized returns are the rule.

In this forum, brokerage commissions are the price of admission. Fees are one of the ubiquitous wild cards that make this activity a province that should be solely composed of professionals. Transactions are executed for a commission of pennies per share regardless of the securities price. It is this difference alone that may create the margin between profit and loss, logically barring all but the most misguided of amateur investors from this domain.

The public is generally unable to prevent a calamity by hedging a deal using a combination of options, convertible securities, warrants, rights, or futures available to the Hedge Funds. Esoteric securities products such as "down and out options"¹⁷ or "synthetics"¹⁸ are also unknown and

¹⁷"Down and out options" are puts or calls that are issued to professional investors for extremely sophisticated trading purposes. The seller offers privately traded, over the counter options at extremely low fees, and when agreement on a transaction is reached he simultaneously makes an offsetting long purchase of the underlying security. If the purchased stock falls below a prearranged price the option is canceled and the stock is liquidated. Unless a halt in trading occurs, creating a reopening at a substantially lower price, the "down and out" issuer cannot lose and has therefore entered into a riskless arbitrage.

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generally unavailable to the public, but a valuable tools used by professional traders.

Having extensive holdings may require the borrowing of substantial quantities of the underlying or similar security to create the offsetting positions. These instruments may be in short supply and, usually under these circumstances, are loaned only to favored clients. If securities are entirely unavailable, hedges have often been created by naked¹⁹short or long sales through American Broker-dealers or foreign intermediaries, without any consideration of delivery.

For his part the purchaser uses this vehicle for controlling large quantities of primarily deal oriented securities in a largely unregulated environment at a reasonable cost.

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¹⁸When securities are borrowed against a sale to make delivery, the proceeds of the transaction change hands in the same manner that they would in a "regular way" transaction. The stock is borrowed, usually from their clients long positions with the firm, and delivered against the short. The funds are paid on settlement day, just as though the security had been sold long. The securities purchaser is usually unaware that he has been on the other side of a short transaction. The owner of the stock that has been lent is equally oblivious to the fact that the securities are being used for a purpose diametrically opposed to his own. Even more ominous is the fact that the owner of the hypothecated securities may unwittingly have lost his voting rights. Short sales add shares to the float, but on the books of the company, the issued and outstanding stock remains constant. During highly contested elections, the fact that an investor votes his proxy does not necessarily mean that his wishes have been recorded on the corporate books. Various regulatory agencies are currently looking into solutions for this virtually unknown form of disenfranchisement.

Interest is earned from the day the proceeds of the short sale are paid, and continue until the short is covered. By prior negotiations, these sums are shared between the lender and borrower until the short is covered.

¹⁹A sale of securities without the intention to attempt to make a timely delivery on the settlement date.

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Unlike Hedge Funds, the public also foregoes tax breaks by being unable to arbitrage. Funds may obtain virtually risk-free tax relief by removing the unprofitable leg of the transaction at year end and temporarily replacing it with the stock's synthetic.

Rumors abound in this market place periodically, taking one of two forms. "The deal will tank", or "another higher bid is going to be made shortly." These fables may circulate figuratively at the twelfth hour and are usually incorrect, often providing the unscrupulous with an escape valve from the potential failure of a transaction.

3. SELLING SHORT

Hedge funds whose primary purpose is selling short demonstrated exponential growth during the eighties. Profits are derived by identifying and short selling, ideally, a combination of thinly capitalized, theoretically overpriced securities, whose accountants may use questionable accounting practices. If there is something unsavory hiding in one or more of the corporate officers' background so much the better. Add to the foregoing an undercapitalized investment banker with a negative regulatory history along with a stock

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with a limited number of retail market makers,²⁰ leaving only one ingredient left to be mixed into the brew; an SEC investigation followed by a negative public relations campaign. Under this scenario no matter how significant the company's product or how capable the management, the company would have little chance of raising additional public funding in the foreseeable future.

Investors threw cash at these Hedge Funds, resulting in too much money chasing a limited number of quality deals. The ensuing decline in the caliber of investment, coupled with a series of critical miscalculations concerning market movements, resulted in substantial negative growth. This trend was not alleviated by a gradual leveling of the regulatory playing field spurred on by Congressional Hearings, which investigated a host of charges brought by companies that had become victims. The Hedge Funds' high profiles also created abundant negative publicity, much of which concerning the manner in which these Funds conducted business, and contributed, albeit to a lesser degree, to a near flood of redemption's.

²⁰Over-the-counter marketmakers fundamentally trade stocks either because they feel trading profits will result in income being generated for the firm, or there is a retail interest in the security by the firm and or its clients. A lack of retail interest tends to put the stock into very weak hands.

