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# Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility: What Regulation by the Securities and Exchange Commission is Appropriate?

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MUTUAL FUNDS, PENSION FUNDS, HEDGE FUNDS  
AND STOCK MARKET VOLATILITY—WHAT  
REGULATION BY THE SECURITIES AND  
EXCHANGE COMMISSION IS APPROPRIATE?

*Roberta S. Karmel\**

INTRODUCTION

Seventy years ago the Securities and Exchange Commission (SEC) was created to serve investors. At that time investors in the public securities markets were primarily individuals investing their own savings. Today, investors in the public securities markets are primarily institutions investing the savings of their beneficiaries. These institutions determine how capital is allocated in the national economy, and they are responsible for managing the private retirement savings of millions of Americans. Under the federal securities laws, they are a privileged and protected class. Yet, their behavior in the stock market bubble of the late 1990s was problematic and contributed to serious losses of retirement savings by many of their beneficiaries. Although the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)<sup>1</sup> imposed many new regulatory responsibilities on public companies, the problem of improving the responsibility of institutional investors to their beneficiaries was not addressed.

The Securities Act of 1933 (Securities Act)<sup>2</sup> and the Securities Exchange Act of 1934 (Exchange Act),<sup>3</sup> which created the SEC, were New Deal statutes passed in the wake of the 1929 stock market crash

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1 Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2 15 U.S.C. §§ 77a-77aa (2000).

3 *Id.* §§ 78a-78mm.

and the Great Depression. The investigation of stock exchange, banking and securities markets practices by the Senate Committee on Banking and Currency which preceded the enactment of the first federal securities laws exposed stock market manipulation, insider trading and breaches of fiduciary duty by those who controlled public corporations and their intermediaries. These laws were based on some fundamental premises which have withstood the test of time. First, when a corporation seeks funds from the public it becomes a public body and its managers and bankers become public functionaries. Therefore, such a body must make full disclosure about its business and financial affairs when it makes a public offering of its securities and subsequently. Although the basic purpose of the securities laws is investor protection, a secondary purpose implicates the national welfare. Because the stock market is efficient in disseminating information, full disclosure by public companies should facilitate the efficient allocation of capital in the national economy.<sup>4</sup>

The second fundamental premise of the federal securities laws, dating back to 1934 and endorsed and amplified by amendments to the Exchange Act in 1964<sup>5</sup> and 1975<sup>6</sup> was that transactions in the pub-

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4 There has been much debate about how efficient the stock market may be and whether the efficient market hypothesis is an adequate explanation for stock market behavior in view of psychological factors affecting the market. See Stephen J. Choi & A.C. Prichard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003) (remarking on the reality of non-rational investor bias); Ronald Gilson & Reineer Kraackman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (attributing market efficiency to a variety of factors, but also noting the absence of any unified explanation of market efficiency); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 140-48 (2002) (regarding "efficiency-defying" market behaviors of investors not related to rational, information-based decisions); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1409-12 (2002) (attributing market inefficiency to investor actions that do not fit the "rational-man model"); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 619-40 (1988) (questioning the influence of informational efficiency objectives on the regulation of the securities market). The SEC continuous disclosure system is based on the efficient market hypothesis to some extent and it has been accepted by the courts. See Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,382 & n.9 (Mar. 16, 1982); Amendments to Annual Report Form, Related Forms, Regulations, and Guides, Integration of Securities Acts Disclosure Systems, Securities Act Release No. 6231, 45 Fed. Reg. 63,630, 63,630-731 (Sept. 25, 1980); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 245-47 (1988) (acknowledging that Congress has relied on the "premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets").

5 Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565.

lic securities markets are affected with a national public interest, and therefore the stock market and securities industry intermediaries need to be regulated to protect the national banking system and the Federal Reserve System and to insure the maintenance of fair and honest markets in securities transactions.<sup>7</sup> Among other things, the Congress which passed the Exchange Act was concerned about market manipulation and stock market speculation caused by undue securities credit.<sup>8</sup> The tools which Congress gave the SEC to deal with these evils have become obsolete to a great extent,<sup>9</sup> but the danger to the capital markets resulting from speculation and leverage was inadequately guarded against during the bubble years of the late 1990s.

In the finger pointing following the collapse of the 1990s stock market bubble, there was a reexamination of the public disclosure system which led to the enactment of Sarbanes-Oxley, giving the SEC much more regulatory power over the accounting profession and public company corporate governance.<sup>10</sup> Underwriting practices in connection with initial public offerings (IPOs) have also come under scrutiny resulting in civil and criminal prosecutions and changes in the regulation of research analysts and underwriting allocations.<sup>11</sup> The SEC also has more recently focused on trading irregularities by mutual funds and has embarked upon mutual fund corporate govern-

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6 Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97.

7 See Exchange Act § 2, 15 U.S.C. § 78b.

8 See H.R. REP. No. 97-626, pt. 1, at 3 (1982) (asserting that uncontrolled trading of securities on credit had been a major cause of the Stock Market Crash of 1929); see also Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 728-33 (1999) (detailing the legislative history of the Securities Exchange Act).

9 For example, the short selling prohibitions make little sense after decimalization, see Short Sales, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004), and the margin regulations have barely been enforced by either the Federal Reserve Board or the SEC for several decades, see Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 797-99 (2000). In any event, the development and growth of the derivatives market has undermined the margin regulations. See *infra* notes 145-75 and accompanying text.

10 This topic was previously explored by the author in Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).

11 See Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21 (2001) (exploring the legal aspects of the IPO process and explaining how its mechanics played a significant role in priming the Internet boom and its eventual implosion); Jaimee L. Campbell, Comment, *Analyst Liability and the Internet Bubble: The Morgan Stanley/Mary Meeker Cases*, 7 FORDHAM J. CORP. & FIN. L. 235 (2001) (commenting on possible liability where analysts engaged in collusive market strategy rather than objective analysis of stock potential).

ance reform.<sup>12</sup> Nevertheless the role of institutional investors in fomenting the stock market bubble of the 1990s has not been scrutinized by the SEC. In part, this is because the SEC is stuck in the paradigm of investor protection rather than institutional investor regulation, and institutions are the biggest and noisiest of the SEC's investor constituents.<sup>13</sup>

Further, the SEC regulates mutual funds, but it does not regulate pension funds, hedge funds or other collective investment pools. Pension funds are regulated by the Pension Benefit Guaranty Corporation (PBGC), the Department of Labor and the states;<sup>14</sup> bank collective trust funds are regulated by the Comptroller of the Currency;<sup>15</sup> commodity pools are regulated by the Commodity Futures Trading Commission (CFTC);<sup>16</sup> and hedge funds are not regulated. The purpose of much of the existing regulation of institutional investors is to safeguard the savings of the beneficiaries of institutional investors through safety and soundness and fiduciary principles, but since this regulation is conducted by so many different regulators for different purposes and constituencies, the regulation is neither consistent nor coherent. Further, little of this regulation takes into account the SEC's essential goals of fostering capital formation or efficiently allocating capital in the national economy.

This Article will question whether institutional investors should continue to be regulated by such different and inconsistent regulators

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12 See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004); Sara Hansard, *New Fund Legislation Unlikely this Year; Congress Leaves Regs in the SEC's Hands*, INVESTMENT NEWS, May 17, 2004, at 12, 12 ("Congress is unlikely to enact a law this year that would impose more regulations on the mutual fund industry. Instead, it is leaving that up to the [SEC].").

13 The author explored this topic in Roberta S. Karmel, *Should A Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1 (2004).

14 See Donna Litman Seiden, *Chapter 7 Cases: Do ERISA and the Bankruptcy Code Conflict as to Whether a Debtor's Interest in or Rights Under a Qualified Plan Can be Used to Pay Claims?*, 61 AM. BANKR. L.J. 219 (1987) (questioning the applicability of bankruptcy law to pension funds, regulated by applicable nonbankruptcy laws); Bradley P. Rothman, Note, *401(k) Plans in the Wake of the Enron Debacle*, 54 FLA. L. REV. 921, 925-41 (2002) (outlining the evolution of retirement and private pension plans and the role of ERISA).

15 The Comptroller's regulation is similar to the SEC's regulation of mutual funds, but bank collective trust funds do not have independent corporate boards. See Deborah S. Prutzman & Edwin C. Laurenson, *Impact of ERISA on Choice of Mutual or Collective Investment Funds as Funding Vehicles*, 651 PLI/COMM. 789, 807 (1993); see also Marvin A. Freedland, *National Banks as Service Providers to Employee Benefit Plans*, 113 BANKING L.J. 994 (1996) (exploring the matrix of laws and regulations governing collective trust funds).

16 7 U.S.C. §§ 6m, 6o (2000).

and whether securities regulation should refocus on the control of speculation and excessive securities credit. It is useful to contrast the SEC's regulation of investment companies to the regulation of pension funds because these are the vehicles for the retirement savings of most individuals. Investors in bank collective trust funds and hedge funds tend to be wealthier and more sophisticated. All of these institutional investors are capable of generating the kind of speculative stock market behavior the federal securities laws were designed to control. Hedge funds in particular are one of the significant forces in speculative markets. Since bank collective trust funds and commodity pools are regulated by other federal agencies and any attempt by the SEC to regulate these entities would involve serious turf warfare, the regulation of these entities will not be discussed in this Article.<sup>17</sup> The SEC has begun to stake a claim for the registration of hedge funds, but remains focused on investor protection rather than institutional investor regulation.

This Article will proceed by summarizing the regulation of the investment practices of investment companies and pension funds and then suggesting that institutional investors were too heavily invested in speculative equities at the top of the technology bubble. Mutual fund and hedge fund reform proposals will be analyzed for the purpose of inquiring whether they would prevent similar unwise investment practices in the future. The relaxation of curbs on speculative trading and securities credit will then be discussed, with some attention to the activities of hedge funds.

Part I of this Article will compare the regulation of mutual fund and pension fund investment practices and discuss institutional investor behavior at the top of the 1990s stock market. In Part II, this Article will then discuss the SEC's ongoing reform of mutual fund regulation and its proposed reform of hedge fund regulation and inquire whether any of these reforms would act as a curb on excessive speculation by these funds. Part III will turn to a discussion of the provisions of the federal securities laws designed to protect against speculation and manipulation and raise questions about why these

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17 Regulatory turf battles between the SEC and CFTC are described in Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 356-66 (2003). Both the SEC and CFTC are independent federal agencies. Regulatory battles between the SEC and the Department of Treasury involve competition between an independent agency and an executive branch agency. See Dan Jamieson & Michael Hayes, *SEC Beat Up in Glass-Steagall Repeal*, REGISTERED REPRESENTATIVE, Jan. 2000, at 40; David Wighton, *SEC and Fed Clash Over Broker-Dealers*, FIN. TIMES, Mar. 29, 2004, at 17.

provisions were inadequate to prevent the 1990s bubble and its inevitable collapse. The author will argue that although there has been considerable regulatory reform since the technology bubble burst, little attention has been paid to whether a contributing cause of the bubble was excessively cheap capital and easy securities credit which encouraged stock market speculation. Perhaps this is because the culprits in this story include the SEC and the Federal Reserve Board, agencies which probably are institutionally incapable of bursting a stock market bubble, as well as very powerful institutional investors.

## I. A COMPARATIVE ANALYSIS OF THE REGULATION OF THE INVESTMENT PRACTICES OF MUTUAL FUNDS, PENSION FUNDS AND HEDGE FUNDS

### A. *Investment Company Act Regulation*

Investment companies are financial intermediaries in that they transform the savings of individuals into capital in the form of buying corporate debt or equity. The main reason for the rise of investment companies, however, was not intermediation, but their offer of affordable, expert and trustworthy management and the opportunity for diversification by small savers.<sup>18</sup> The most common type of investment company is a mutual fund. Functionally, the investment company is "a shell, a pool of assets consisting of securities, belonging to the shareholders of the fund."<sup>19</sup> Such companies may be closed-end or open-end companies (which issue redeemable shares). Investment companies in the United States generally are organized as corporations and they have separate advisers and underwriters. The investment company generally has no employees and its investments are managed by an affiliated organization. These relationships give rise to a variety of conflicts of interest which are regulated under the Investment Company Act of 1940 (Investment Company Act).<sup>20</sup>

Mutual funds are required to register with the SEC pursuant to the Investment Company Act<sup>21</sup> in addition to having to register a pub-

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18 See TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 16-17 (1998).

19 Zell v. Intercapital Income Sec., Inc., 675 F.2d 1041, 1046 (9th Cir. 1982).

20 15 U.S.C. §§ 80a-1 to -64 (2000).

