Hedge-Funds Crisis Breaks Into the Open

Since the May 5 downgrade of General Motors' and Ford's corporate debt to "junk" status by Standard & Poor's, the signs of a catastrophe in the hedge-funds markets has exploded into public view. Hedge funds are a form of mutual fund for the super-rich, which are permitted to engage in aggressive speculative activities prohibited to ordinary mutual funds; a substantial amount of betting in derivatives is done through hedge funds, with no government regulation whatsoever. An estimated $2 quadrillion in derivatives is traded per year—although nobody really knows the full dimensions of this house of cards.

For a month now, the financial press has been warning of an imminent blowout; Federal Reserve Chairman Alan Greenspan admitted on June 6 that "the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy"; and a battle royal has broken out at the U.S. Securities and Exchange Commission.

The Tip of the Iceberg

Here is a review of the latest reports on the crisis. Rest assured that what is coming out into the press of Wall Street and the City of London is what they want "the mickies" to hear; the true extent of the problem is certain to be much worse, and who exactly is doing what to whom remains shrouded in secrecy.

May 17: The London *Financial Times* reported that "hedge funds are liquidating positions in the expectation that investors will be redeeming substantial sums in early July. . . . The past two weeks have proved one of the most testing times for hedge funds since the collapse of Long Term Capital Management in 1998."

May 19: The Centre for Economics and Business Research was quoted by *This Is London* saying that 10% of the world's 8,000 hedge funds will fail or close this year, and another 10% will fail or close next year, for a total failure of 1,600 hedge funds over two years.

May 23: The *Wall Street Journal* reported from London on the implosion of the Bailey Coates Cromwell hedge fund. The company lost 5% of its value in March, and another 10% in April. It closed its United States operations, and is firing some of its British staff.

May 30: The bankers' magazine *Barron's* ran a cover story titled "For Hedge Funds, Is the Party Over?" It reported that "hedge funds now control $1 trillion in assets. But too much money may be chasing too few opportunities. The likely outcome: a shakeout."

June 3: Hans Fahr resigned as CEO of IWKA AG, a German engineering company based in Karlsruhe. The move reportedly came because of pressure from hedge funds, and follows the ouster of Deutsche Boerse AG CEO Werner Seifert on May 9, amid opposition from hedge funds, including Atticus Capital LLC in New York.

June 5: The *New York Times Magazine* ran a special 106-page "Money Issue," instead of its usual 40-pager. While trying to assure readers that there's really nothing to panic about, the paper does give the idea that something big is going on, with respect to hedge funds and "the growing financial complexity of risk." One article, "See a Bubble," by Roger Lowenstein, includes this table of annual performance of major hedge funds (from the NYT/CSFB/Tremont Hedge Fund Index):

2005: –0.11%
2004: +9.64
2003: +15.44
2002: +3.04
2001: +4.42
2000: +4.85

June 8: The *Toledo Blade* reported that the Ohio Bureau of Workers' Compensation lost $215 million investing in a high-risk hedge fund, in just eight months last year.

Calls for Regulation

In Europe, panicked calls for regulation of hedge funds are emerging from some of those tasked with keeping the financial ship afloat. On May 19, Jochen Sanio, president of the German financial supervision agency BaFin, referred to hedge funds as "black holes of the international financial system," and said that we need to "systematically monitor the opaque sections" of the financial system. "Regulation is a must," he said. The latest BaFin annual report warns, "The growth rate raises the question whether hedge funds could threaten the stability of the financial system." The European Commission is planning a review of the hedge fund "industry."

The most public fight is in the United States, where the chairman of the Securities and Exchange Commission (SEC), William Donaldson, was dumped by President Bush on June 1. Donaldson was trying to place at least minimum controls on the hedge-fund scam artists. Bush has nominated Christopher Cox to replace him, a Republican Congressman from California, and one of the most rabid anti-regulation fanatics in the nation.

Bush's 'Enron Reflex'

Donaldson, founder of the Donaldson Lufkin Jenrette brokerage firm, former head of the New York Stock Exchange, and an old friend of the Bush family, was appointed by Bush in December 2002 to replace Harvey Pitt, who had been discredited by his failure to act on the Enron, WorldCom, and

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cox.senate.gov.

William Donaldson (left) was dumped as head of the Securities and Exchange Commission by President Bush, who nominated Rep. Christopher Cox (right) to replace him. Donaldson had tried to introduce some minimal regulation on hedge funds: not liked by Wall Street.

related scandals. Because the Enron pirates had been among the leading supporters of the year 2000 Bush/Cheney election campaign, Donaldson faced a near-impossible task, especially since he attempted to take seriously his job as the head of one of the nation's most important regulatory agencies.

Under Donaldson's chairmanship, the SEC began to strictly enforce regulations on corporate stock operations imposed by the 2002 Sarbanes-Oxley Act—much to the horror of the free-marketeers on Wall Street.

In a June 1 press conference announcing his early resignation, Donaldson made it clear that he was being forced to leave, and that the primary issue of contention was his effort to regulate hedge funds. He noted that few of these funds were actually hedged, so they would be more accurately known as "pooled vehicles that you can do anything you want with."

What is the job of a regulator, he asked? "It would be almost impossible for me to conceive of a Securities and Exchange Commission that didn't recognize an industry that was at a $3 trillion level and wasn't being regulated at all," Donaldson said. "And we've set about to regulate that industry in a rather benign way . . . simply to get the most fundamental knowledge about the hedge fund industry. Who's running the money? What's their investment record? What's their track record as far as infractions with the law? How do they do their accounting? This was the simplest of kinds of things that will pertain to anybody that runs money. And, of course, the other part of that is that this knowledge will help us, I believe, understand better what impact the hedge funds are having on the other side of the market."