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Although there are undoubtedly many exemplary inhabitants of the financial limbo of short sales, the sobriquets "Mortician" or "Undertaker" are aptly applied to some of the players. (In most cases, those names were chosen by the Hedge Fund itself, solely to add an unnerving element to their victim's perception of their powers.) Once the target is identified, rumors and innuendo abound, at times preventing target companies from completing an existing financing or re-entering the capital markets. The result is often the destruction of what, under other circumstances, would have been a perfectly viable business.

To prevent a recurrence of the market collapse of 1929 and to foreclose the possibility of "bear raids", it was determined that, on listed exchanges, securities could not be sold short unless the last previous different way trade was lower than the short sale. These regulations encompassed the perceived loopholes within the then existing market environment. The modifications did not include non-exchange traded securities. At the time, unlisted securities could not generally be sold short, as timely delivery was not possible. Fully paid for shares, which were the non hypothecatable²¹ property of their owner and could not be used for the settlement of a transaction. With the advent of margin eligible OTC securities, decades later, almost all

²¹"Street" parlance for "lendable".

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securities became lendable and could be shorted with reasonable impunity. A regulatory door had unintentionally been left ajar in an environment that could not have perceived the dramatic changes that would occur decades later in over-the-counter marketplace.

The Eleventh Report by the Committee on Government Operations states: "The committee has found, however, that many of the reports of rumor-spreading abuse are entirely credible and are strongly suggestive of abuse. Moreover, the widespread nature of these reports and the high degree of similarity among them constitute a highly consistent pattern. The committee finds, therefore, that a pattern of abusive and destructive rumor mongering, targeted specifically at companies in the equity securities of which some short-selling investors have established major short positions, appears to be occurring." The report continues: "This study has not been completed, but the evidence examined so far suggests that naked short selling or its functional equivalent does occur in large volume in some equity issues."

The Committee on Government Operations of the Securities and Exchange Commission concluded: "The SEC has never, as far as the committee is aware, brought an enforcement case, or even sought seriously to investigate a case in which, the central allegation of abuse was the malicious

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dissemination of false or unverifiable negative reports about a public company, its officers, its products, or other matters that, if true or believed by investors, would be likely to influence negatively the trading price of the company's stock."

"For this reason, the committee finds substantial basis for concern that the SEC's policing of the fairness of the markets in this respect may not be adequate."

The committee's concern regarding this aspect of the SEC's enforcement program is further heightened by the prepared testimony of Mr. Sturc for the SEC's Division of Enforcement. In explaining why the SEC has not found it practical to bring enforcement cases against short sellers in most instances, he stated: "Finally, many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities and other laws. When there is an obvious economic justification for short sales, it is extremely difficult to prove:...(ii) the material false statement/omission and fraudulent intent requirements of Rule 10b-5. This is particularly true in those situations where, for example, our investigation tends to show that at the time when short sellers were allegedly disseminating false

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rumors, in fact, the issuer was disseminating materially false financial statements."

The committee concluded that: "This statement by Mr. Sturc has the appearance of a de facto "no-action" assurance to short sellers concerning any actions they may take to disseminate false rumors about companies that are the object of SEC fraud investigations." Further the committee stated: "Finally, the committee finds that there has been an uncomfortably close direct working relationship between certain unknown short sellers and the SEC enforcement staff." The committee concludes that: "Regardless of the appropriateness, from an enforcement perspective the investigations opened regarding possible fraud by short-seller target companies, the de facto working relationship between short sellers and the SEC enforcement staff has the effect of providing bounties to the short sellers for their enforcement tips when the enforcement investigations become known in the market."

A strategic alliance between the Securities and Exchange Commission, various influential financial publications, and Hedge Funds, has taken its toll on many emerging companies. (The SEC has stated accurately that Hedge Funds provide valuable research to the government in their effort to uncover violations.) The Securities Acts of 1933 and 1934 omitted regulations that would have offered the same

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protection to over-the-counter securities that these regulations provide to historically higher priced and more adequately capitalized listed companies. Peculiarly, those entities that did not require increased regulation for their survival were granted it, while those that required protection were ignored. The regulators had unknowingly compromised an entire segment of the securities industry, thus making it susceptible to the same bear raids the Securities Acts had been formulated to eliminate. This historic oversight has been exacerbated by the NASD's sluggish response in addressing these inequities. The consequence of this regulatory foot dragging, has been the perpetuation of the obscene profits made by both the Hedge Funds engaged in these activities, as well as the broker-dealers that are the beneficiaries of the considerable commission income that is generated.

Over-the-counter market makers have been indulged excessively by regulators, concerning the delivery of securities that they have sold short for their proprietary trading accounts.²² Within the over-the-counter market's "Alice In Wonderland" world of non-regulation, short sales are allowed

²²An additional advantage enjoyed by the short sellers is a unique tax shelter, which kicks in when either the company has self-destructed, or the shorts have destroyed it. In either case, the stock is trading at little or nothing and without covering, the profits may be pocketed and used for other endeavors, without incurring a tax. These transactions usually require the borrowing of non-marginable securities ad infinitum. Considering that the lending of fully paid for securities is generally illegal, another "can of worms" has been opened that is currently being addressed in other forums.