21 *Id.* § 80a-8(a) (requiring investment companies to register by filing a notification of registration with the Commission). However, there are exemptions from registration allowing private investment companies (which includes most hedge funds) not to register under the Investment Company Act, e.g., companies with less than one hundred shareholders are exempted from the registration requirement. *Id.* § 80a-

lic offering of their shares pursuant to the Securities Act.<sup>22</sup> Once registered, the Investment Company Act requires that forty percent of the board be “independent” or “disinterested.”<sup>23</sup> Interested directors are defined to include a long list of persons who have some business or professional relationship with the investment company or are affiliated with the adviser, underwriter or broker for the investment company.<sup>24</sup> The investment company’s independent directors are given special statutory responsibilities with regard to the supervision of management and financial auditing. In particular, they have the duty of reviewing and approving the contracts of the investment company with its investment adviser and principal underwriter.<sup>25</sup>

Congress’s purpose in structuring the Investment Company Act in this way was to place the disinterested directors in the role of watchdogs to act as an independent check on the management of the investment company. Therefore, even where state rather than federal law determines a conflict of interest issue such as the dismissal of a derivative suit, the policies of the Investment Company Act must be taken into consideration.<sup>26</sup> Yet, because an investment company is the creature of its sponsor/adviser, there have been persistent questions as to whether independent directors can provide effective oversight of the contractual relationship between the fund and the adviser.<sup>27</sup> Although the fund’s directors can and do perform a watchdog function, they do not function like directors of an industrial or financial services company, participating in decisions about the fund’s strategy or investment activities. Fund boards do not and cannot supervise the business and management of the firms that manage fund assets or distribute and market fund shares.

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3(c)(1). Investment companies selling their shares to unrestricted numbers of qualified purchasers are also exempted from registration. *Id.* § 80a-3(c)(7).

22 *Id.* § 77e.

23 Section 10(a) of the Investment Company Act requires that a registered investment company’s board of directors may not consist of more than sixty percent “interested” persons. *Id.* § 80a-10(a). In 2001, the SEC mandated that more than fifty percent of an investment company board be composed of independent directors. Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, 66 Fed. Reg. 3734 (Jan. 16, 2001). Currently, the SEC requires that boards have a supermajority of seventy-five percent independent directors. *See infra* notes 125–29 and accompanying text.

24 Investment Company Act § 2(a)(19), 15 U.S.C. § 80a-2(a)(19).

25 *Id.* § 15(c), 15 U.S.C. § 80a-15(c).

26 *See Burks v. Lasker*, 441 U.S. 471, 477–78 (1979).

27 *See* DIV. OF INV. MGMT., SEC. & EXCH. COMM’N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 264–66 (1992) (discussing advisor fee arrangements designed to protect investors).



Over the years, the SEC has conditioned a number of exemptive rules under the Investment Company Act upon review and approval by independent investment company directors. Because the Investment Company Act contains numerous sweeping prohibitions against transactions with affiliated entities which are, in fact, commonplace, reliance on these exemptive rules are necessary to permit investment companies to conduct business in many situations. The most important of these exemptions permit funds to purchase securities in a primary offering where an affiliated broker-dealer is a member of the underwriting syndicate,<sup>28</sup> permit the use of fund assets to pay distribution expenses,<sup>29</sup> permit securities transactions between a fund and another client of the fund investment adviser,<sup>30</sup> and specify conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange.<sup>31</sup>

Investment companies are organized under state law and therefore can structure their capitalization like other corporations<sup>32</sup> except for certain restrictions set forth in the Investment Company Act. Although the federal statute does not require investment companies to have redeemable securities, if they do, purchases and redemptions must be effected at the current net asset value per share computed after the receipt of the purchase or redemption order.<sup>33</sup> Investment companies are severely limited in their ability to borrow. The undue use of leverage was one of the evils the Investment Company Act was

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28 Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, 17 C.F.R. § 270.10f-3 (2004).

29 Distribution of Shares by Registered Open-End Management Investment Company, *id.* § 270.12b-1.

30 *Id.*

31 Brokerage Transactions on a Securities Exchange, *id.* § 270.17e-1. The other exemptive rules are 17 C.F.R. § 270.17a-8 (permitting mergers between certain affiliated funds), 17 C.F.R. § 270.15a-4(b)(2) (permitting boards to approve interim advisory contracts without shareholder approval), 17 C.F.R. § 270.17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies), 17 C.F.R. § 270.17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange), 17 C.F.R. § 270.17g-1(j) (permitting funds to maintain joint insured bonds), 17 C.F.R. § 270.18f-3 (permitting funds to issue multiple classes of voting stock) and 17 C.F.R. § 270.23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares).

32 Maryland is the state incorporation jurisdiction of choice because of some statutory provisions targeted at investment companies. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 721-22 (2002).

33 15 U.S.C. § 80a-22(c) (2000); Pricing of Redeemable Securities for Distribution, Redemption and Repurchase, 17 C.F.R. § 270.22c-1.

designed to prevent.<sup>34</sup> Open-end companies may issue only one class of stock and may not issue senior securities.<sup>35</sup> Closed-end companies may borrow from a bank, or issue bonds, debentures or preferred stock but such senior capital is limited in that the company must have a ratio of assets to debt of at least three to one, and, if preferred stock is issued, the ratio must be at least two to one.<sup>36</sup> Other restrictions involving the prevention of undue leverage are that mutual funds may not make margin purchases, sell securities short or invest more than a small percentage of assets in other investment companies.<sup>37</sup> Although trading in derivatives by funds is not clearly contrary to the Investment Company Act, it raises questions about whether some derivatives trading strategies involve the kind of undue leverage the statute was designed to prevent.<sup>38</sup>

The Investment Company Act does not restrict or control what securities are proper investments for an investment company, but in keeping with the general full-disclosure philosophy of the federal securities laws, it requires a mutual fund to notify shareholders of its fundamental investment policies.<sup>39</sup> There are some exceptions. The statute prohibits investment companies from purchasing or acquiring securities of any broker, dealer, underwriter or investment adviser.<sup>40</sup> The purpose of this prohibition was to protect investment companies against risky investments and to restrict reciprocal practices between investment companies and securities industry members.<sup>41</sup>

If an investment company advertises itself as a "diversified" mutual fund, it must invest its assets in a specified manner. Seventy-five percent of its assets must consist of cash and cash items, government securities, securities of other investment companies, and other securities.<sup>42</sup> But a fund may not include in this seventy-five percent asset class securities of a single issuer accounting for more than five percent of the fund's assets or consisting of more than ten percent of the is-

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34 See Investment Company Act § 1(b)(3)-(8), 15 U.S.C. § 80a-1(b)(3)-(8).

35 *Id.* § 18(f), 15 U.S.C. § 80a-18(f). Such a company may borrow from a bank provided that immediately after such borrowing there is an asset coverage of 300%.  
*Id.*

36 *Id.* § 18(a)-(e), 15 U.S.C. § 80a-18(a)-(e).

37 *Id.* § 12(d), 15 U.S.C. § 80a-12(d).

38 See Memorandum Regarding Mutual Funds and Derivative Instruments from Division of Investment Management to Chairman Levitt (Sept. 26, 1994), in *THE SEC SPEAKS IN 1995*, at 520, 542-44 (I PLI Course Handbook B-880, 1995).

39 FRANKEL & KIRSCH, *supra* note 18, at 291.

40 Investment Company Act § 12(d)(3), 15 U.S.C. § 80a-12(d)(3).

41 FRANKEL & KIRSCH, *supra* note 18, at 292.

42 Investment Company Act § 5(b)(1), 15 U.S.C. § 80a-5(b)(1).

suer's voting securities.<sup>43</sup> In order to register with the SEC, an investment company must disclose, among other things, whether it will be open- or closed-ended, whether it will be diversified or nondiversified, whether the company will concentrate its investments in a particular industry or group of industries, whether it plans to purchase and/or sell real estate or commodities, whether it will make loans to other persons, and it must describe the company's portfolio turnover for the preceding three years.<sup>44</sup> Further, the fund must describe all of its investment policies which may change only if authorized by a shareholder vote, and those policies which are fundamental to the company.<sup>45</sup>

As the foregoing reflects, investment companies are free to fashion whatever investment strategies they wish, with some limited restrictions, provided that any significant changes in that strategy are ratified by shareholders. While this regime separates government from private sector decisionmaking as to which companies merit capital investment, as is fitting in a capitalistic economy, it is premised on the notion that investment companies will employ investment strategies that are competent and trustworthy, keeping in mind the interests of their shareholders. Unfortunately, this ideal has not always been followed.

### B. Pension Fund Regulation

#### 1. Federal Law

To the extent pension funds are regulated by federal law, they are subject to supervision by the Internal Revenue Service,<sup>46</sup> the Department of Labor and the PBGC. Most of this oversight and regulation is conducted pursuant to the Employee Retirement Income Security Act of 1974 (ERISA).<sup>47</sup> Pension funds fall into two basic types—defined benefit plans and defined contribution plans.<sup>48</sup> If a pension plan is terminated (due to a corporation's insolvency, for example) the

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43 *Id.*

44 15 U.S.C. § 80a-8(b)(1).

45 *Id.* § 80a-8(b)(2)–(4).

46 In order for payments into pension funds by corporations to be tax deductible, the funds must comply with certain provisions of the Internal Revenue Act. I.R.C. §§ 401, 404, 501 (Lexis 2005).

47 Pub. L. No. 93-405, 88 Stat. 829 (codified as amended at 29 U.S.C. § 1001 (2000)).

48 Defined benefit plans collect individual assets into an aggregated plan account and guarantee a particular amount upon retirement. By contrast, defined contribution plans give employees an individual account which an employee will receive upon retirement. Defined contribution plans allow an employee to control the investment

PBGC guarantees basic, vested benefits, up to a monthly dollar limit for defined benefit plans.<sup>49</sup> However, the PBGC does not insure defined contribution plans.

ERISA establishes some rudimentary guidelines for the funding of defined benefit plans. Pre-1974 plan obligations must be funded with contributions to amortize them over a forty-year period; post-1974 obligations must be funded with contributions to amortize them over a thirty-year period. Reasonable actuarial procedures and estimates must be used for these amortization programs, taking into account asset values and portfolio earnings.<sup>50</sup> There are no such funding requirements for defined contribution plans.

ERISA mandates fiduciary responsibilities for investment managers, trustees or any other person with control over the pension plan or its assets. The applicable legal standard is the same standard long applied under trust law—the skill and diligence of a “prudent man” loyal to the plan and without conflicting interests.<sup>51</sup> This requirement applies to both defined benefit and defined contribution plans. Defined benefit plans must be reasonably diversified. This diversification requirement prohibits a fiduciary from investing the whole or an unreasonably large proportion of the trust assets in either one type of security or a group of securities that are all dependent on the welfare of one industry or the conditions in one geographical area.<sup>52</sup> The

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decisions made by the account and are therefore more risky. See Rothman, *supra* note 14, at 929.

49 See 29 U.S.C. §§ 1322, 1322a, 1322b (2000).

50 *Id.* § 1082. The negative impact on corporate financial statements of these requirements because of stock market declines after 2000 led to congressional relief for public companies. Pension Funding Equity Act, Pub. L. No. 108-218, 118 Stat. 596 (2004); see *Pension Pork*, THE ECONOMIST, Apr. 17, 2004, at 73; see also Editorial, *Pension Bailout Forgets Little Guy*, ATLANTA J.-CONST., Apr. 12, 2004, at A10 (calling for a “more comprehensive and thoughtful solution”); Editorial, *Pensions Still in Crisis*, DENVER POST, Apr. 18, 2004, at E6 (criticizing pension relief bill as a short-term solution to a long-term crisis), available at 2004 WL 59323416.

51 29 U.S.C. § 1104(a)(1); see Regina T. Jefferson, *Defined Benefit Plan Funding: How Much Is Too Much?*, 44 CASE W. RES. L. REV. 1 (1993); Roger C. Siske et al., *What's New in Employee Benefits: A Summary of Current Case and Other Developments*, in A.L.I.-A.B.A. COURSE OF STUDY: PENSION, PROFIT-SHARING, WELFARE, AND OTHER COMPENSATION PLANS 81–82 (2004); see also RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (referring to the prudent person standard). One court described ERISA's fiduciary duties as having three components: a duty of loyalty pursuant to which all investment decisions must be made with an eye to the interests of the participants and beneficiaries, a prudent man obligation, and an obligation to act for the exclusive purpose of providing benefits to the beneficiaries. *Gregg v. Transp. Workers of Am. Int'l*, 343 F.3d 833, 840–41 (6th Cir. 2003).

