Fordham Journal of Corporate & Financial Law

Volume 4, *Number* 1 1999 *Article* 4

Recent Market Events and The Foundation for Global Market Crises: A Lawyer's Perspective

Philip H. Harris*

*

RECENT MARKET EVENTS AND THE FOUNDATION FOR GLOBAL MARKET CRISES: A LAWYER'S PERSPECTIVE*

*Philip H. Harris***

I am afraid that you have all been deceived a bit if you expect that I will be discussing Long-Term Capital Management ("LTCM").[1] It was an entirely private transaction and ethical

---

* This speech was originally presented at the Derivatives and Risk Management Symposium on Stability in World Financial Markets, held at Fordham University School of Law on January 28, 1999.

** Partner, Investment Product Group, Skadden Arps Slate Meagher & Flom LLP. Mr. Harris served as Lead Counsel to the consortium of investors which infused $3.625 billion into Long-Term Capital Management, L.P. [hereinafter "LTCM"] in September, 1998.

1. On September 23, 1998, with the encouragement of the Federal Reserve Bank of New York, fifteen major banks injected $3.625 billion into LTCM, a private investment fund engaged in highly leveraged securities transactions based on advanced mathematical models, to prevent its collapse and potential default on an estimated $125 billion it had borrowed on $2.2 billion in capital. *See* Anita Raghavan & Mitchell Pacelle, *To the Rescue? A Hedge Fund Falters, so the Fed Persuades Big Banks to Ante Up; Firms to Lend $3.6 Billion as Long-Term Capital Loses on its Bond Bets*, WALL ST. J., Sep. 24, 1998 at A1 (reporting on an "extraordinary gathering" in which the Federal Reserve Bank of New York persuaded large banks to invest over $3.5 billion in LTCM in return for a 90% ownership stake, and to prevent a financial crisis should it unwind its positions); Steven Mufson, *What Went Wrong? Fund's Big Bettors Learned that Risk Trumps Math, History*, WASH. POST, Sep. 27, 1998, at H1 (corrected Sep. 29, 1998) (listing fourteen major banks and institutions which invested a total of $3.6 billion); Steven Syre, *Fleet, BankBoston in Syndicate Backing Troubled Hedge Fund*, BOSTON GLOBE, Sep. 26, 1998, at F1 (reporting that Fleet Financial Group had loaned $25 million to LTCM as part of the bail-out); Joseph Kahn & Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion*, N.Y. TIMES, Sep. 26, 1998, at A1 (citing financiers' estimates that LTCM had leveraged borrowings of $125 billion into $1.25 trillion in open trading positions). For comprehensive information on LTCM's background and near-collapse, see Michael Lewis, *How the Eggheads Cracked*; N.Y. TIMES, Jan. 24, 1999, § 6, at 24; Carol J. Loomis, *A House Built on Sand*, FORTUNE, Oct. 26, 1998, at 110; Michael Siconolfi, Anita Raghavan & Mitchell Pacelle, *All Bets are Off: How the Salesmanship and Brainpower Failed at Long-Term Capital*; WALL ST. J., Nov. 16, 1998, at A1.

constraints prohibit me from discussing its details or what I did. Therefore, unfortunately, notwithstanding hundreds of calls from the press over the last few months, I have nothing to say about LTCM.

That being said, I have been in the hedge fund business for many, many years. I have worked with an awful lot of managers on both sides of the street, from representing the sponsors who organize the funds, to the Wall Street firms who place them and facilitate their trading of derivative products. Therefore, I know all the agreements. I think that there are a few useful things that relate to what has happened in the markets and the calls for more regulation of hedge funds and derivatives.

CROSS-DEFAULT PROVISIONS

In the global financial system that exists today, there is hardly a loan or swap agreement that does not have a cross-default provision. Therefore, every enterprise that enters into multiple master swap agreements, credit facilities or any other form of financial relationship with multiple counter-parties, accepts a cross-default provision on virtually every agreement it enters into. These provisions basically state that, "If you default on any agreement with any other party, you also default on this agreement and must immediately settle up." ISDA swaps[2] and other collateralized arrangements generally do not provide for net settlement. Instead, each trade has collateral that is priced separately upon default, based on a pricing regime embedded in the agreement that assumes the availability of rational quotes. Thus, if an investor defaulted on a bank loan, then it would also default on the reported many thousands of other transactions that this enterprise had been engaged in. The entire financial system would then have to settle everything immediately during a period of illiquidity and pricing difficulties.