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on down ticks, marketmakers are not obligated to effectuate timely delivery, and reporting rules, in place for decades on the exchanges are not considered necessary. Even legal challenges have been hampered by anomalies in the securities laws governing unlisted trading. Self regulatory agencies, particularly the National Association of Securities Dealers, have been apathetic when it came to enacting the modifications essential for the protection not only of public investors, but of the companies listed within the marketplace. These regulatory flaws have continued to enable Hedge Funds to act with impunity.

The Securities and Exchange Commission expresses some frustration with respect to short selling when it states, "Restrictions on short sales (e.g., selling an index future without owning the underlying component stocks) have never been imposed on options and futures products. Moreover, the difficulties of extending such restrictions to options and futures products would be substantial. The Commission's short sale rule, Rule 10a-1 under the Exchange Act prohibits persons from selling stocks short at a price below the last sale price (minus tick) or when the last trade involving a change in price was a minus tick.

A futures or options trader who sells short on a minus tick is simply responding to price declines in the cash index. A short sale restriction that takes into account move-

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ments in the underlying cash index would be extremely complicated and would impose substantial compliance burdens and risks on traders. Nevertheless, the absence of short sale restrictions, coupled with the greater leverage of futures arguably presents the potential for greater speculative selling than could occur in the stock market." (Nowhere does the SEC address the fact that one does not need to be hedging to sell indexes short. This represents a clear violation of the intent that regulators have applied to the listed exchanges.)

A unique technique for permitting the public unconstrained access into the short selling arena without concern for normal regulations, was recently the subject of a Wall Street Journal Article: "At a time when many investors are wondering if stock prices are too high, Fidelity Investments is reviving a program that allows investors to bet on the share price declines in 10 stock market sectors.

The giant Boston mutual fund company is letting its discount-brokerage customers short-sell a fistful of Fidelity's 35 Select mutual funds, each of which invest in a single industry group. Just as in shorting a regular stock, investors can sell borrowed shares of the 10 earmarked funds, hoping to profit by later repurchasing the fund shares at a lower price.

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The most popular funds for shorting at this moment are Fidelity's three health care specialty funds: Select Biotechnology, Select Health Care and Select Medical Delivery. These three account for more than 90% of the \$6.5 million in mutual-fund short positions held by Fidelity Brokerage Services customers.

Along with Fidelity, mutual fund short-selling is also offered by Jack White & Co., the San Diego discount brokerage firm. Jack White offers approximately 100 funds for short selling, including funds from Janus Group, T. Rowe Price Associates and Twentieth Century Investors."

As a consequence of recent hearings held by the House Commerce, Consumer and Monetary Affairs Sub Committee, momentum toward the creation of a more level regulatory playing field seems to be developing.

4. ACQUISITION OF COMPANIES

Many Hedge Funds have chosen the purchase of "deal stocks"²³ as their milieu. Will the deal print? What is the probability of a higher offer? Acquisition-oriented Hedge Funds have benefited from their own substantive internal

²³Once interest has been shown by anyone in acquiring a public company, it becomes generically known on "The Street" as a "Deal Stock".

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research, industry forecasts, and in-house capability to evaluate the spectrum of elements comprising these remarkably complex transactions. The clout provided by the generation of enormous commissions, provides access to "the Street's" highly technical institutional research and sophisticated corporate finance generated analysis. The Hedge Funds' propinquity to financing and their capability of paying the massive success fees investment bankers require for the provision of capital, gives them access to any American publicly traded Company. Many of today's corporate Chief Executive Officers started out as Hedge Fund managers, dominating assets that later allowed an orderly evolution into corporate raiding. As a result these CEO's now control many highly leveraged public and private companies. Some of the largest, most rapidly accumulated fortunes in America have been assembled by (and for) Hedge Fund managers.

On occasion, an acquisition may be the consequence of a miscalculation. A number of proxy battles have arisen from "greenmail", Wall Street's generic term for blackmail. By assembling large quantities of the securities in an ostensible target and simultaneously transmitting ominous signals, the Company's management will often pay a bounty to convince its unwelcome suitor to back off. Occasionally the bluff is called and the pseudo acquirer is obliged to proceed or suffer a substantial financial setback and, potentially more damaging, the loss of face. In these skirmishes the target

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is frequently critically injured even though the aggressor has been vanquished. The converse is also true; the Hedge Fund may have won a Pyrrhic victory. An inescapable consequence of this form of financial combat is a crippled target and a lower stock price. The Company may be left noncompetitive, saddled with debt and generally far less valuable. No matter what the eventual outcome, the reality is that the attorneys invariably profit while the stockholders assuredly will lose.²⁴

When the ranch has been wagered on the outcome of a deal that later aborts, passive Hedge Funds are often mystically transformed into "Deal Hedge Funds". Either the loss may be unacceptably large, or the elimination of the main pursuer may cause a substantial contraction in the securities price, impinging upon the Fund's performance, thus, the investor, out of necessity, may well turn out to be the eventual acquirer.