52 See *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 438 (3d Cir. 1996).

degree of investment concentration is not stated as any fixed percentage, although no more than ten percent of a plan's assets are supposed to be invested in securities of the employer.<sup>53</sup> After ten years of an all-equities investment strategy, the PBGC decided it had taken on too much risk and is reducing stocks to as little as fifteen percent of its total investments, but this change in investment policy does not apply to regulated pension funds.<sup>54</sup> Many defined contribution pension plan funds are invested in mutual funds or are in self-directed accounts at securities firms. These pension plans are not subject to any investment guidelines.<sup>55</sup>

Unfortunately, the enforcement powers of the PBGC are meager. Responsibility for monitoring the financial soundness of pensions is split with the Internal Revenue Service and the PBGC does not have strong corrective authority. Since the PBGC is basically an insurer of certain pension plans, it does not have specific authority to intervene in corporate transactions, but it does have de facto power to intervene to protect its own interests. The PBGC can seek court approval for plan termination when the employer fails to satisfy funding standards or when the potential long-term loss for the PBGC can be expected to increase unreasonably if the plan is not terminated.<sup>56</sup> Suits to enforce fiduciary duties of pension plan trustees are brought by the Depart-

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53 See PAUL J. SCHNEIDER & BARBARA W. FREEDMAN, *ERISA: A COMPREHENSIVE GUIDE* § 6.06 (2d ed. 2003). ERISA bans a defined benefit plan from acquiring employer securities if after the acquisition the aggregate fair market value of employer securities and employer property is over ten percent of the fair market value of the assets of the plan. 29 U.S.C. § 1107(a)(2). However, ERISA does not significantly limit the ability of 401(k) participants to invest in employer securities. After the Enron debacle, the problem of employee investment in employer securities was given attention, but the only provision included in Sarbanes-Oxley banned corporate insiders from selling company stock during periods when plan participants cannot sell their employer's stock. 15 U.S.C.S. § 7244 (Lexis Supp. 2004). There was an attempt in recent pension reform legislation to limit investments in an employer's securities in a 401(k) plan to twenty percent, but this legislation was eventually abandoned. See Amy B. Monahan, *Addressing the Problem of Impatients, Impulsives and Other Imperfect Actors in 401(k) Plans*, 23 VA. TAX REV. 471, 505 n.135 (2004).

54 See Mary William Walsh, *Pension Agency to Cut Its Stock Holdings*, N.Y. TIMES, Jan. 30, 2004, at C3.

55 A large number of pension plans are managed by insurance companies and therefore are regulated by state insurance laws. Banks also manage a large number of other private pension funds and the investment of such funds is regulated by the banking laws. A discussion of these laws is beyond the scope of this Article. The Department of Labor can enforce ERISA provisions governing 401(k)s that invest in mutual funds. See, e.g., Kathy Chu, *Fund Track: U.S. Investigated Funds Over 401(k)s*, WALL ST. J., Apr. 22, 2004, at D9 (reporting on Labor Department probes into investment companies).

56 29 U.S.C. § 1342(a)(1), (a)(4), (c).

ment of Labor.<sup>57</sup> Such suits may also be brought by plan participants or beneficiaries, or other fiduciaries.<sup>58</sup>

Many 401(k) plans, regulated under ERISA, are heavily invested in company stock of an employer. After the bursting of the stock market bubble in 2000, employees in such plans saw the value of their account balances decline drastically. In some situations involving particularly high flying corporations which had financial restatement or even insolvency problems, lawsuits were brought under ERISA charging breach of fiduciary duty or violations of the federal securities laws in class actions or actions by the Department of Labor.<sup>59</sup> Union pension funds as well as corporate and individually directed pension funds are covered by ERISA. As the result of the insolvency of Capital Consultants, an investment management company, the Department of Labor filed five consent orders against more than forty trustees of union pension and benefit funds for, among other things, ignoring their funds' guidelines on the amount of their funds that should be invested in risky private investments, such as collateralized notes.<sup>60</sup>

## 2. State Law

ERISA broadly preempts state law breach of fiduciary duty actions.<sup>61</sup> Therefore state law does not regulate the investment or capital funding policies of ERISA-regulated pension plans.<sup>62</sup> State law does regulate the investment policies of state pension funds. Such regulation is a curious, and probably obsolete, mélange of ideas designed on the one hand to prevent pension funds from unduly risky investments and on the other hand to promote local industry.

New York retirement law, for example, requires that not more than 2.5% of pension fund assets shall be invested in a railroad, tele-

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57 See *id.* §§ 1134–1135. Enforcement of the diversification requirements is not always rigorous. See, e.g., *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997) (finding that the plan administrator did not violate his duties under ERISA even though he invested sixty-five percent of the plan assets in one area of undeveloped land).

58 See 29 U.S.C. § 1132(a)(3).

59 See Susan J. Stabile, *I Believed My Employer and Didn't Sell My Company Stock: Is There an ERISA (or '34 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 385–89 (2004).

60 See Nat'l Legal & Policy Ctr., *DOL Settles Five Portland Pension Fund Suits*, UNION CORRUPTION UPDATE, Apr. 15, 2002, at [http://www.nlpc.org/olap/UCU3/05\\_08\\_17.htm](http://www.nlpc.org/olap/UCU3/05_08_17.htm).

61 29 U.S.C. § 1144; see also *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 44, 52 (1987) (stating that the "section's pre-emptive scope was as broad as its language").

62 See NICHOLAS KASTER ET AL., 2000 U.S. MASTER PENSION GUIDE ¶¶ 2726, 2728; see also *Dist. of Columbia v. Greater Wash. Bd. of Trade*, 506 U.S. 125, 129–30 (1992) ("ERISA pre-empts any state law that refers to or has a connection with covered benefit plans.").

phone, gas or electrical corporation.<sup>63</sup> Massachusetts prohibits more than twenty percent of any assets of a state retirement pension fund of any county, city or town to be invested in railroad obligations, more than thirty-five percent of such assets to be invested in telephone companies' bonds and more than fifty percent of such assets in the bonds of public service companies.<sup>64</sup> Codes attempt to guarantee some diversification by requiring that only a limited percentage of assets shall be invested in a specific company.<sup>65</sup> States may encourage investments in local businesses<sup>66</sup> or place limitations on investments in particular geographical areas outside the state or the United States.<sup>67</sup>

Some state codes place limitations on the debt to equity allocations of the pension funds. New York dictates that not more than seventy percent of a public retirement system pension fund shall be invested in equity.<sup>68</sup> Florida requires that no more than eighty percent of a fund's assets shall be invested in equity and no more than eighty percent of the assets shall be invested in interest-bearing obligations with a fixed maturity of any corporation.<sup>69</sup> Notwithstanding such provisions, the state codes leave the pension fund boards considerable freedom in deciding not to follow these guidelines in their business judgment.<sup>70</sup>

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63 N.Y. RETIRE. & SOC. SEC. LAW § 177 (McKinney 2001).

64 MASS. ANN. LAWS ch. 32, § 23(2)(b)(i)(A), (B), (C) (Lexis 2001).

65 See, e.g., FLA. STAT. ANN. § 215.47 (West 1999) (not more than three percent in the stock of one issuing corporation); MASS. ANN. LAWS ch. 32, § 23(2)(b)(i) (not more than two percent in one railroad company, not more than four percent in the bonds of one public service company).

66 California dictates that a teachers' pension fund board shall give first priority to investing not less than 25% of all funds of the plan that become available in a fiscal year for new investments, in . . . [s]ecurities representing a beneficial interest in a pool of obligations secured by a lien or charge solely on residential realty located in the state.

CAL. EDUC. CODE § 22362 (West 2002 & Supp. 2004).

67 See, e.g., FLA. STAT. ANN. § 121.153 (regulating investments in institutions doing business in Northern Ireland); MASS. ANN. LAWS ch. 32, § 23 (limiting investments in Northern Ireland and South Africa); N.Y. RETIRE. & SOC. SEC. LAW § 177 ("[T]he aggregate unpaid principal amount of all obligations of the Dominion of Canada . . . shall not exceed five per centum . . .").

68 N.Y. RETIRE. & SOC. SEC. LAW § 177.

69 FLA. STAT. ANN. § 215.47.

70 See CAL. EDUC. CODE § 22362(a), (d) (board may substitute higher-yielding investments if it determines during any fiscal year that compliance with the code will result in overall lower earnings); FLA. STAT. ANN. § 215.47 (five percent can be invested as deemed appropriate notwithstanding limitations); N.Y. RETIRE & SOC. SEC. LAW § 177 (twenty percent may be invested within board's discretion notwithstanding limitations).

### C. Hedge Funds

Hedge funds are investment vehicles that hold a pool of securities, and perhaps other assets, whose interests are not sold in a registered public offering and which are not registered as investment companies under the Investment Company Act.<sup>71</sup> The classic hedge funds were formed for the purpose of hedging highly leveraged long positions by utilizing short sales and put and call options.<sup>72</sup> Today's hedge funds engage in a wider variety of investment strategies.

Ever since hedge funds became participants in the securities markets in the 1950s, they have endeavored to operate as unregulated entities and the SEC has been uncertain about how, if at all, to regulate them. Most hedge funds in the United States are formed as limited partnerships in order to obtain flow-through tax treatment.<sup>73</sup> The general partner of the partnership falls within the definition of an "investment adviser" under the Investment Advisers Act of 1940 (Advisers Act),<sup>74</sup> but if the hedge fund is counted as only one client, the entity is exempt from registration because it has fewer than fifteen clients and it does not hold itself out to the public as an adviser.<sup>75</sup> Many hedge funds nevertheless have registered as investment advisers, but the majority are not so registered.<sup>76</sup> One of the reasons the classic hedge funds were reluctant to register with the SEC was that they traditionally charged performance fees. SEC regulation has dealt with this problem, however, so that a registered adviser can charge a performance fee to qualified clients.<sup>77</sup>

If investment partnerships or hedge funds have fewer than one hundred beneficial owners, they ordinarily are exempt from registra-

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71 SEC. & EXCH. COMM'N STAFF, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 3 (2003) [hereinafter GROWTH OF HEDGE FUNDS], available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

72 Ralph S. Janvey, *Hedge Funds*, 21 REV. OF SEC. & COMMODITIES REG. 91, 91 (1998).

73 *Id.* Some overseas hedge funds are differently organized. Iain Cullen, *Hedge Funds: Structure and Documentation*, in HEDGE FUNDS: LAW AND REGULATION 1, 1-4 (Iain Cullen & Helen Parry eds., 2001).

74 15 U.S.C. §§ 80b-1 to -13 (2000). Section 202(a)(11) defines an "investment adviser" to include "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities." *Id.* § 80b-2(a)(11).

75 Investment Advisers Act § 203(b), 15 U.S.C. § 80b-3(b)(3); see Investment Advisers Act Release No. 983, 40 Fed. Reg. 29,206 (1985).

76 GROWTH OF HEDGE FUNDS, *supra* note 71, at 22.

77 *Id.* at 61-62.



tion under the Investment Company Act.<sup>78</sup> Hedge funds also raise issues as to whether registration as broker-dealers under the Exchange Act might be required.<sup>79</sup> The SEC has distinguished between "dealers" and "traders," however, and has not insisted that hedge funds register as dealers.<sup>80</sup> Unless a hedge fund is managing plan assets it would not be regulated as a fiduciary under ERISA.<sup>81</sup>

Since hedge funds generally operate as exempt entities under the federal securities laws and ERISA, they are not subject to any funding or diversification requirements with regard to their trading activities except to the extent that the partnership agreements pursuant to which they operate contain such restrictions. The general partner could be subject to general fiduciary obligations under state law or the antifraud provisions of the federal securities laws, but it is unlikely that such obligations would inhibit their investment practices.

#### D. *Investment Practices by Institutions*

In 1948, one-third of pension fund assets were invested in insurance company annuity products backed up by long-term bonds, primarily government bonds. More than eighty percent of the remainder was also invested in bonds. Only five percent or less was invested in corporate equities.<sup>82</sup> But economic events and economic theory changed this conservative investment strategy. Modern portfolio theory (MPT) argued that it was essential to diversify investment portfolios,<sup>83</sup> the mantra that over time equities were a better invest-

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78 15 U.S.C. § 80a-3(c)(1).

79 Section 3(a)(5) defines a dealer as a person engaged in the buying and selling of securities for his own account. *Id.* § 78c(a)(5).

80 See GROWTH OF HEDGE FUNDS, *supra* note 71, at 18. Hedge funds may also be required to register as commodity pool operators or commodity trading advisors with the CFTC. See *id.* at 23.