2. "ISDA swaps" refers to swap transactions executed in conformity with standard contractual documentation developed and maintained by the International Swaps and Derivatives Association [hereinafter ISDA]. *See* ISDA, *Overview of the ISDA Organization* (last visited Sept. 3, 1999) <http://isda.org/ala.html> (summarizing the objectives of the ISDA).

I believe that the crux of the additional regulation and systemic risk issues is the cross-default clause. It should be inconsequential if you default on one agreement, when you have, for example, $150 billion in assets, because the remaining agreements should continue to operate normally. But, because the system is now designed so that if you default on any agreement, you automatically default on every agreement with every other counter-party, the global financial system is interlinked and affected. A single default in the right place can rock the system into a mad scramble to sell collateral at the worst time with respect to each trade. The agreements do not provide a mechanism for a portfolio windup; they only provide for a transaction windup.

Unless you abolish cross-default clauses or modify them to permit the orderly liquidation of a portfolio, you are unable to control systemic risk. You can claim to reduce risk. You can measure it in an infinite number of ways, from value-at-risk,[3] to BIS[4] standards, to any other measurement. Ultimately, that risk will need to be internally controlled by the creditors, but the risk to the system cannot be controlled. Some general level of risk control may be obtained through some arbitrary measure. But clever people who are not totally committed to controlling risk within their own institutions will be able to comply with guidelines, and still maintain virtually any level of risk, by going off the reservation or truly off the balance sheet.

---

3. Value-at-risk [hereinafter VAR] is a type of sophisticated risk-management model used by banks to estimate the amount of given portfolio loss they are likely to incur over a given period of time. *See The Risk Business*, ECONOMIST, Oct. 17, 1998, at 21, 23 (discussing VAR modeling and its vulnerabilities). *See also* Risk-Based Capital Standards: Market Risk, 62 Fed. Reg. 68,064, 68,064-65 (1998) (to be codified at 12 C.F.R. pt. 3, 208, 225 & 325 as amended by 64 Fed. Reg. 19,034 (1999)) (explaining how institutions use VAR calculations in connection with regulatory capital standards).

4. "BIS standards" refers to risk measurement standards developed and published by the Bank for International Settlements [hereinafter BIS]. Information on the BIS and its publications can be obtained from its website, at <http://www.bis.org>.

THE EVENTS WHICH LED TO MARKET ILLIQUIDITY

I agree with Leon Metzger and Walter Weiner,[5] in terms of their views of the sequence of events and how the cycling-down and overall panic resulted in the market illiquidity. The core problem is that when there are no buyers and only sellers, or, only buyers without sellers in any market, it is not a true market anymore.

I believe that there is no need for any fundamental regulatory changes, because the firms and the hedge funds have taken steps since October to better control their risk. Regulation cannot create markets; only buyers and sellers can create markets.

When you have a panic that creates total illiquidity, and price spreads where a single trade moves an entire market, the problem is not of a regulatory nature, but of a psychological nature. You cannot stop a panic. If you are in front of the herd, you had better get out of the way. You are not going to change their minds when their only concern is to protect their own institutions' level of exposure. They cannot worry about the market because they must worry about their own firms.

I do not think that any regulation would have prevented the market panic. Even if all of the world's financial centers had created a cohesive structure that overcame the secrecy issues and differences in regulatory approach that inhibit transparency, a market panic could not have been prevented.

In a way, it was very positive that so much attention was focused on LTCM. The public did not realize that while LTCM was a huge player, it was hardly alone. Therefore, the public believed that everything was okay when the private market was perceived to have corrected LTCM's problem. The professionals, however, were still extremely worried. The structural problems and the spreads did not immediately revert to normal levels. Thus, it was very positive that everyone focused

5. *See* Leon M. Metzger, *Recent Market Events and the Foundation for Global Market Crises: Hedge Funds*, *supra* at 5, 12-13; Walter H. Weiner, *Recent Market Events and the Foundation for Global Market Crises: The Experience of Republic National Bank*, *supra* at 17, 21-22.

on this one entity. The public perception was that since LTCM was fixed, the market was fixed.