Hedge Funds have been embroiled in a substantial number of the recent, large, unfriendly corporate public acquisitions. Their intimate knowledge of "The Street" and its nuances provide them ready access to financing, often initiated by hungry investment bankers. The latter may well

²⁴In the short term this is a given, but management can be shaken-up enough to make changes that over time may substantially benefit the company.

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have identified the target, proposed the deal, fabricated the blueprint, and then provided the funds to proceed.

The demise of junk bonds and the overall dismal plight of American Banking has virtually brought this activity to a standstill. In spite of Wall Street's current record profitability, there are currently more out of work investment bankers than at any time in financial history.

5. HEDGING (ARBITRAGE)

Since we have had financial markets, anomalies have occurred within two or more classes of similar securities issued by the same company. The equivalent is also true of comparable companies within industry groups as well as the various debt instruments issued by the same or equivalent issuers. By establishing a long position in one instrument and the simultaneous shorting of its equivalent, within a limited time, these anomalies customarily disappear, and the securities once more resume trading within their historic relationships. The SEC Staff Report the October 1987 Market Break stated that, "Under normal market conditions, any significant deviation from theoretical value for more than a few minutes results in arbitrage programs that act to reduce the premium or discount". Gains tend to be small,

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but frequent, and inasmuch as the transactions are so highly leveraged, minute aberrations usually result in substantial profits relative to the actual equity invested.

Arbitrage requires liquidity and functions most effectively in markets having a substantial degree of public participation. For the most part it is a general lack of sophistication within this group that gives birth to the distortions essential for pure arbitrage to recur often enough to provide a comfortable living for the many people engaged in this activity.

With the advent of publicly traded options, additional opportunities emerged, bringing with them infinite permutations and combinations. Puts, calls, convertible securities, along with rights, warrants, synthetics and derivative index products provided previously unimagined variations for the participants. For a time, the complexity of these combinations played havoc with margin requirements. For example, Hedge Funds, acting as Arbitrageurs, might purchase an "in the money"²⁵ call at a negligible premium, and simultaneously sell the security. The arbitrageur avoids losses by receiving the stock loan rebate, and if the stock value declines, he stands to make substantial profits.

²⁵"in the money" refers to an option that is trading at a premium to its strike price.

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There currently exists some type of financial instrument designed to prevent just about any conceivable market loss. Some derivative products have been designed to create portfolio insurance.²⁶ The SEC when reporting on the effect of derivatives as they interrelated to the October, 1987 market decline stated, "In reviewing the events of October 1987, it is important to emphasize that the increased concentration of trading in the derivative index products is not attributable only to portfolio insurers. While more difficult to quantify, we believe that low execution cost and margin requirements for derivative index products have encouraged a wider group of institutions to depend on the liquidity of the index futures markets to liquidate substantial portions of their equity portfolio more quickly than they would be able to through the stock market. As demonstrated on October 19, however, the assumed liquidity levels of the futures market became dramatically lower during a market plunge resulting in large futures price discounts and spillover stock selling."

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²⁶a product, usually a commodity, that can be sold against an existing portfolio, preventing losses on the downside but allowing no appreciation if the component securities rise in price. This instrument is particularly useful in that it can usually be executed quickly during periods of market uncertainty. The definition used by the Wall Street Journal in a recent article regarding the leverage, derivatives provide may convey a broader picture: "Derivatives are financial contracts that amount to bets on the direction of underlying stocks, commodities, currencies or bonds. These financial IOUs don't fit into ordinary categories of assets and liabilities; they aren't listed on balance sheets, so regulators call them off-balance-sheet leverage."

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The latest entrant in an already crowded field is a creation of the Chicago Board of Trade labeled a "Cap". Caps guard against a drop of 30 points in the Standard and Poor's 100 stock index over a three month period. New to the fixed income arena is the Chicago Board of Options Exchange's Long-Term Interest Rate Option or LTX which offers impunity against certain interest rate changes. These, and other types of hedging, were described in the Forbes issue of October 23, 1989 about S. Donald Sussman, General Partner of Poloma Partners, which at the time was a \$400 million Hedge Fund: "Since June ('89) for instance, he has been buying Del Webb Corporation's convertible debentures and shorting the company's common stock. If Del Webb's stock falls, Sussman will make heaps of money on the short sale, but won't lose too much on the convertible debenture, because the bond's price [sic] supported by its 10 3/8% coupon. But if the stock takes off, the convertible is likely to get as big a kick as the stock because of the bond's conversion privilege."

"Not only do Sussman's clients stand to win whatever the stock price, they also pick up the coupons on the bond and make money from the short rebate." Sussman indicated that he has achieved returns of over 20% a year at the level of risk associated with T Bills."²⁷

²⁷Although Mr. Sussman's transaction seems fairly riskless, his analogy is a little strong.