81 *Id.* at 28.

82 See MICHAEL J. CLOWES, THE MONEY FLOOD: HOW PENSION FUNDS REVOLUTIONIZED INVESTING 5-6 (2000).

83 MPT is an investment strategy aimed at achieving a specified level of return at the minimum investment risk. Portfolio managers utilizing MPT diversify their portfolios according to the MPT risk/return model. The investment portfolio is evaluated on the basis of its overall performance instead of performance of particular stocks. Two main factors in MPT are expected return and standard deviation return. Assets with various rates of return and standard deviations are selected by a fiduciary to achieve an expected return and reduce standard deviations. MPT is a basis for the Uniform Prudent Investor Act. See Frederic J. Bendremer, *Modern Portfolio Theory and International Investments Under the Uniform Prudent Investor Act*, 35 REAL PROP. PROB. & TR. J. 791, 792, 798-801 (2001); see also Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L.J. 39 (1996) (discussing the evolution of the prudent investor rule and

ment than bonds<sup>84</sup> persuaded many investors to heavily weight their portfolios in equities, and inflation and rising salaries made pension plans which relied upon low fixed-income returns very expensive for corporations and others with defined contribution plans.<sup>85</sup> Therefore, pension funds turned increasingly to equity investments and other more speculative ventures.

For example, the ownership of common stocks in public employee pension funds increased from twenty-six percent of their assets in 1980 to sixty percent in 1999.<sup>86</sup> By the end of 2003, state pension portfolios had a sixty-five percent average allocation to equities (including real estate and private equity) and a thirty-five percent allocation to fixed income.<sup>87</sup> However, asset allocation varies widely from state to state. Six of the 123 retirement systems had allocations to equity that equaled or exceeded seventy-five percent and nine systems had equity allocations below fifty percent.<sup>88</sup> The median equity allocation for corporate pension funds was sixty-five percent and ranged from a low of fifteen percent to a high of ninety-six percent in 2003.<sup>89</sup>

State defined benefit retirement systems have become seriously underfunded. In 2000, at the top of the bull market, state pension assets exceeded liabilities by \$245 billion and the ratio of assets to liabilities was 115%. At the end of 2003, assets had fallen to \$1.7 trillion, while liabilities had increased six percent and the ratio of assets to liabilities was only eighty-two percent.<sup>90</sup> During that same year, pen-

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developments in light of the MPT); John Lintner, *Security Prices, Risk, and Maximal Gains from Diversification*, 20 J. FIN. 587 (1965) (discussing risk and portfolio strategies); James Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 REV. ECON. STUD. 65 (1958) (attributing the relationship between cash demand and interest rates to assumptions regarding liquidity preference in the market).

84 See Hu, *supra* note 9, at 802–07. This is true only over the long run, and pension fund obligations may have a shorter time span.

85 Fin. Pipeline, *Pension Fund Investments*, at <http://www.finpipe.com/peninvest.htm> (last visited Nov. 29, 2004); see also Mark McSherry, Reuters, *Pensions Take More Risks as Shortfalls Grow—Survey*, Mar. 22, 2004, available at <http://www.globalaging.org/pension/us/private/2004/shortfall.htm>.

86 CLOWES, *supra* note 82.

87 WILSHIRE RESEARCH, 2004 WILSHIRE REPORT ON STATE RETIREMENT SYSTEMS: FUNDING LEVELS AND ASSET ALLOCATION, available at [http://www.wilshire.com/Company/2004\\_State\\_Retirement\\_Funding\\_Report.pdf](http://www.wilshire.com/Company/2004_State_Retirement_Funding_Report.pdf). Both U.S. equity (42.71%) and non-U.S. equity (13.31%) were included in these figures. *Id.* app. G.

88 *Id.* at 2.

89 John Ehrhardt, *Milliman Pension Fund Survey*, at <http://www.milliman.com/eb/pension-fund-survey> (last visited Nov. 29, 2004).

90 WILSHIRE RESEARCH, *supra* note 87, at 3–4.

sion funds began to move money into hedge funds.<sup>91</sup> Corporate pension funds also have become seriously underfunded. According to the Wilshire Survey of 2004, eighty-one percent of corporate pension plans are now underfunded, down from eighty-nine percent in 2003. The median corporate funded ratio is eighty-two percent, up from seventy-eight percent a year ago.<sup>92</sup> Indeed, because of the adverse impact of such underfunding on public companies, Congress recently passed legislation to ameliorate the charges against earnings that such underfunding would reflect by changing the interest rate used for calculating a number of defined pension plan funding parameters.<sup>93</sup>

Institutions were big investors in the now grounded high flyers of the bull market of the 1990s. Sometimes this occurred because of trading strategies based on indexation and sometimes because of poor analysis of an issuer's business prospects and financial statements. Although a number of these companies were required to restate their financial statements, issuer fraud is not an adequate explanation for such large investments at the top of the bull market by supposedly sophisticated investors.<sup>94</sup>

Let us take Enron as an example. The ten largest shareholders in Enron in December 2000 were Alliance Premier Growth Fund (4.1%), Fidelity Magellan (0.2%), AIM Value (1%), Putnam Investors (1.7%), Morgan Stanley Dividend Growth Fund (0.9%), Janus Fund (2.9%), Janus Twenty (2.8%), Janus Mercury (3.6%) and Janus Growth and Income (2.7%).<sup>95</sup> Numerous public retirement accounts also lost enormous amounts of money; for example, the New York City pension fund lost \$110 million, the Ohio state pension fund lost \$114 million, the New York State Pension Fund lost fifty-eight million dollars and the total aggregate loss across all University of California portfolios

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91 See Chris Clair, *Seeking Diversification: Institutions Pump Billions into Hedge Funds; Industry on Target for up to \$4 Billion in Allocations by Year's End*, PENSIONS & INVESTMENTS, July 21, 2003, at 1, available at 2003 WL 9143177.

92 WILSHIRE RESEARCH, 2004 CORPORATE FUNDING SURVEY ON PENSIONS, at [http://www.wilshire.com/Company/2004\\_Corporate\\_Funding\\_Survey.pdf](http://www.wilshire.com/Company/2004_Corporate_Funding_Survey.pdf). However, these aggregate figures hide considerable differences between individual plans. Only nineteen percent of the plans have pension assets that equal or exceed liabilities. This is down from 2000 when seventy-one percent of corporations had funding ratios greater than one hundred percent. *Id.*; see also *Pension Gap at Companies Eases Slightly*, N.Y. TIMES, June 18, 2004, at C3 (noting drop in percentage of underfunded pensions).

93 Pension Funding Equity Act, Pub. L. No. 108-218, 118 Stat. 596 (2004).

94 See Hu, *supra* note 9.

95 Turtle Trader, *If You Think the Enron Story Is About One Company—Think Again. Enron Is About You—Your Retirement and Who Manages Your Money*, at <http://www.turtle-trader.com/hall-of-shame.html> (last visited July 30, 2004).

was \$145 million.<sup>96</sup> Some pension funds, including the Arkansas Teachers' pension fund and the California Public Employees' Retirement System (Calpers) also invested in Enron's off-balance sheet partnerships or "special purpose entities." Calpers earned a twenty-three percent return on the \$250 million it contributed to Jedi I in 1993, but had problems when it tried to reclaim its capital stake three years later. Nevertheless, it converted its claim into a \$500 million stake in a new Raptor-style vehicle.<sup>97</sup>

Institutional investors generally contribute to market volatility. Since open-end investment companies are required to be sufficiently liquid to be able to redeem shares on a daily basis,<sup>98</sup> trading by mutual funds significantly contributes to the severity and speed of market declines.<sup>99</sup> Although there are a wide variety of hedge funds and hedge fund investment strategies, hedge funds focus on an absolute return rather than benchmarking an index, and as a general matter their trading activities are more aggressive than the activities of mutual funds, utilizing short selling and leverage.<sup>100</sup> In the autumn of 1998, the near collapse of Long-Term Capital Management, L.P. (LTCM) due to a portfolio that was not as diversified as thought posed a systemic threat to the global capital marketplace.<sup>101</sup>

Momentum trading, one of the strategies employed by mutual funds and hedge funds, predicts the behavior of the markets around the world at the end of their trading day and then attempts to exploit this prediction. This market timing strategy results in rapid trading during the course of a single day.<sup>102</sup> Such trading contributes to market volatility and is inconsistent with any concept of a shareholder as an owner of a corporation. Yet, such trading has been defended by

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96 *Id.*

97 Richard A. Oppel, Jr., *Employees' Retirement Plan Is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 23, 2001, at A1. Similarly, large value and large growth as well as specialty mutual funds had more than five percent of their assets in Worldcom when it collapsed. See Frank W. Stanton, *Funds that Got Walloped by WorldCom*, MORNINGSTAR.COM, Nov. 1, 2000, at <http://news.morningstar.com/doc/news/0,2,8322,00.html>.

98 15 U.S.C. §§ 80a-22, -24(a) (2000).

99 Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDHAM L. REV. 191, 240-46 (1988).

100 See GROWTH OF HEDGE FUNDS, *supra* note 71, at 33-43.

101 See Paul N. Roth & Brian H. Fortune, *Hedge Fund Regulation in the Aftermath of Long-Term Capital Management*, in HEDGE FUNDS: LAW AND REGULATION, *supra* note 73, at 83, 83-84.

102 See James N. Benedict, *Overview of Recent Regulatory and Private Proceedings Concerning Market Timing and Other Related Activity in the Mutual Fund Industry*, 1420 PLI/CORP. 35, 39 (2004).

the Chairman of the Federal Reserve Board as a contribution to market liquidity.<sup>103</sup>

Although this Article is focused on speculative trading by institutional investors, speculation by individual investors during the 1990s bubble needs to at least be mentioned. Just as frenzied momentum trading by institutions became fashionable, day trading by individual investors became popular. Like their institutional big brothers, day traders were individual investors, not registered as broker-dealers or associated persons, who traded stock at a firm that allowed real time access to exchanges and the Nasdaq Stock Market (Nasdaq).<sup>104</sup> Day traders, whether they are institutions or individuals, attempt to make a profit by executing intra-day trades to take advantage of small price movements in stocks. They are not investors, but traders, holding stocks for only hours, or even only seconds.<sup>105</sup> At the height of the bull market it was estimated that there were about 7000 day traders who accounted for approximately fifteen percent of Nasdaq's daily volume.<sup>106</sup>

Although the SEC staff did worry about violations of net capital, record keeping, margin and short selling rules by broker-dealers allowing day trading, the staff seemed more concerned about protecting day traders themselves from fraud by the broker-dealers at which they traded.<sup>107</sup> Because day trading was online and took advantage of pricing anomalies at the exchanges and Nasdaq, day trading may have seemed to have some value from a market structure perspective.<sup>108</sup>

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103 See Editorial, *The SEC's Expanding Empire*, WALL ST. J., July 13, 2004, at A14.

104 OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC. AND EXCH. COMM'N, SPECIAL STUDY: REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS (2000), at <http://www.sec.gov/news/studies/daytrading.htm> [hereinafter DAY TRADING STUDY].

105 *Id.*

106 *Id.* pt. III.A.

107 See *id.* The NASD similarly focused on risk to investors rather than trying to stop day trading speculative market activity. See Self-Regulatory Organizations: National Association of Securities Dealers, Inc., Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, Exchange Act Release No. 43,021, 65 Fed. Reg. 44,082 (July 10, 2000).

108 The SEC was prompted to move to decimalization because the conventional one-eighth spread on over-the-counter trading was enforced by traders in violation of the antitrust laws. See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Exchange Act Release No. 37,542, 62 S.E.C. Dock. 1385 (Aug. 8, 1996). But the shift to decimals did not occur until 2001. See Kate Kelly & Jeff Opdyke, *Nasdaq to Complete Its Shift to Decimals with All Stocks Priced in Dollars, Cents*, WALL ST. J., Apr. 9, 2001, at C9; Jeff D. Opdyke, *NYSE Adds Decimals, Subtracts Fractions*, WALL ST. J., Jan. 29, 2001, at C1. Decimalization

Further, the SEC generally focuses on investor protection from the standpoint of disclosure regulation. So while the SEC showed some appreciation for the danger posed by day traders, and it took some enforcement actions against firms encouraging day trading, it did not campaign against day trading itself. Similarly, the SEC did not campaign against momentum or day trading by institutions.