The *Wall Street Journal* reported that Fidelity Investments led the campaign by the Wall Street financial institutions to dump Donaldson, working through Bush political guru Karl Rove, and with help from Al Hubbard, who became Bush's top economic advisor early this year.

A rule change proposed by Donaldson would require hedge funds to register with the SEC, and force them to submit to regular audits and inspections. Funds would also have to provide details of trading strategies and how they value their portfolios, giving the SEC a "better sense of the goings-on in business long shrouded in mystery," the *Wall Street Journal* reported on June 8.

In opposition to regulation, the Managed Funds Association has argued that there has not been enough malfeasance in the business to justify the rule change. And the portfolio manager for Opportunity Partners, has even sued the SEC over the rule.

Donaldson said in his parting press conference that his greatest fear in leaving the post was that there would be a "legalistic rollback of . . . key items that we've put forward." The most useful of the regulations passed under Donaldson's chairmanship came as a result of 3-2 votes at the SEC, with Republican Donaldson voting with the two Democrats on the Commission against the other two Republicans. The bipartisan spirit of those actions at the SEC is now doomed, if Representative Cox is approved as the new chairman.

'Cox to the Rescue'

Bush and Cheney retreated to their "Enron reflex" by naming Cox—who proudly declares that he believes there should be virtually no government regulations—to be the chief regulator of the collapsing securities industry. Cox was perhaps best known for his leadership of the Cox Commission on

China, which was used as part of the impeachment campaign against President Bill Clinton, lying that the Clinton Administration was illegally selling "sensitive" technology to China in exchange for campaign contributions—a campaign LaRouche described at the time as a "scientifically illiterate hoax."

But Cox has also made a name for himself as a defender of speculators. As a lawyer in California in the 1980s, specializing in venture capital, Cox was named in a lawsuit brought by investors for fraud. The plaintiffs accused Cox of misleading regulators and investors about the conditions of a real estate investment. Although he was ultimately dropped from that suit before his firm settled out of court, he admits that he learned from that experience to "sympathize with people who are victimized in these lawsuits."

This sympathy for speculators led Cox in 1995—by then a Congressman—to write the "Private Securities Litigation Reform Act," which restricted the ability of clients to sue their brokers for securities fraud. As part of the "Gingrich Revolution" after the 1994 mid-term election—the "Contract on America"—Cox's bill became the only legislation to become law over a veto by President Clinton. (Cox's callous view of investors who get swindled by speculators did not hold him back from demanding a government bailout when his own Orange County, California, went bankrupt as a result of bad derivatives investments!)

Wall Street greeted the appointment of Cox with delight. Henry Manne, the Dean of the George Mason University Law School, was given the lead op-ed in the June 6 *Wall Street Journal* to hail the hedge funds as those "powerful institutions which have sprung up on their own as a new and competitive technique for getting investors' money into productive [sic] use without the baleful cost of deadweight regulations."

Manne identified the broader target in going after Donaldson and the SEC: the entire Franklin Roosevelt legacy of public investment, regulation, and the defense of the general welfare. Manne denounced Roosevelt's New Deal policies, describing the SEC as one of the "various alphabet agencies that sprang up during the New Deal era. These agencies were designed to—and did, in fact—protect the chosen industries from competition, a sort of legalized cartel arrangement that also misled the public into believing that these agencies were really about consumer or investor protection."

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Real Estate Bubble Brings 'Depression' Foreclosures

by Michele Steinberg

One of the great nightmares of the 1930's Great Depression—sheriff's sales and home foreclosures—has returned to the United States with a vengeance, while George W. Bush touts his "ownership society," and brags that the number of new homeowners is the highest in American history. Indeed, the National Association of Realtors reported that in April 2005, the sales of existing homes reached an all-time record—but, so did the number of foreclosures. According to RealtyTrac(R), which publishes a monthly report on foreclosures, the April number hit a new high, rising 2.6% over March, which had itself increased 17% over February.

On May 30, the *Washington Post* reported that there are fears of "Depression-era" numbers of foreclosures in Pennsylvania, where a report by the Pennsylvania Banking Department ("Losing the American Dream: A Report on Residential Mortgage Foreclosures and Abusive Lending Practices in Pennsylvania") was released in March. That study was prompted by the concern that Pennsylvania was ninth in the nation in the number of foreclosures in 2003, and fourth in the category of "subprime" loans—the high-interest, high-risk loans that go to lower-income borrowers.

But the pattern is broader. On June 2, former U.S. Labor Secretary, Robert B. Reich, wrote in the American Prospect Online, that "Banks are engaged in an orgy of risky mortgage lending. . . . More than half of all new mortgages are either interest-only loans with no down payments or adjustable rate mortgages, whose monthly payments will rise. . . ." It is not a good economic sign, observed Reich, when homeowners are willing to pay a high price just because they think somebody else will pay more.

The usurious looting process known as subprime loans is rising rapidly; there were $20 billion worth of these loans in 1993, but they rose to more than $330 billion in 2003. These loans, extended to lower-income Americans with little or no assets and unsteady credit, have rates that are 50-100% above prime loans.

Pennsylvania is the only state in the union which has a program to save homes, known as the Homeowners Emergency Mortgage Assistance Program (HEMAP). But it is unable to protect its citizens because of Federal banking deregulation, going back to the 1980s. Nonetheless, because of HEMAP, Pennsylvania was able to correlate foreclosures with economic factors: More than 40% of those applying for HEMAP assistance cited health-care costs as the reason they