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This is a precise example of what is referred to in "Street" parlance as a bonafide arbitrage. Margin requirements only require the deposit of nominal amounts of cash or securities when it appears that both sides of a transaction are equivalent, and that, to a substantial degree, what occurs to one segment will also occur to the other. The appreciation that Mr. Sussman alludes to usually necessitates substantial leverage. An example used by the SEC provides insight into this. "The impact of current margin levels is that an institution could use the SPZ futures contract to establish a speculative long position in order to increase quickly its stock portfolio position, or a speculator could buy or sell the SPZ futures contract, and with a margin deposit of \$1 million, could control a stock-equivalent position of over \$8 million. Similarly, a portfolio insurer or other institution wishing to adjust its portfolio quickly through the sale of futures could create a hedged short futures position with a market value exceeding \$12 million, with the same \$1 million deposit. This is significantly higher leverage than can be achieved under stock margin requirements. Moreover, the increasing popularity of index substitution, index arbitrage, and portfolio insurance, has resulted in an increasingly greater percentage of

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futures positions being taken precisely for the purpose of replicating cash market stock positions.²⁸

In contrast to the securities markets, futures markets are not subject to federal margin levels. The CFTC²⁹ has authority to prescribe margin levels for futures only in emergency situations. Otherwise margin levels are set by the commodities exchanges."

Stock loan rebates substantially increase transactional profitability with the potential resultant income factored into the financial model. Depending on the ratio of financial instruments that are long and short, it is conceivable that even a failed deal may be profitable for the investor. Stock loan rebates are virtually unknown and, for the most part, unavailable to the public.

²⁸The SEC example pales in comparison when off balance sheet items are included. A recent Wall Street Journal article provides insight into what real leverage is all about: "Last summer, Salomon's traders cranked up the highest leverage in its history; for every dollar of Salomon equity, the firm was holding \$34 in securities positions. After the auction bidding scandal erupted, creditors wanted to see less leverage, and the figure dropped to \$24.20 in securities positions.

But to the surprise of some analysts, Salomon didn't reduce its market bets much. I merely moved most of them to another market, the futures and options arena, where leverage can be even greater.

By late 1991, one analyst reckons, for every dollar of Salomon equity, the firm had an astonishing \$196 "notion amount" (Notion amounts may not represent actual risk capital, but more realistically indicates how much each dollar controls. There is no way of determining the actual amount actually at risk by backing into these numbers.) of derivatives bets - a higher figure than similar tallies for Goldman, Sachs (\$138) or Morgan Stanley (\$106), also known for derivatives-trading prowess."

²⁹The Commodity Futures Trading Commission, although more recently created, is virtually equivalent to the SEC in its powers to regulate.

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Stock loan income may provide a fail-safe to arbitrage transactions. Hardly understood, even on Wall Street, stock loan activity enjoys a sinister reputation. Only recently has it been fully integrated into the general back office function of most brokerage firms. Other brokerage firms still prefer to deal through intermediaries rather than institute their own departments, further narrowing the membership of a misunderstood, exclusive club.

By operating stock loan as stand-alone or brokered facilities, and failing to integrate arbitrage and stock loan into a common function, canny traders were able to take advantage of their less knowledgeable associates. Stock loan departments make massive profits, often to the disadvantage of competing in-house divisions, and still represent a virtual wilderness of regulation. The undisclosed fringe benefits available to entrepreneurs that wheel and deal in the lending of securities make them among Wall Street's highest paid "professionals", both on and off the books.

6. EXEMPT SECURITIES

The more aggressive Hedge Funds are willing to speculate on almost any securities transaction. Although they may not be ordinarily considered a component of the Hedge

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Fund arsenal, Government Securities and commodities present unique opportunities and contrasted to other investment vehicles. Control can be gained over prodigious quantities of securities by using insignificant expenditures of capital. Normal margin requirements do not apply to unregulated securities, (Government Issues) and the amount of money or collateral that is required will vary from brokerage house to brokerage house and from client to client. Margin requirements are a matter of negotiation and clout, varying dramatically. Obviously Hedge Funds fall into a most favored status in margin negotiations. Commodity margins, although more formal, are elastic, and relatively insignificant equity is required to enter into a futures transaction.

Until May 1991, the Government granted primary dealers impunity in connection with various types of trading irregularities.³⁰ The perception by the Government was that this

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³⁰Crain's New York Business, June 1-7, 1992 contains an interesting chronology on some of Paul W. Mozer's actions on behalf of Salomon Brothers.

"August, 1989, he had asked a trader at another firm to submit a \$3 billion bid for Salomon in a cash management bill auction, whose rules prevented Mr. Mozer from buying that much.

June 27, 1990, Salomon bids for 240% of Treasury auction, prompting warning from Treasury officials.