It is very difficult to generalize about the trading practices of institutional investors because they are so diverse. Nevertheless, complaints from the corporate community that institutions do not invest for the long term, but have a trader's mentality, are long standing.<sup>109</sup> Institutions hold very large positions and it is difficult for them to be nimble investors. Many rely on passive index strategies or investment managers who they are unable to realistically properly supervise. The foregoing facts suggest that such trading strategies are harmful not only to the markets but to the beneficiaries of these funds. Further, it is these beneficiaries that the SEC should be seeking to protect, rather than the institutional investors.

## II. MUTUAL FUND AND HEDGE FUND REFORMS

### A. *Trading Problems at Mutual Funds*

The New York Attorney General kicked off a widespread investigation into the mutual fund industry in early September 2003 by bringing an action involving late trading, deceptive market timing and sales practices by mutual funds dealing with a hedge fund against Canary Capital Partners, LLP.<sup>110</sup> Late trading is permitting a purchase

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resulted in changes in day trading strategies. It became much more difficult to engage in a strategy called "cutting the spread," which means buying stocks on a bid side and selling immediately afterwards on the ask side for a small profit. See Jens Clever, DayTradingCoach.com, *Daytrading Strategies: For the ShortTerm*, at <http://www.daytradingcoach.com/daytrading-articles-shortterm.htm> (last visited Nov. 29, 2004).

109 See Carolyn Brancato & Michael Price, *The Institutional Investor's Goals for Corporate Law in the Twenty-First Century*, 25 DEL. J. CORP. L. 35, 44 (2000) ("No issue continues to polarize corporations and institutional investors more than 'short-termism'—the notion that institutional investors are only speculators or traders . . ."); Solomon & Dicker, *supra* note 99, at 241 (noting that "major institutional investors view stocks and futures as interchangeable instruments used for the purpose of implementing short-term trading strategies designed to earn quick profits"); see also David Wessel, *Closing the Door: Two Economists Discuss the Wisdom of Exchange Controls for Emerging-Market Countries*, WALL ST. J., Sept. 18, 1997, at R21 (posing a question whether emerging market countries should restrict the flow of short-term investments by institutional investors).

110 See Complaint, *State v. Canary Capital Partners, LLC* (N.Y. Sup. Ct. Sept. 3, 2003) (No. 402830/2003), available at <http://news.findlaw.com/nytimes/docs/nys/nyscanary90303cmp.pdf>; [http://www.oag.state.ny.us/press/2003/sep/canary\\_com](http://www.oag.state.ny.us/press/2003/sep/canary_com)

or redemption order received after the 4:00 p.m. pricing of a mutual fund's net asset value. Market timing is the frequent buying and selling of mutual fund shares to take advantage of price disparities between a mutual fund's portfolio securities and the reflection of that change in the fund's share price. The former is unlawful, the latter not necessarily so, but it can nevertheless harm mutual fund shareholders by giving traders a windfall at the expense of long-term shareholders.<sup>111</sup>

The SEC was already working on mutual fund reform by the time the New York Attorney General brought these cases. During 2003, the SEC initiated sixteen rulemaking proceedings involving mutual funds.<sup>112</sup> Further, since the mutual fund scandals broke, the SEC and state regulators have taken enforcement action against nearly half of the largest mutual fund companies.<sup>113</sup> In addition to permitting improper trading, the cases involved sales practice abuses and other matters. As the result of all of these problems, the SEC is engaged in corporate governance and other reform of fund practices.

In 2001, at a time when there was debate over the corporate governance of public companies because of Enron and other scandals, the SEC determined to require the boards of investment companies to have a majority of independent directors. At the time, there was no apparent crisis of confidence with respect to mutual fund governance, but the SEC was generally making a bid to regulate corporate governance and board composition, which resulted in the passage of Sarbanes-Oxley. The SEC accomplished its goal of mandating that an investment company board be composed of a majority of independent

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plaint.pdf; Ann Davis et al., *Fund Probe Turns to Wall Street*, WALL ST. J., Sept. 10, 2003, at C1; see also Kip Betz & Rachel McTague, *Spitzer Brings Criminal Charges, SEC Sues Over Alleged Late Trading in Funds*, 35 Sec. Reg. & L. Rep. (BNA) 2018, 2018 (Dec. 8, 2003) (discussing the *Canary* case).

111 See Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714, 74,714–15 & nn.6–7 (Dec. 24, 2003); see also Stephen J. Crimmins et al., *The Mutual Fund Crisis—Beginning to See a Resolution*, 36 Sec. Reg. & L. Rep. (BNA) 349, 349 (Feb. 23, 2004) (describing late trading and market timing, as well as their potential effects).

112 See *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Senate Subcomm. on Fin. Mgmt., the Budget and Int'l Sec., Comm. on Governmental Affairs*, 108th Cong. 13 (2003) (testimony of Paul F. Roye, Director, Div. of Inv. Mgmt., Sec. & Exch. Comm'n), available at <http://www.sec.gov/news/testimony/ts110303pfroral.htm>.

113 See Paul F. Roye, *Mutual Fund Industry at a Crossroads: The Losers, the Winners, and the Spirit of Reform*, Speech by SEC Staff: Remarks Before the ICI General Membership Meeting (May 20, 2004), available at <http://www.sec.gov/news/speech/spch052004pfr.htm>.

directors by conditioning the operation of its exemptive rules under the Investment Company Act upon such a structure. Further, the SEC required the independent directors to select and nominate the board's independent directors, and to hire new counsel with no substantial ties to a fund's manager.<sup>114</sup> Although the SEC's method for imposing its corporate governance ideas on mutual funds was not challenged by the fund industry, in part because many funds already had a majority of independent directors, the SEC's authority for changing the statutory standard of forty percent independent directors to more than fifty percent could have been questioned since the statute grants a mutual fund the right to have up to sixty percent of its directors be non-independent.<sup>115</sup>

Since the autumn of 2003 numerous additional reform proposals have been generated by the SEC and a number of mutual fund legislative proposals have been floated in Congress.<sup>116</sup> Some of these proposals relate to substantive changes in the way in which fund shares are purchased and sold. SEC proposals and new rules include imposing a mandatory two percent redemption fee on sales made within five days of a purchase,<sup>117</sup> imposing a "hard close" on share pricing,<sup>118</sup> eliminating 12b-1 fees,<sup>119</sup> eliminating the payment of soft dollars<sup>120</sup> and a variety of improved disclosure regulations.<sup>121</sup> A bill sponsored

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114 Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734, 3737-39 (Jan. 16, 2001).

115 See W. Hardy Callcott, Comments on S7-03-04 (Apr. 11, 2004), at <http://www.sec.gov/rules/proposed/s70304/whcallcott04112004.htm>; Complaint, Chamber of Commerce v. SEC (D.D.C. filed Sept. 2, 2004) (No. 04-CU-01522), available at <http://www.uschamber.com/nclc/caselist/issues/partylitigation.htm>.

116 See Rachel McTague, *Outlook 2004: Mutual Funds at Center of Arena; Reform a Good Bet, but Scope Unclear*, 36 Sec. Reg. & L. Rep. (BNA) 149, 149 (Jan. 26, 2004).

117 Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375, 69 Fed. Reg. 11,762 (proposed Mar. 11, 2004).

118 Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388 (proposed Dec. 17, 2003).

119 Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,356, 69 Fed. Reg. 9726 (proposed Mar. 1, 2004).

120 *Id.*; see Karen Damato & Judith Burns, *Cleaning up the Fund Industry*, WALL ST. J., Apr. 5, 2004, at R1 (noting proposals to eliminate or restrict "soft dollars").

121 Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,287, 68 Fed. Reg. 70,402 (proposed Dec. 17, 2003) (proposing to require open-end management investment companies to disclose the risks of the frequent purchases and redemption of investment company shares and the investment company's procedures in this respect); Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820 (Dec. 24, 2003); Disclosure Regarding Portfolio Managers of Registered Management Investment



by Senator Kerry would establish an independent regulatory organization or mutual fund oversight board for investment companies.<sup>122</sup> The SEC also embarked upon some far-reaching reforms of mutual fund corporate governance.

Effective October 5, 2004, every mutual fund and adviser to a mutual fund must adopt and implement written policies and procedures designed to prevent violations of the federal securities laws and must appoint a chief compliance officer (CCO) who will have overall responsibility for the management of a fund complex's compliance program.<sup>123</sup> Although some of the required provisions of such a compliance policy specifically relate to the market timing and late trading abuses by funds uncovered by the SEC, the requirements go far beyond these matters. The CCO must report directly to the mutual fund board and meet in executive session annually with the board, and must furnish the board with a written annual report on the operation of the fund's policies and procedures and those of its service providers. A fund's board of directors must approve the designation and compensation (including bonuses of the CCO) even though the SEC contemplates that the CCO will normally be an employee of the fund's adviser or management company. Further, the CCO is protected from coercion, manipulation, misleading or fraudulently-influencing activity by the officers, directors or employees of the fund, its adviser or its principal underwriter.

The SEC has determined that any fund relying on any of its exemptive rules have a board comprised of at least seventy-five percent independent directors, and further, that the chairman of the board be an independent director. A further new requirement is that fund di-

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Companies, Investment Company Release No. 26,383, 69 Fed. Reg. 12,752 (proposed Mar. 17, 2004) (proposing amendments to improve the disclosure provided by registered management investment companies regarding their portfolio managers); Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,464, 69 Fed. Reg. 33,262 (June 14, 2004) (requiring open-end management investment companies to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (June 30, 2004) (improving disclosure by investment companies about how their boards of directors evaluate and approve investment advisory contracts).

122 Bill to Prevent the Practice of Late Trading by Mutual Funds, and for Other Purposes, S. 1958, 108th Cong. § 201 (2003). Such a body would be similar to the Public Company Accounting Oversight Board established by Sarbanes-Oxley.

123 Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714, 74,720-22 (Dec. 24, 2003).

rectors perform an evaluation, at least once annually, of the effectiveness of the board and its committees, and explicit authority is given to the independent directors to hire employees and others to help them fulfill their fiduciary duties.<sup>124</sup> This new rule has been controversial. Members of both parties in Congress endorsed the idea of an independent chairman, but other congressmen opposed the idea.<sup>125</sup> Two commissioners dissented from the adoption of the proposed rule.<sup>126</sup> Since approximately eighty percent of investment companies now have a board chairman who is an officer of the fund's adviser, the SEC's rule will work a significant change in mutual fund governance.<sup>127</sup> Strong opposition to this rule has sparked an action for a declaratory judgment declaring the rule invalid as beyond the SEC's statutory authority and in violation of the Administrative Procedure Act.<sup>128</sup>

There may be a mismatch between the trading abuses by mutual funds and the corporate governance reforms adopted by the SEC. Although some of these reforms, particularly the requirement that funds employ a CCO, may assure against violations of the federal securities laws, it is unclear whether all of the trading abuses were actually illegal. Further, there is little evidence that a fund with a majority of independent directors and an independent chairman will better comply with legal requirements.<sup>129</sup> In any event, none of these reforms are designed to regulate the investment practices of mutual funds or their own speculative trading activities which may contribute to market volatility.

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124 Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,380–81 (Aug. 2, 2004).

125 *Compare, e.g.*, John Sununu et al., Comment on S-7-03-04 (Apr. 7, 2004) (opposing the proposal), available at <http://www.sec.gov/rules/proposed/s70304/s70304-157.pdf>, with Michael G. Oxley et al., Comment on S-7-03-04 (May 20, 2004) (asking for adoption of the proposal), available at <http://www.sec.gov/rules/proposed/s70304/s70304-157.pdf>.

126 Investment Company Governance, 69 Fed. Reg. at 46,390–93 (dissent of Commissioners Glassman and Atkins).

127 *Id.* at 46,391 n.25 (dissent of Commissioners Glassman and Atkins).

128 Complaint, Chamber of Commerce v. SEC (D.D.C. filed Sept. 2, 2004) (No. 04-CV-01522), available at <http://www.uschamber.com/nclc/caselist/issues/partylitigation.htm>; see Kristen French, Thomson Corp., *U.S. Chamber of Commerce Challenges SEC on Rule*, Sept. 3, 2004, available at <http://www.financial-planning.com/pubs/fpi/20040903102.html>.

129 See Investment Company Governance, 69 Fed. Reg. at 46,390–93 (dissent of Commissioners Glassman and Atkins).

### B. Hedge Fund Regulation

The enforcement, regulatory and legislative activity with regard to mutual funds, has opened the door on the question of whether hedge funds should be registered with the SEC and/or regulated in some way. This is because a high percentage of the enforcement cases brought against mutual funds involved trading by hedge funds. Hedge funds have long posed a challenge to the SEC because they are unregulated.<sup>130</sup> They tend to be entrepreneurial and can generate large profits for their promoters and investors. Since hedge funds are essentially private investment funds, the success of the hedge fund industry raises questions as to whether the Investment Company Act is too restrictive, resulting in significant pools of money escaping from its reach, or alternatively, whether the growth of hedge funds poses an undue risk to investors and markets because they are unregulated.