Paracelsus, the famous alchemist, said that if you take anything in a large enough dose, it becomes a poison. A lot of people describe derivatives as being loaded guns, but that is completely silly. "Over-the-counter derivative" is just a term. No one will complain if I do a highly leveraged over-the-counter swap trade as a substitute for a classic currency arbitrage, where you know that tomorrow the trade will make X dollars because the two currencies are at a spread and the transaction is leveraged. No one thinks of that transaction as something to worry about. But it is a swap, it is a derivative, it is leveraged, and it is over-the-counter.

The real question is how to decide the level at which risk becomes poison. It is a truism that if you want to make money, you must take risk, and the greater the risk, the greater the potential return. If you want to invest in low risk securities, such as money market funds or AAA-rated securities, which the whole world could do, you will have much less risk and the concomitant rewards.

Hedge fund managers, in my experience, are very sophisticated professionals. They are very much like their brethren in the Wall Street firms and the banks, which is where most of them began their careers. They all understand each other and operate at very high levels. They raise capital from people who trust them to manage it. The first rule of asset management is don't give your money to somebody that you don't trust. If you think that someone is untrustworthy or that they may steal your money, you shouldn't give them a penny. Hedge fund managers are highly professional and do the best they can. The investors who give them money generally understand the speculative nature of the investments.

This takes us to the interesting issue of regulation, which is being played at a very high level. Regulators do not create a market; the market participants create the market. Regulation clearly has a place in the scheme. I would also argue that it is appropriate and essential for regulators and regulated institutions to work together in a cooperative way to preserve the marketplace. In this respect their interests are alike, and they are not adversaries.

The regulators and the private market, in fact, got together and the private market fixed itself without cost to the public. As a result, people have learned many lessons. You could now analyze this whole situation and conclude that the private market works.

To my knowledge, there has been no credible claim or allegation against any hedge fund of engaging in fraud or other illegal or improper behavior as a result of this market turmoil. A significant sum of money was lost, though not as a result of criminal behavior or fraud, which people instinctively suspect when there is a huge loss. However the risks of the marketplace are real, and losses are incurred as a result of the risks that are taken.

If there is any need of regulation, it is on the credit and investment sides of already regulated entities such as broker-dealers and banks. There is no need to control the hedge funds themselves. They consist of inherently opportunistic, private capital that the investors can afford to lose. That is why the offerings are private and the offering materials contain pages and pages of disclosure that says, "You can lose all your money and here are all the ways it can happen."

One of the topics that was on today's agenda was, "How do you advise a hedge fund in times of market turmoil?" Lawyers will find this somewhat distressing, but realistically there is no adequate legal remedy even if your counter-party has improperly raised its haircuts[6] and is squeezing[7] you to death, and you believe that they have no right to hold the collateral that you need to pay the margin call on the off-setting trade to avoid default. Depending upon how the agreement was written, you may be

6. "Haircuts" refers to the "formulas used in the valuation of securities for the purpose of calculating a broker-dealer's net capital." BARRON'S DICTIONARY OF FIN. & INV. TERMS 252 (5th ed. 1998). "The haircut varies according to the class of a security, its market risk, and the time to maturity." *Id.*

7. A "squeeze" in the investment industry refers to a "situation when stocks or commodities futures start to move up in price, and investors who have sold short are forced to cover their short positions in order to avoid large losses." *Id.* at 584.

correct. That is a very nice lawsuit. But the fund will be ancient history and long forgotten by the time that lawsuit is ever resolved or even well underway.

The only answer is to advise your clients to call in their counter-parties' most senior business people to look at the investment portfolio and make them comfortable that they do not need to hold on to that money because your client is not really as great a risk as they instinctively think. That is, increase the transparency and data flow.