At the next, for \$5 billion in 30-year Resolution Funding Corp. bonds, Mr. Mozer ignored "Treasury's" warning. He bid for \$15 billion of the issue.

July 10, 1990, Salomon ignores Treasury warning. Treasury decides to limit bids to 35% of auction.

August 29, 1990, Unauthorized \$1 billion bid in the name of S. G. Warburg.

December 26, 1990, False \$3 billion bid in the name of Soros Capital Management.

December 27, 1990, Unauthorized bid of \$1 billion in the name of Mercury (Warburg) Asset Management.

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trade off would continue to aid in the maintenance of an extremely liquid marketplace for its securities. This was believed necessary for the continued issuance of substantial quantities of Federal debt. Primary dealers have an affirmative obligation to consistently maintain substantive two way markets to preserve their primary dealer status. A number of firms have dropped out recently due to mergers. Trading losses caused by obligations to trade even under undesirable conditions have created an even greater toll. Although a still much desired status, primary dealership is no longer a license to print money, especially if one is not a member of the ruling, inner circle.³¹

February 7, 1991, Unauthorized \$1 billion bid in the name of Pacific Investment Management Co.

February 21, 1991, Two unauthorized \$3.15 billion bids in the name of Warburg Asset Management and Quantum Fund.

April 21, 1991, Paul W. Mozer informs Salomon's senior management that he has submitted one false bid in a U.S. Treasury auction.

April 25, 1991, A false \$2.5 billion bid on behalf of Tudor Investment Corp.

May 22, 1991, Mozer bought heavily in the when-issued market, accumulating a \$485 million "long position," He failed to disclose that position to the government as required.

May, 1991 Mozer illegally increased Tiger's bid by \$500 million to \$2 billion. (May two-year note auction)

August 9, 1991, Salomon informs government of unauthorized bids and management's prior knowledge."

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³¹The honeymoon may soon be over. The Senate has already proposed additional regulation for trading in Government Securities. (This proceeded the Salomon revelations that shook Wall Street, thus did not represent any substantive change, the investing public will not be pleased with regulations not demonstrably stronger than what currently exists.)

The "House", Energy and Commerce Subcommittee on Telecommunications and Finance, headed by Edward J. Markey, will shortly propose stronger and more controversial measures. A June 1, 1992 article in the New York Times states: "The bill would require traders to keep better records and set up procedures to insure compliance with Federal anti-fraud laws and other rules. It would also give the Securities and Exchange Commission broad authority to police the government securities market. (The legislation would give the National Association Dealers the

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Three Hedge Funds, Quantum Fund, Tiger Fund and Steinhart Partners, along with Salomon, bought \$10.6 billion of the \$11.3 billion, May 1991, two-year, Treasury note issue. This action effectively cornered³² the market, creating substantial trading losses among competing dealers. Simultaneously, it increased the cost to the Government and taxpayers in floating this issue. Considering that the Hedge Funds which were embroiled in the recent Solomon scandal are neither the most aggressive nor the most accomplished in Government Securities trading, it is unlikely that this incident occurred in a vacuum. Professor John R. Coffee,³³ stated: "Financing arrangements such as the kind the Steinhart Partners is said to have requested from Salomon could

authority to set up an entire system of rules governing the selling of government securities.)

Wall Street, which staunchly opposed a stronger version of the bill, says it will not oppose the measure for now, hoping instead to weaken it after the House approves it. The Senate approved a much milder bill last summer and the ensuing conference is likely to be the next battlefield.

The Administration has come out against many provisions of the legislation, notably those that take away the authority of the Treasury Department to have the final say on the regulations governing sales practices between brokers and investors."

Unhappy with the "House Bill", along with the Administration, is the Treasury, The Federal Reserve, and the Primary Dealers. The Times article indicates that, "Congressional aides said the heaviest lobbying by individual firms had come from Lehman Brothers, Prudential Securities, Greenwich Capital Markets, Goldman, Sachs, Bear Stearns, J. P. Morgan, and Morgan Stanley.

The House legislation is warmly endorsed by the largest purchasers of government securities - states, municipalities and pension funds - which see it giving them significant protection against fraudulent sales."

³²Webster defines corner as a monopoly produced by buying up all or most of the available supply of some stock or commodity so as to raise the price.

³³New York Law Journal, September 26, 1991.

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serve as a vehicle for tacit collusion."³⁴ This incident changed the manner in which the Government and the public perceived primary dealers. Whether regulators were compelled to take action due to the accusations lodged by disgruntled competition, or the feeling that the American public would no longer countenance the ongoing blatant disregard for regulation exhibited by dealers conducting business within the Treasury Markets, the incidents surrounding the May 1991 "Bill Auction", will cause the primary dealer community to straighten up their act, and play by the rules, at least for a time.

These Hedge Fund Managers did not wake up one morning and say to each other, "let's corner the Government Securities Markets". It is certain that if the transaction could have been cornered in house without having to share the spoils with outsiders, Salomon would have done so. Although it may seem hard to believe, the issue was not the \$11 billion, which could have been handled internally.