The SEC, on its own or in conjunction with other federal agencies, has repeatedly studied hedge funds from the perspective of whether investors in such funds need better protection and whether hedge funds pose a systemic risk to the public securities markets.<sup>131</sup> One of the developments that has persuaded the SEC to finally force hedge funds to register with the SEC is that much of the recent growth in the hedge fund industry has come from investments by institutions such as pension plans, endowments and foundations looking for new investments during the bear market which followed the bursting of the stock market bubble of the late 1990s.<sup>132</sup> Thus, the beneficiaries of these investors are exposed to the risks of hedge fund trading.<sup>133</sup>

Among the SEC staff's more serious concerns with regard to the agency's lack of regulatory oversight over hedge funds are that the SEC is unable to detect fraud and other misconduct at an early stage,<sup>134</sup> there is no independent check on a hedge fund adviser's valuation of a fund's portfolio securities,<sup>135</sup> and the conflicts of interest which hedge fund advisers have may not be properly disclosed.<sup>136</sup> Accordingly, the staff recommended that the Commission consider requiring all hedge fund advisers to register under the Investment

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130 Nevertheless, numerous enforcement cases have been brought against them under the antifraud provisions of the federal securities law.

131 See GROWTH OF HEDGE FUNDS, *supra* note 71, app. A.

132 *Id.* at 43-44.

133 *Id.* at 82.

134 *Id.* at 76.

135 *Id.* at 79.

136 *Id.* at 83.

Advisers Act.<sup>137</sup> More intriguing was the suggestion that the SEC issue a concept release to explore the wider use of hedge fund investment strategies by investment companies.<sup>138</sup>

On the basis of the staff's recommendations, the SEC adopted a new rule requiring the registration of hedge funds as investment advisers.<sup>139</sup> Two commissioners dissented from this rule's adoption, arguing that there was not an adequate basis for such registration, and Federal Reserve Board Chairman Alan Greenspan was cool to the idea.<sup>140</sup> It is therefore unlikely that a comprehensive regime for the regulation of hedge funds, comparable to the regulation of investment companies, will be put in place at this time.

### III. SPECULATION AND LEVERAGE

#### A. *Securities Law Provisions Regarding Margin, Short Selling, Manipulation and Derivatives Trading*

The Exchange Act was based on the premise that stock market speculation was inherently evil. President Roosevelt asserted in a message to Congress in February 1934:

[O]utside the field of legitimate investment, naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pay envelop[e] or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corporations with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in

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137 *Id.* at 89. Some ancillary recommendations were also made, such as requiring a specially designed brochure to be provided to hedge fund clients and rulemaking with regard to valuation procedures, but instead of recommending a full-blown regulatory regime, the staff report suggests that the industry expand and develop best practice guidelines. *Id.* at 97–101.

138 *Id.* at 103–06.

139 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

140 *Id.* at 72,089 (dissent of Commissioners Glassman and Atkins); see Deborah Brewster, *Opposition Grows to SEC Hedge Fund Plan*, FIN. TIMES, Feb. 19, 2004, at 24; Miklos Nagy, *Investors Don't Want More Regulation: Regulators Eager to 'Help' People Who Don't Need Help*, FIN. POST, Feb. 23, 2004, at FP6; Editorial, *SEC Crime Spree*, WALL ST. J., Sept. 27, 2004, at A18. Perhaps this is because hedge funds have been useful in permitting banks to lay off some of their risks. See *The SEC's Expanding Empire*, *supra* note 103 (commenting on the financial function of hedge funds in diversifying risk across the market).

loss to the average investor, who is of necessity personally uninformed.<sup>141</sup>

After James Landis was appointed a Commissioner of the Federal Trade Commission, which administered the Securities Act until the SEC was created, he recommended a bill to regulate stock exchanges to a committee chaired by Assistant Commerce Secretary John Dickinson.<sup>142</sup> The “irreducible minima” of such a bill in Landis’s view would be a requirement of periodic annual reports by public companies; reports by corporate insiders of their stock dealings; “police regulation” of specialists, brokerage houses, customers’ men, pool operations, shortselling, manipulative transactions such as wash sales and matched orders; and regulation of the over-the-counter market.<sup>143</sup> Indeed, the SEC was created to be the policeman of Wall Street, a regulator of the stock exchanges and securities industry, and the Exchange Act was designed primarily to control speculators, manipulators and insider traders.<sup>144</sup> The most significant tools given to the SEC in this regard, in addition to compelled registration of stock exchanges and broker-dealers, were provisions regarding margin lending, short selling, manipulation and derivatives trading. These means were supposed to prevent another 1929 speculative bull market. One of the questions this Article is intended to raise is why these statutory mechanisms failed to prevent another speculative bull market in 1999.

The margin requirements, set forth in section seven of the Exchange Act, were designed to prevent the “excessive use of credit for the purchase or carrying of securities.”<sup>145</sup> The Federal Reserve Board was accorded the responsibility for prescribing regulations with respect to the amount of securities credit that could be extended and maintained by financial institutions in an amount not greater than either fifty-five percent of the current market price of the security, or one hundred percent of the lowest market price during the preceding thirty-six calendar months but not more than seventy-five percent of the current market price.<sup>146</sup> The SEC was given the responsibility for then enforcing the margin regulations. When the Exchange Act was being debated in Congress, some thought buying securities on credit

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141 S. REP. NO. 73-792, at 1-2 (1934); H.R. REP. NO. 73-1383, at 1 (1934).

142 JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 79-80 (3d ed. 2003).

143 *Id.* at 81-82.

144 See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 409 (1990).

145 15 U.S.C. § 78g(a) (2000).

146 *Id.* Regulation T, applicable to broker-dealers, is 12 C.F.R. § 220.12 (2004).

should be prohibited,<sup>147</sup> others thought that the margin requirements should be fixed, but as adopted the establishment of margin rates was left to the Federal Reserve Board.<sup>148</sup>

The Congress which passed the Exchange Act believed that the trading of securities on credit could lead to significant problems in the national economy as well as the financial markets because credit-financed securities speculation diverted resources from more productive uses in commerce, industry and agriculture.<sup>149</sup> Such activities created or reinforced stock market bubbles and led many people "perhaps drawn in by the exuberance of the market" to assume securities positions of undue risk.<sup>150</sup>

Between 1936 and 1974, the Federal Reserve Board changed margin ratios twenty-five times, with levels ranging from a low of forty percent in the late 1930s to a high of one hundred percent just after World War II, but generally kept ratios between fifty and seventy percent.<sup>151</sup> In 1974, the Federal Reserve Board set margin rates at fifty percent and it has not changed them since.<sup>152</sup> During and after the bull market of the late 1960s, when margin rates were high, the margin regulations were taken so seriously that there were criminal prosecutions for their violation.<sup>153</sup> In 1984, however, the Federal Reserve Board recommended that margin regulation by the Federal Reserve Board be abolished for two reasons: first, the primary purpose of such regulation should become to ensure the integrity of the marketplace by seeing that there is protection against significant credit loss for bro-

147 STAFF OF THE BD. OF GOVERNORS OF THE FED. RESERVE SYS., A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATIONS 3 (1984) [hereinafter MARGIN STUDY].

148 SELIGMAN, *supra* note 142, at 93-94, 97-98.

149 MARGIN STUDY, *supra* note 147, at 3.

150 *Id.*

151 *Id.* at 48; see 23A JERRY W. MARKHAM & THOMAS L. HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 8:3, at 8-11 & nn.1-2 (2d ed. 2002).

152 Hu, *supra* note 9, at 798.

153 See, e.g., United States v. Weisscredit Banca Commerciale E d'Investimenti, 325 F. Supp. 1384 (S.D.N.Y. 1971) (finding Regulation T applicable to foreign banks); United States v. Whorl, Litigation Release No. 4478 (Nov. 24, 1969). Further, violations of the margin rules were actionable in private lawsuits. See, e.g., Junger v. Hertz, Neumark & Warner, 426 F.2d 805, 806 (2d Cir. 1970) (per curiam) (finding existence of a private cause of action for a violation of § 7(c), but denying broker liability in this case); Newman v. Pershing & Co., 412 F. Supp. 463, 468-69 (S.D.N.Y. 1975) (finding an "implied right of action" for private plaintiffs against creditors for violations of § 7); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949) (construing § 7(c) as allowing a private cause of action). This principle was later abandoned. See Bennett v. U.S. Trust Co. of N.Y., 770 F.2d 308 (2d Cir. 1985) (holding no civil action available under § 7, irrespective whether the case arises under Regulation U or T).

kers, banks and other lenders; and second, stock-based futures and options contracts had become close substitutes for margin leverage and, therefore, if the margin regulations were to be maintained, margins in the derivatives markets should be significantly raised. This task should be done either by self-regulatory organizations or an inter-agency task force involving the SEC and the CFTC.<sup>154</sup>

Thereafter, despite evidence of speculation and volatility in the stock market in the middle and late 1980s<sup>155</sup> and the late 1990s, Congress did nothing with regard to this recommendation and the Federal Reserve Board did nothing with regard to margin rates.<sup>156</sup> While admittedly, in view of widespread leverage through derivatives trading, raising margin rates might have been a futile gesture, it would at least have been a gesture, a warning to investors and the financial community. The real issue, however, is whether the kind of leverage that now exists in the market is salutary. Should federal law be amended so that margins on stocks and derivatives can be harmonized, and should the SEC or some other federal agency be given the task of controlling the amount of securities credit in the financial markets?

The Exchange Act's bans on short selling were supposed to prevent precipitous market declines. They did not do so during the stock market crash of 1987, and they have become somewhat obsolete as a result of derivatives trading and decimalization. Section 10 of the Exchange Act<sup>157</sup> gave the SEC the ability to prohibit or regulate short selling and the SEC adopted Rule 10a-1 for the purpose of permitting short selling in an advancing market, but preventing short selling from driving a market down or accelerating a declining market.<sup>158</sup> For years, some have argued for the elimination of the short sale

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154 Letter from Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, to the Honorable Jesse Helms, Chairman, Committee on Agriculture, Nutrition and Forestry, United States Senate (Jan. 11, 1985) (copy on file with author).

155 See *infra* notes 176–201 and accompanying text.

156 It cannot be argued that the Federal Reserve Board was unaware of the stock market bubble of the late 1990s. In July 1999, the Federal Reserve Board's model gave a reading that the Standard & Poor's 500 was almost fifty percent overvalued versus its thirty-four percent overvaluation in 1987, just before the 1987 market crash. Chairman Alan Greenspan then referred in a speech in August 1999 to the extraordinary increase in stock prices and the possibility of a "bursting bubble." Hu, *supra* note 9, at 788–89.

157 15 U.S.C. § 78j-1(a)(1) (2000).

158 Short Sales of Securities, Exchange Act Release No. 13,091, 41 Fed. Reg. 56,530 (Dec. 28, 1976).

rules.<sup>159</sup> The SEC recently has changed the way in which the short sale rules operate.<sup>160</sup>

Just as the short sale provisions of the Exchange Act were supposed to prevent the “bear raids” which were blamed for the 1929 stock market crash,<sup>161</sup> the antimanipulation provisions of sections 9 and 10 of the Exchange Act were supposed to prevent the infamous “stock market pools” of the 1920s.<sup>162</sup> The closest analogues to these pools since the enactment of the Exchange Act were the leveraged buyout junk bond deals engineered by Drexel Burnham Lambert and Michael Milken in the 1980s<sup>163</sup> and the underwriting practices of the 1990s.<sup>164</sup> Instead of attacking either of these operations under the anti-manipulation provisions, the SEC utilized the insider trading prohibitions.<sup>165</sup> Further, with respect to questionable underwriting practices of the 1990s, the SEC was upstaged by the New York Attorney General.<sup>166</sup>

When the Exchange Act was passed, the SEC was given plenary authority over options trading, and it continues to be unlawful for options trading to occur in contravention of any SEC regulations.<sup>167</sup> Prior to 1973, options trading was conducted over the counter and options were not standardized. In 1973, the SEC authorized the Chicago Board Options Exchange (CBOE) to trade standardized, ex-

159 See Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 100–01 (1986); David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255 (1990).

160 Short Sales, Exchange Act Release No. 50,103, 69 Fed. Reg. 48,008 (Aug. 6, 2004).

161 See 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3200–04 & n.213 (3d ed. 2003).

162 Daniel R. Fischel & David J. Ross, *Should the Law Prohibit “Manipulation” in Financial Markets?*, 105 HARV. L. REV. 503 (1991); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 439–49 (1991); Thel, *supra* note 144, at 424–61.