Absent that, little can be done. Many hedge funds were terribly squeezed as a result of the process that Leon described.[8] Haircuts went up and the funds needed immediate cash at a time when many, many credit arrangements were being terminated. There was a mad scramble for cash at the very moment that cash was least available, and it all just kept feeding on itself.

Recent Changes

My next topic is the changes that I have seen in both the hedge funds and the counter-parties since last fall. I think that these changes are, to a great degree, the response that cures the problem. That is one of the reasons that the industry prefers to deal with the problems themselves and is opposed to direct regulation of hedge funds.

First, what you might consider "best industry practices" have been ratcheted up a few notches. Counter-parties and creditors already had high-level risk management, risk control personnel and credit standards, and those standards are being tightened. Risk managers who already had very significant authority have gained even more, especially in the reputable institutions that are genuinely committed to controlling risk. In my experience those are virtually all of the institutions.

Overall, there has been a reduction in credit to hedge funds. Just as the dealer books were reduced, the leverage that hedge funds were permitted to use has generally become more restricted. There is simply less capital available for them.

---

8. *See* Leon M. Metzger, *Recent Market Events and the Foundation for Global Market Crises: Hedge Funds*, *supra* at 5, 10-13.

On the hedge fund side, the funds have all made great efforts to become more transparent to their counter-parties. As long as the funds have reasonable comfort that their counter-parties will not trade against their own positions because those counter-parties have reasonable Chinese walls[9] protecting the information, the hedge funds have become much more comfortable providing their risk analysis, their positions, and virtually anything else that their counter-parties want.

In fact, I understand that there is one fund that opened its own password protected website. The credit departments of its counter-parties can log on whenever they want, at any time during the day or night, and see in real-time what the fund is doing. I am not sure that this is appropriate, or even necessary, for everyone. But, to the extent that you are dealing with psychology and comfort levels, the fact is that when creditors get nervous, their initial reaction is to try to pull the money back. To the extent that the information provided can resolve the anxiety, it is very effective.

I think that the level of risk that can be taken by the institution must ultimately be controlled by the institution. There are plenty of external standards out there that entities, especially the international banks, must follow. The entities do adhere to those risk standards. Think about the structures that are already in place to ensure safe and sound practices for banks and broker-dealers. Combine this with the fact that most of these are public companies whose managers have personally invested in the stock. Management likes their stock to go up, not down. Negative publicity is detrimental to their own personal portfolios. Therefore, everyone's incentives are oriented toward taking less risk or really understanding the risks.

---

9. The term "Chinese wall" refers to internal controls used to prevent the transfer of certain sensitive information from the investment, corporate finance and research departments of brokerage houses to the sales and brokerage departments, as necessary to comply with the securities laws against insider trading. BARRON'S DICTIONARY OF FIN. AND INV. TERMS 94 (5th ed. 1998).

As Leon said, the models have also been adjusted.[10] This is perhaps no longer a rare event. The institutions are still protecting against significant volatility and keeping more powder dry, but all the structural incentives are already in place to try to control these problems in the future.

I think, as an anecdote, that there were a tremendous number of people up until last September who viewed some of this quantitative analysis and the people who practiced it in almost a religious light. Walter used the word "mesmerized,"[11] but it wasn't just the counter-parties who were mesmerized. A very strong belief in these mathematical theories has developed over the last few years. As the people at MIT and other places have developed ever more sophisticated models, they were perceived as infallible, notwithstanding the nod given to its inherent limitations.

I know someone very well who really understands the mathematics. When that person heard that LTCM was basically melting down, he actually broke down and cried because he had such faith in the mathematical modeling. It was a personally and emotionally painful experience for him.

To a greater or lesser degree, notwithstanding the cold-hearted cost-benefit analysis that Wall Street is so famous for, I think everyone had that same faith in the quantitative analysis to some degree, which will now have to re-prove itself. But, the counter-parties have learned a significant lesson; they will now accept less on faith and act more conservatively in the future.

---

10. Leon M. Metzger, *Recent Market Events and the Foundation for Global Market Crises: Hedge Funds*, *supra* at 5, 13.

11. Walter H. Weiner, *Recent Market Events and the Foundation for Global Market Crises: The Experience of Republic National Bank*, *supra* at 17, 21.