³⁴The SEC and the Justice Department are currently investigating potentially illegal Treasury transactions, the result of which will provide insight into the interrelationships among Primary Dealers. The Wall Street Journal of May 21, 1992 stated relative to a story regarding Salomon's settlement with the Government: "Salomon's relief could spell trouble for several other Wall Street firms whose trades with the firm are now being investigated by the SEC and the Justice Department. The settlement includes charges that in 1986, Salomon set up illegal prearranged trades in Treasury securities that allowed the firm to falsely pay lower income taxes by claiming \$160 million in trading losses. The SEC has asked four major Wall Street firms that are believed to have been on the other side of those trades - Goldman, Sachs & Co., Morgan Stanley Group Inc., Kidder, Peabody Group Inc. and Greenwich Capital Markets Inc. - to supply their relevant records, people familiar with the investigation said."

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Outside clients were necessary to complete the sham and make it appear legitimate.

A November 1, 1991 memorandum to Hays Gorey Jr., from The Department of Justice stated: "It was recently reported that prior to the April note auction a dozen Wall Street professionals met and discussed, among other things, the upcoming two year Treasury auction. The group included representatives of Steinhardt Partners (Michael Steinhardt), the Caxton firm (Bruce Kovner and Scott Luttrell) and others who purchased substantial amounts of April and May two year notes." According to another article, bidding information was routinely shared among primary dealers.

Assuming, *arguendo*, that no collusion occurred, there is still no apparent motive for market-cornering unless more than just transactional benefits were exchanged. Obviously, the many variables within a transaction, such as commission, can be adjusted to recapture a portion of the spoils, or conceivably an outstanding chit had been called. (The Treasury limits any purchaser to 35% of the auction's total. To the extent that a dealer is acting as an agent for others, such purchases are not included in the total).

Professor John R. Coffee also reports the following: "Perhaps the oddest circumstance surrounding the standard operating behavior of Salomon (and probably other firms) is that it often did not charge any retail spread to its larg-

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est customers because it wanted their business in order to learn the volume and price level of their bids. In effect, Salomon was paying (by foregoing the customary spread) to learn the terms of competing bids from its own customers. This fact underscores the anomaly (and fundamental conflict of interest) in securities firms being both agents for customers and bidders for their own accounts at the same time. In truth, the position of the largest primary dealers resembles that of the specialist on a stock exchange; the specialist knows from its book of limit orders what the likely future direction of trading will be. As a result, the securities laws subject the specialist to a negative obligation not to trade, except to the extent necessary to maintain a "fair and orderly" market. In contrast, primary dealers are subject to no similar limitation and in fact constantly trade for their own accounts."

At least one source has laid the blame for the recent Government trading scandal upon Liberty Brokers, "A bond brokerage firm owned by Salomon and several other large primary dealers. It shows (the memorandum) how Liberty's favoritism, towards its joint venture parents, distorts the market to the detriment of the other participants therein. It demonstrates how the transmission of certain information can be used to increase the interest rate the Government pays, to provide profit making opportunities for large dealers who receive such information at the expense of other

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dealers and investors in the market, and otherwise to create anti-competitive distortions. It concludes that the current structure of the market, with Liberty being owned by the major primary dealers, encourages collusion and competitive distortions, and urges that the present investigation be focused on the conduct which the structure suggests is indicative of violations of the antitrust laws and portends future structural changes which will render the anti-competitive consequences even more dire." This memorandum of November 1, 1991 to the Justice Department, suggests that Liberty engaged in improper transmission of information which gave an unfair advantage to its owners.

The peculiar element in the May 1991 transaction was only that, when the Government raided the chicken coop they accidentally caught a couple of turkeys that had made a wrong turn. The "Treasury" had suddenly changed the rules of the game at the most inopportune of moments. One would almost believe that Salomon dealer had somehow stepped on the wrong toes, once to often and "The Street" fed the firm to the wolves at the most embarrassing time possible. Pure chance could not have produced these strange bedfellows. It is doubtful that the Hedge Funds involved in the deal either originated or orchestrated it.

All unregulated commodities create the same market-cornersing opportunities that occurred in the Solomon mat-

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ter. Hedge Funds will again strike in unfamiliar venues potentially reaping havoc as the Hunts did in the silver market. You can wager, however, that the plan for the transaction will have been created elsewhere. These people did not become extremely affluent by playing all their games on the road.