163 See generally Margaret M. Blair & Robert E. Litan, *Corporate Leverage and Leveraged Buyouts in the Eighties*, in DEBT, TAXES, AND CORPORATE RESTRUCTURING 43 (John B. Shoven & Joel Waldfogel eds., 1990) (analyzing trends behind corporate leverage and leveraged buyouts in the 1980s).

164 See Richard W. Painter, *Standing up to Wall Street (and Congress)*, 101 MICH. L. REV. 1512, 1517 (2003); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 326.

165 See *Commercial Union Assurance Co. v. Milken*, 17 F.3d 608, 615 (2d Cir. 1994); *Neubronner v. Milken*, 6 F.3d 666, 669 (9th Cir. 1993); *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993).

166 Michael S. Greve, *Federalism’s Frontier*, 7 TEX. REV. L. & POL. 93, 102 (2002).

167 15 U.S.C. § 78i(b)–(g) (2000) (amended 2004).



change listed options.<sup>168</sup> The rapid growth of options trading during the 1970s and the development of certain questionable trading practices prompted the SEC to initiate an investigation and study of the listed options markets in October 1977. The SEC was concerned about (1) the ability of SRO surveillance systems to detect or prevent fraudulent, deceptive and manipulative activity in the trading of options and underlying stock; (2) the adequacy of SEC and SRO rules to prevent fraud and manipulation in options trading; (3) the role of options trading in the national market system; and (4) the development of standards by which to measure options trading programs.<sup>169</sup> Accordingly, the SEC conducted a comprehensive study of the options markets and then published a report recommending a large number of new regulations with respect to surveillance of the options markets, trading practices, selling practices and customer protection, and broker-dealer capital adequacy rules.<sup>170</sup> The focus of this study was on customer protection and the prevention of manipulation. The study did not cover "the effect of options on the trading in the underlying stocks or on the capital raising functions of the securities markets" or "whether there should be changes in the present system of credit regulation" for options trading.<sup>171</sup> Had the SEC decided to more severely limit options trading its actions probably would have been effectively nullified by trading in financial futures regulated by the CFTC, a competing regulator. Turf battles between the SEC and the CFTC during the last quarter of the twentieth century, aggravated by their differing congressional oversight committees, and the threat to both securities and commodities exchanges posed by unregulated derivatives trading, made any effective curtailment of derivatives trading and the leverage they involved practically impossible.<sup>172</sup>

The SEC, like the Federal Reserve Board, was not blind to the dangerous market conditions of the 1990s. Yet, both agencies failed to act to prevent the stock market bubble from growing bigger and bigger. It has been persuasively argued that both agencies had an un-

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168 *In re* Application of the Chicago Brand Options Exchange, Inc., Securities Exchange Act Release No. 9985, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,213, at 82,669 (Feb. 1, 1973).

169 *See* Investigation of Standardized Options Trading and Regulation of Such Trading; Proposed Restriction of Further Expansion of Pilot Options Trading Programs, and Commission Disapproval Proceedings, Securities Exchange Act Release No. 14,056, 42 Fed. Reg. 56,706, 56,708-09 (Oct. 27, 1977).

170 *See* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96TH CONG., REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1978).

171 *Id.* at viii-ix.

172 *See* Markham, *supra* note 17, 341-66.

reasonable faith in the superiority of common stocks as an investment asset class and the magic of time diversification.<sup>173</sup> Others might argue that these agencies had been captured by the industries they were supposed to regulate.<sup>174</sup> Clearly another factor is that Congress had no interest in pricking a feel-good stock market bubble that might enhance the election chances of its members.<sup>175</sup>

## B. Past Crises

### 1. The 1987 Market Crash

Monday, October 19, 1987, was the blackest day in Wall Street history. The 508 point drop in the Dow Jones Industrial Averages on a record high volume of over 600 million shares was an even steeper decline in stock prices than Black Thursday of October 29, 1929. The New York Stock Exchange came very close to closing on Tuesday, October 20, 1987, and probably would have done so but for the intervention of the Federal Reserve Board and the seemingly miraculous rebound in the market at midday.<sup>176</sup> Market crashes are a reaction to grim economic realities finally emerging after a period of unjustified euphoria. Prior to the crash, there had been a five-year bull market in the face of twin trade and budget deficits, a low savings rate, mounting debt to foreign investors due to oil prices and a decline in the value of the dollar. Immediately prior to the crash, merger and acquisition

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173 Hu, *supra* note 9, at 817.

174 See SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 21–33 (1981) (analyzing public choice theory and its effects on the regulatory process); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 *CARDOZO L. REV.* 909, 948–49 (1994); Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 *U. ILL. L. REV.* 315. *But see* SELIGMAN, *supra* note 142, at xix (stating that the SEC is not captured by the industries it regulates).

175 It is widely acknowledged that stock options were one of the primary causes of the 1990s stock market bubble. See Gary S. Becker, *Options Are Useful—But Only If they're Used Right*, *BUS. WK.*, Aug. 5, 2002, at 26; Mara Der Hovanesian, *The Buyback Boomerang*, *BUS. WK.*, Sept. 23, 2002, at 98; David Wessel, *Why the Bad Guys of the Boardroom Emerged En Masse*, *WALL ST. J.*, June 20, 2002, at A1; *see also* Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 *HOUS. L. REV.* 1, 29–71 (2003) (noting the Sarbanes-Oxley Act's failure to address the issue of expensing stock options). Yet, when the Financial Accounting Standards Board (FASB) attempted to change the accounting for stock options so that they would have to be reflected as an expense, Congress threatened to abolish the FASB and the SEC also backed off of this reform. See ARTHUR LEVITT, *TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW* 105–11 (2002).

176 See James B. Stewart & Daniel Hertzberg, *Terrible Tuesday: How the Stock Market Almost Disintegrated a Day After the Crash*, *WALL ST. J.*, Nov. 20, 1987, at A1.

activity had become frenzied, involving the break up and liquidation of many major industrial companies and the financial leveraging of assets to finance recapitalizations. An immediate cause of the crash was proposed congressional action to destroy takeover activity by eliminating the interest deduction on certain junk bonds.<sup>177</sup>

The culprit of market volatility most immediately identified after the crash was "program trading." This inexact term covered a variety of computer-assisted trading strategies involving derivative products, particularly stock index futures. All of these strategies involved efforts to hedge against stock market risk, but functioned during the crash to increase a market decline. Numerous studies were conducted after the crash by government and exchange bodies<sup>178</sup> which agreed upon little other than the prices of stocks during the crash were being established by the derivative markets in Chicago instead of the stock exchanges in New York and elsewhere. A presidential committee recommended that one government agency regulate intermarket issues and suggested that the Federal Reserve Board should do so, but Alan Greenspan declined this dubious honor.<sup>179</sup>

After these reports were issued, the President appointed a Working Group on Financial Markets comprised of the Chairmen of the SEC, CFTC and Federal Reserve Board, and the Secretary of the Treasury to agree within sixty days on intermarket mechanisms to prevent

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177 See Thomas E. Ricks, *Ruder Says SEC Plans to Examine Role of 'Takeover Stocks' in Market's Crash*, WALL ST. J., Nov. 16, 1987, at A6.

178 The first study to be published was one commissioned by the NYSE before the crash. NICHOLAS DEB. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES (1987). The next day, a committee of inquiry appointed by the Chicago Mercantile Exchange published a report. MERTON H. MILLER ET AL., PRELIMINARY REPORT OF THE COMMITTEE OF INQUIRY APPOINTED BY THE CHICAGO MERCANTILE EXCHANGE TO EXAMINE EVENTS SURROUNDING OCTOBER 19, 1987 (1987). A blue-ribbon presidential committee headed by Nicholas Brady was then published. NICHOLAS BRADY ET AL., REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (CCH Special Report No. 1267, 1988). The SEC issued a staff report, DIV. OF MARKET REGULATION, SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK (1988), and so did the CFTC Division of Economic Analysis and Division of Trading and Markets, FINAL REPORT ON STOCK INDEX FUTURES AND MARKETS DURING OCTOBER 1987 TO THE U.S. COMMODITY FUTURES TRADING COMMISSION (1988). The U.S. General Accounting Office also rushed to issue a report. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, FINANCIAL MARKETS: PRELIMINARY OBSERVATIONS ON THE OCTOBER 1987 CRASH (1988).

179 *The Turbulence in the Financial Markets Last October, the Functioning of Our Financial Markets During that Period, and Proposals for Structural and Regulatory Reforms: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 100th Cong. 87 (1988) (statement of Alan Greenspan, Chairman, Fed. Reserve Sys.).

another crash.<sup>180</sup> But this working group was unable to agree to raising margin rates or otherwise addressing stock market leverage.<sup>181</sup> The only concrete proposal put forward in its report was that a circuit breaker mechanism should be established.<sup>182</sup> Not surprisingly, the only recommendation of the various groups that studied the market crash which came to fruition was the establishment of circuit breakers. The Working Group specifically proposed an intermarket trading halt of one hour if the Dow Jones industrial average should fall 250 points below its previous day's closing value and for a two-hour halt if the Dow Jones industrial average should fall 400 points.<sup>183</sup> The NYSE then put a circuit breaker mechanism in place.<sup>184</sup>

## 2. The LTCM Collapse

LTCM was an investment vehicle for a number of hedge funds. Its principals included a former vice-chairman and bond trading chief at Salomon Brothers, Inc., and two Nobel laureates in economics, and it began with a capital base of five billion dollars.<sup>185</sup> Its portfolio was extraordinarily large and extraordinarily risky. Approximately eighty percent of LTCM's balance sheet positions were in treasury securities of the major industrial countries and this portfolio, as of the end of 1997, was leveraged twenty-eight to one.<sup>186</sup> But its off-balance sheet

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180 *White House Issues Order Creating Working Group on Financial Markets*, 20 Sec. Reg. & L. Rep. (BNA) 452, 452 (Mar. 25, 1988).

181 SEC Chairman David Ruder dissented from the Report on this ground. See Exec. Order No. 12,631, 3 C.F.R. 559 (1989), *reprinted as amended* in 15 U.S.C. § 78 (2000) (establishing a working group on financial markets); see also Andre R. Fiebig, *Regulatory Cooperation for Effectiveness and Compliance: Strategies for Joint Action Among Securities, Banking and Antitrust Regulators*, 91 AM. SOC'Y INT'L L. PROC. 223 (1997) (discussing the importance of transnational regulatory communication); Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 119–20 (1991) (noting the failure of the working group to address the issue of merging in its efforts to regulate); Ambrose Evans-Pritchard, "Plunge Team" Ready to Spring into Action, DAILY TELEGRAPH (London), Sept. 2, 1998, at 4 (describing the team of financial officials set up to avoid another stock market crash).

182 WORKING GROUP ON FIN. MKTS., INTERIM REPORT DELIVERED TO THE PRESIDENT (1988).

183 *Id.*

184 Exchange Act Release No. 26,198, 53 Fed. Reg. 41,637 (Oct. 24, 1988); see also Brandon C. Becker & David L. Underhill, *Market Reform Proposals and Actions*, in ALL-ABA COURSE OF STUDY: BROKER-DEALER REGULATION 193 (1989); Thomas E. Ricks, *U.S. Regulators Clear 'Circuit Breakers' to Halt Trading After Big Market Drop*, WALL ST. J., Oct. 19, 1988, at A18 (discussing the approval and effect of "circuit breaker" plans).

185 Roth & Fortune, *supra* note 101, at 85 n.4.

186 *Id.* at 85.

activities and its use of derivatives made its activities much more leveraged and risky. By August 31, 1998, LTCM had approximately \$1.4 trillion in notional value of derivatives off-balance sheet on a capital base of approximately \$ 2.3 billion.<sup>187</sup> When Russia devalued the ruble and declared a debt moratorium on August 17, 1998, LTCM became highly vulnerable to the market conditions which ensued and by September it had lost almost fifty percent of its equity.<sup>188</sup>

The Federal Reserve Board was required to intervene because of the systemic threat which the collapse of LTCM would have posed to the capital markets. Although the Federal Reserve Board did not lend money to LTCM itself, it facilitated a private sector recapitalization of LTCM composed of fourteen banks and securities firms which were LTCM's largest creditors.<sup>189</sup>

As was the case with the 1987 stock market crash, a number of governmental, international and private sector groups were convened to study the financial crisis, several bills were introduced in Congress, and little happened.<sup>190</sup> The general consensus of these various reports was that LTCM's counterparties took undue risks and ignored some of their own credit risk parameters, but that regulators should rely on transparency and market forces to improve risk management by institutional investors. The "regulatory gap" between the SEC and the CFTC was noted, and homage was paid to greater regulatory coordination,<sup>191</sup> but regulation of hedge funds was not recommended. A working group report from members of the U.S. Treasury Depart-

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187 *Id.*

188 *Id.* at 85–86.

189 *Id.* at 86–87.

190 See BASLE COMM. ON BANKING SUPERVISION, SOUND PRACTICES FOR BANKS' INTERACTIONS WITH HIGHLY LEVERAGED INSTITUTIONS (1999), available at <http://www.bis.org/publ/bcbs46.pdf>; COUNTERPARTY RISK MGMT. POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES (1999), available at [http://www.default.risk.com/pp\\_other\\_08.htm](http://www.default.risk.com/pp_other_08.htm); IOSCO TECHNICAL COMM., HEDGE FUNDS AND OTHER HIGHLY LEVERAGED INSTITUTIONS (1999), available at <http://www.iosco.org/news/pdf/IOSCONEWS34.pdf>; MANAGED FUNDS ASS'N, HEDGE FUNDS: ISSUES FOR PUBLIC POLICY MAKERS (1999), available at <http://www.mfainfo.org/whatsnew/Hedge%20Funds.doc>; PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999), available at <http://www.treas.gov/press/releases/reports/hedgfund.pdf>; SNIPER MKT. TURING, SOUND PRACTICES FOR HEDGE FUND MANAGERS (2000), available at [http://www.sniper.at/literate/hedge\\_funds\\_003.pdf](http://www.sniper.at/literate/hedge_funds_003.pdf); GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTORS, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK (1999); see also H.R. 3483, 106th Cong. (1999); H.R. 2924, 106th Cong. (1999); S. 1968, 106th Cong. (1999) (proposing bills to increase the regulation of hedge funds).

191 GEN. ACCOUNTING OFFICE, *supra* note 190, at 24.

ment, the Federal Reserve, the SEC, the CFTC and others specifically declined to recommend the direct regulation of unregulated hedge funds or derivatives dealers on the grounds that regulation would drive these entities offshore.<sup>192</sup>

It can be anticipated that many of the same actors, and particularly the Federal Reserve Board, which have ignored the systemic and investor protection threats posed by leverage in the past will object to the SEC's truly very modest proposal to require hedge fund registration. But unregulated hedge funds probably pose a greater risk to the markets than any other institutional investors, and to the extent that pension funds and other institutions are increasing their investments in hedge funds, an evaluation of the soundness of the country's retirement systems cannot be made without a better ability on the part of regulators to evaluate hedge fund activities.

### C. Underwriting in the 1990s

The way in which underwritings were conducted in the 1990s was highly questionable. Practices not unlike the pools of the 1920s have come to light, in part because of actions initiated by the New York Attorney General after the bubble,<sup>193</sup> which the SEC should have at least wondered about. The enormous premiums at which many technology offerings traded immediately after going public turned out to be based on such problematic practices as laddering, flipping and spinning.<sup>194</sup> Institutional investors, particularly hedge funds, as well as favored officers of prospective clients, benefitted from allocations at the IPO offering price and their ability to sell out at a significant pre-

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192 PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 190, at 32–41.

193 See Eliot Spitzer, *Keynote Address, Enron and Its Aftermath*, 76 ST. JOHN'S L. REV. 801, 812 (2002); Charles Gasparino, *New York Sues Telecom Executives over Stock Profits*, WALL ST. J., Oct. 1, 2002, at A1; Patrick McGeehan, *E-Mail Gaps May Mean Fines for Big Firms*, N.Y. TIMES, Aug. 2, 2002, at C4; Dan Carney et al., *The Street's New Cleanup Crew*, BUS. WK. ONLINE, June 3, 2002, at [http://www.businessweek.com/bwdaily/dnflash/jun2002/nf2002063\\_8860.htm](http://www.businessweek.com/bwdaily/dnflash/jun2002/nf2002063_8860.htm).

194 Laddering is an agreement by an IPO investor to purchase additional shares of stock on the open market at an escalating series of inflated prices. Therese H. Maynard, *Law Matters. Lawyers Matter*, 76 TUL. L. REV. 1501, 1514 n.34 (2002). Spinning is a term used by Wall Street to describe an underwriter's practice of allocating shares in hot IPOs to influential individual investors "as the quid pro quo for future underwriting business." Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023, 2028 (2002). Flipping is the term used to describe the conduct of a CEO who sells shares after receiving an allocation of shares in a hot IPO. *Id.* at 2027.

mium.<sup>195</sup> While there have been after-the-fact prosecutions for some of these underwriting practices,<sup>196</sup> the only significant action the SEC took before the bubble burst was the adoption of Regulation FD to curb leaks to research analysts.<sup>197</sup> A proposal by the NASD to establish a new rule on Trading in Hot Equity Offerings<sup>198</sup> went through a three-year comment process and was not finally adopted until October 24, 2003.<sup>199</sup> Although the participation of research analysts in underwritings became the subject of enforcement actions by the New York Attorney General<sup>200</sup> and the SEC,<sup>201</sup> less attention was paid to the operation of underwriting syndicates and the manner in which institutional investors profited from these underwritings.

Yet the excesses in the initial public offering market as much as any other development in the securities markets fueled the 1990s bubble. While it was not the SEC's responsibility or mandate to prevent issuers with few assets, no earnings and no real prospect of ever having

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195 See *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003); *SEC v. Credit Suisse First Boston Corp.*, 2002 U.S. Dist. LEXIS 2416, at \*1 (D.D.C. Jan. 29, 2002); *MDCM Holdings, Inc. v. Credit Suisse First Boston Corp.*, 216 F. Supp. 2d 251 (S.D.N.Y. 2002); Randall Smith & Charles Gasparino, *Research Pact: All-in-One Deal?*, WALL ST. J., Nov. 4, 2002, at C1.

196 See, e.g., *Credit Suisse*, 2002 U.S. Dist. LEXIS 2416.

197 Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259, 64 Fed. Reg. 72,590, 72,592 (Dec. 28, 1999). In the 1980s the SEC also attacked Michael Milken and other risk arbitrageurs under the insider trading prohibitions rather than analyzing the junk bond buy out craze as manipulative. See *supra* note 165.

198 Self-Regulatory Organizations; Notice of Filing of Amendment Nos. 3 and 4 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Restrictions on the Purchase and Sale of Initial Public Offerings, Securities Exchange Act Release No. 46,942, 67 Fed. Reg. 75,889 (Dec. 10, 2002).

199 Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 Through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the National Association of Securities Dealers, Inc. Relating to Restrictions on the Purchases and Sales of Initial Public Offerings of Equity Securities, Exchange Act Release No. 48,701, 68 Fed. Reg. 62,126 (Oct. 31, 2003).

200 See Charles Gasparino, *Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts*, WALL ST. J., May 22, 2002, at A1; see also *Spitzer v. Merrill Lynch & Co.*, No. 02/410522 (N.Y. Sup. Ct. May 21, 2002) (settlement agreement), available at [http://www.oag.state.ny.us/investors/merrill\\_agreement.pdf](http://www.oag.state.ny.us/investors/merrill_agreement.pdf); Ann Davis, *Bear Stearns Used Analyst to Tout IPO Despite Pact with Regulators*, WALL ST. J., May 12, 2003, at A1.

201 See *Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts: Hearing Before the House Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters.*, 107th Cong. (2001) (statement of Laura S. Unger, Acting Chairman, Sec. & Exch. Comm'n), available at <http://financialservices.house.gov/media/pdf/073101lu.pdf>; Randall Smith et al., *Record Payment Settles Conflict-of-Interest Charges*, WALL ST. J., Apr. 29, 2003, at A1.

earnings from going public, it was the SEC's responsibility to regulate underwriting practices, and many of the practices employed in the late 1990s were illegal. It is interesting that few Sarbanes-Oxley reforms were addressed in any way to underwriting practices or the role of institutional investors in these offerings.

*D. Should Anything Be Done to Dampen Speculation?*

Since the technology bubble burst in 2000, the SEC has had so many challenges and was given so many added responsibilities by Sarbanes-Oxley that it may seem inappropriate to suggest that further work is required to prevent future stock market bubbles. But the sad fact is that neither the SEC nor the Federal Reserve Board nor any other financial regulatory agencies made a strenuous effort in the late 1990s to dampen the rampant speculation which was occurring. The lessons of the 1920s were apparently forgotten. The financial regulatory agencies were either too myopic, too weak or too timid to speak out or take action against a runaway stock market.<sup>202</sup> According to one scholar, the financial agencies were themselves victims of irrational exuberance.<sup>203</sup> Although they had some tools for dealing with stock market excesses, the most important of these tools, margin regulation, had been compromised a long time before by the development of derivatives. To the extent that anyone thought to fill the "regulatory gap" between the SEC and CFTC, Congress included some provisions in the Gramm-Leach-Bliley Act<sup>204</sup> with respect to single stock futures and financial holding companies which left conflict resolution to the Federal Reserve Board.<sup>205</sup>

For many years, the financial regulatory agencies, including the SEC, have been more concerned about the promotion of trading effi-

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202 The theory of agency capture emerged during the period from 1967 to 1983 questioning prevailing perceptions of administrative agencies as instruments for promoting the public interest. The agency became viewed as a vulnerable governmental institution more concerned with expanding its budget than serving the public. Administrative agencies were regarded as subject to interest group capture. Therefore, rigid control is needed in order to fight the distortions of the administrative process. One way to do so is to make agency work more open. For an analysis of the development of agency capture theory, see Thomas W. Merrill, *Capture Theory and the Courts: 1967-1983*, 72 CHI.-KENT L. REV. 1039, 1050-52 (1997); see also *supra* note 174.

203 PETER H. HUANG, REGULATING IRRATIONAL EXUBERANCE AND ANXIETY IN SECURITIES MARKETS, (Inst. for Law and Econ., Research Paper No. 03-34, 2003).

204 Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified at scattered sections of 12 and 15 U.S.C.).

205 KENNETH R. BENSON ET AL., FINANCIAL SERVICES MODERNIZATION: GRAMM-LEACH-BLILEY ACT OF 1999, LAW AND EXPLANATION 3 (1999); Jonathan R. Macey, *The Business of Banking Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 710 (2000).



ciencies and giving financial institutions, especially banks, the ability to lay off risk in the markets than they have been about preventing securities speculation. Even after the warnings sounded by the 1987 stock market crash and the LTCM debacle, regulators focused on encouraging risk management by financial institutions and markets rather than worrying about leverage and market manipulation. Whether such a focus is wise is an important public policy question which does not seem to have been much debated.

### CONCLUSION

This Article suggests that an important cause of the 1990s stock market bubble was speculative trading by institutional investors. Further, the regulation of the investment practices of such investors is conducted by a plethora of federal and state regulators, is uncoordinated and is generally lax to nonexistent. While federal government control of institutional investor decisionmaking would be unfortunate, better federal articulation and regulation of a prudent investor standard for pension fund assets, including assets in defined contribution plans, would be worthy of consideration, particularly in view of ERISA's preemption of state law fiduciary standards.

Although the SEC and Federal Reserve Board were aware of the irrational exuberance of the stock market in the late 1990s and they had some regulatory tools for pricking the bubble, they did not make use of any such tools to control securities credit or leverage in the markets or to dampen speculative trading. If the SEC had decided to do so, the agency probably would have been frustrated by opposition from the Federal Reserve Board, the CFTC and, finally, Congress.<sup>206</sup>

After the stock market crashed, Congress and financial regulators blamed public companies and their managers and directors for the bubble. Sarbanes-Oxley was addressed almost entirely to questionable financial reporting by public companies and their officers and directors, and failures by their gatekeepers to prevent such misreporting. Prosecutions by federal and state law enforcement officials satisfied the public's need for scapegoats. Few, if any, of these actions fingered the role of institutional investors in the stock market debacle. More recently, the SEC (and the New York Attorney General) have focused on questionable trading practices by mutual funds and hedge funds, but the focus of these actions has not been the prevention of specula-

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<sup>206</sup> Congressional oversight of financial regulators is dysfunctional, corrupted by campaign contributions and competition between congressional committees for oversight responsibility with regard to the numerous agencies regulating the capital markets and financial institutions.

tive stock market run ups. Further, the SEC and others have focused on the role of securities analysts in underwritings, but not on whether or how customary underwriting practices could be reformed.

In the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investor behavior. This is unfortunate, since institutions control and invest the retirement savings of most investors in the public securities markets.