7. PRECIPITATING DECLINES IN FALLING MARKETS

During the October 1987 market crash, Hedge Funds may, as some have alleged, have added fuel to the fire by selling into a decimated market. The logic of this allegation, as it relates to listed securities, however, seems highly flawed. It would appear much more reasonable to take advantage of a panic to cover short positions at unusually favorable prices. Like any other investor, a Hedge Fund sells its securities to avoid the consequences of market erosion. I have seen no allegations that during the October 1987 crash, Hedge Funds illegally sold short selectively on down ticks within a group of stocks in which they were already short. This would have been illegal, unless the transaction was executed in the over the counter markets. (This is not to say that this isn't the modus operandi for many Hedge Funds. Piling on, bear raids and rumors are part and parcel of their way of life. The circumstances existing in October

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of 1987 hardly required any additional help from this group, having been presented a spectacular opportunity to cover their shorts, not to enlarge them.)

The breed of Hedge Fund that primarily deals in over the counter securities does not traffic in broad market issues, but concentrates within a group of stocks that it has extensively researched.

Hedge Funds would be more likely to use the over the counter market in a panic due to its lack of regulation, and illiquidity to legally cause margin calls and liquidations. In view of this, the overall October 1987 market collapse, should, perhaps, be blamed on the use of indexing, the failure of the specialist system, irregularities in the OTC marketmaking system, along with a generally dismal business outlook, rather than Hedge Fund activity.

8. CONFLICTS BETWEEN PROFITS AND REGULATION IN OFF SHORE FUNDS

Hedge Funds' extraordinary growth in the eighties was, in large measure, due to the enormous profits that they generated for their principals. Global Asset Management has over \$4 billion under allocated management and is the larg-

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est of Multi-managed funds, using over 60 different managers. Many ceased accepting investors' funds, concerned that managing too much money could cause them to become unwieldy and unable to maintain the historically high returns that their investors had come to expect.

Hypothetically, the limited partner would receive a preferred return off the top. (i.e 8 1/2%) and a 50/50 split of the profits, or 20% of the profits and various assorted fixed management fees. Annual growth rates of the more successful types of these funds during the 80's were no less than 20% per year. Assuming a \$100,000,000 fund earning \$20,000,000, in the first instance it would throw off over 14% to the limiteds and almost \$6,000,000 per year to the general partner. In the second more common example, the manager would receive \$4,000,000 and the limited a 16% return. There are nuances in each example, attributable to variations in fees and the non-participation of managers in losses.

Should the size and/or activity of Hedge Funds be regulated? Assuming that these parameters can be defined, how are Hedge Funds to be prevented from moving offshore, in search of more lenient securities regulations? Some of the household names in fund management such as Fidelity, Scudder, Alliance Capital Management, Putnam and Merrill Lynch are advising and/or managing Off Shore Funds. Optima Fund

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Management successfully took their Fund of Funds concept overseas through a Bermuda-based vehicle. Its twelve managers comprise the Who's Who of the American Hedge Fund Industry, including noted short seller James Chanos. His Optima Futures Fund, Ltd., another offshore vehicle, was set up solely to short American securities.

Offshore funds are not constrained relative to the aggregate number of investors they can represent, nor are they constrained by capital gains taxes. Additionally, the European Economic Community's relaxed regulations on cross-border sales, under which a registration in one country is accepted in all, result in ease of entry and provide the capability of establishing businesses within time frames inaccessible to institutions subject to U.S. securities regulations. Surprisingly, the liberal EEC regulations will soon apply to American funds, that do business in Europe as well.

The cliché that "the world has become much smaller" is more meaningful within the financial arena than in any other. Global markets coupled, with round the clock trading, create an environment in which U. S. regulators may soon have insignificant impact even with respect to the functioning of our securities markets. Whenever there are rules, there invariably are techniques to circumvent them, especially when the potential return is such a tantalizing

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prize. Securities laws, unless internationally administered, will at best have trivial significance. World markets are far more sophisticated than those of two decades ago when IOS was allowed to run amuck, but this time, the shoe may be on the other foot. Archaic American securities laws may be our undoing in the global marketplace. These regulations were created in an environment of isolationism and protectionism and have not changed to keep pace with the current dynamics of the global economic environment.

Regulators are on the horns of a dilemma; by moderating regulations to remain competitive with international securities markets we will be compromising many of the laws that were enacted as a result of 1929 crash and ensuing global depression.

A shift towards the liberalization³⁵ of our securities markets could imperil the investing public and eliminate the more level playing field enacted in the 30's. By not conforming to the world's more generally relaxed regulatory environment we are running the risk of perceptibly eroding this country's greatest resource, the American Securities Markets. The market's historic liquidity, coupled with the flexible approach essential to promptly respond to the investment community's ever-changing appetite for the indis-

³⁵Lessening of regulation

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pensable financial products are essential in underwriting the continued growth of this country. The capitalism that separated us from the remainder of the world is no longer solely our province. In less than one decade we have witnessed a dramatic change within the global capital raising process. Stock markets, almost unheard of scant years ago, are now active throughout the Pacific Rim, Eastern Europe, and South America. They potentially offer to their own investment communities the economic muscle once peculiar to this nation, which facilitated the financial growth that made our country the economic power it has become.

The correct answer may only exist retrospectively and already we no longer may be the masters of our destiny.