Chapman, Spira & Carson, LLC

A History of the New York Stock Exchange and America's Financial Markets

ANOTHER TIME AND ANOTHER PLACE

Not many people are aware of the fact that securities trading existed in other parts of the world substantial before the New York Stock Exchange came into being. This was not an American innovation. Moreover, the markets were sophisticated as well, with attempts to utilize whatever technology was available to get the jump on competitors. Some of the stories that make up the market's lore are anecdotal while others are totally based on fact. This is one arena where no matter whether fact or fiction, the stories are always intriguing.

One of the more famous anecdotes in financial history concerns the occasion when Napoleon took on the Duke of Wellington at Waterloo. At the time, it was widely felt that the loser of the battle would also lose the war, and as a result either France or England were about to pay a horrible economic price; but who would it be and when would we know?

As the story goes, Nathan Rothschild equipped an observer with a homing pigeon and when the Duke of Wellington, with help from Russian mercenaries, won the day, he released it with the good news. Being a good British Pigeon, it flew directly to London with the tidings. Rothschild alerted his agents to sell securities and started a panic, as everyone believed that he must have inside information that France had been victorious. Unbeknownst to the exchange members, Rothschild had other cohorts, strategically placed on the exchange floor, to buy back whatever he sold and then some. Ultimately, the news of Napoleon's defeat at Waterloo arrived and the market skyrocketed.

Although his tactics could be criticized, Rothschild knew that if he started buying, everyone would have assumed that the battle had been won and the market would have risen. He would not have received a payday for his brilliant strategy. What this story best describes is the fact that those who have early access to information can be well rewarded if, and only if, they know how to take advantage of it.

Rothschild had set up an intricate communications device for the time. Not everyone was so brilliant. In another anecdote of the world's early financial history, we have to go to Holland in the early 1600s, where everyone had gone temporarily mad. Their belief, somehow, had become that tulip bulbs would become a global medium of exchange and that the price of particular bulbs would be extremely valuable. The prophecy became self-fulfilling and within a space of two years, tulip prices soared. ()

Holland, at that time, had become the civilized world's financial capital, and most of their strength from the trading their merchant seaman did in all corners of the earth. Journeys often took the sailors away for two years at a time and during that period, there obviously was little or no communication with home.

One of the ships that left Holland, just before the madness took hold arrived back in its home port after being away and out of communication for two years, and as the seamen left the ship they walked through a warehouse in which some goods were being readied for export and others were being received. As he passed a particular area, a seaman noticed what he thought was an onion laying on a countertop; not feeling that it had any value, and having a strong liking for onions, he proceeded to

swallow the morsel. As the story goes, the sailor was condemned to debtor's prison for his transgressions, as he had consumed the most valuable bulb in the land. The seaman was relegated to hard labor for his transgressions; yet had he eaten the same bulb several weeks later it would have been almost worthless as the market had collapsed.

I am also reminded about the story of John Law, who grew up in the early 17th century. John was precocious as a youngster, showing early signs of being a mathematical genius by solving exceedingly complicated analytical questions that were enigmas to even the most clever people of his day. He also possessed two other distinct disadvantages; he was extremely handsome as well as being an inveterate gambler. As his successes exceeded his failures in all of his many pursuits, his fame spread far and wide, and eventually he caught the eye of Louis XIV of France. Louis, as opposed to Law, was having a bad time of it. He wanted all the better things in life, but not having enough money in his own treasury, thought to take from his neighbor's kingdom. Alas, he did not choose his adversaries well and although he escaped with his life, he went further into debt.

Law, always on top of his game, came up with the solution, "We'll start a Royal Bank and I'll run it", he told Louis. Louis retorted, "what good will that do"? Law was prepared, "Lou, you know all those stories about the New World, you know, all that gold and stuff like that"? Louis indicated he was indeed familiar with those stories. Law continued, "We start a company and sell stock in it to the peasants. You know yourself that if we give it the right amount of hype, those guys will believe anything. We take all of the money that comes from them, put it in the treasury and pay off all of your debt, and Louis, there may be even a little left for some of those little trinkets you really like." Louis though for a moment and concluded, "John, I think that is a capital idea, we have nothing to lose and if it works, I will owe you really big time."

Well the idea worked, and it wasn't a fairytale, it was for real. The money came in by the gobs and the debts were paid, and there was even enough left for Louis to throw a party or two for his friends in the court. But wait!

The peasants, having lost all of their money, couldn't pay taxes. They were thrown out of work, and the country went into a depression far worse than when John Law had originally been given his assignment. Louis became disenchanted with his erstwhile friend, while the people harbored grave ill feelings. John Law, a brilliant man who just hadn't thought his plan through to its inevitable conclusion, was run out of town and died a pauper. You may know the plan he devised became know as the "Mississippi Scheme", which along with England's "South Sea Bubble", almost drove Europe back into the dark ages.

IN THE BEGINNING

In spite of romantic tales, financial markets in this country did not suddenly spring from a Buttonwood Tree and begin its historic transcendence. As a matter of fact, its early beginnings were so uninspiring; almost no record was made of the events that transpired. A commodity market came into being sometime in the 1720s. This market dealt in everything but securities, but was primarily interested in the wheat and tobacco markets as well as the slave trade.

When the Revolutionary War ended, Alexander Hamilton, then Secretary of the Treasury called for a refunding of all debts incurred by the Continental Congress and the original colonies. This created a substantial excitement as the holders of this debt had all but written it off. At the same time, The First Bank of the United States was formed and began selling its stock primarily to insiders. It's massive run-up caused substantial interest within the country and the first touch of "stock market fever" infected the nation.

Seeing that there was a market for equities, the traders that regularly assembled at 22 Wall Street divided themselves into two groups. Those that wanted to continue in the commodities markets and the slave trade continued to hold fort at the same address while those interested in securities moved under the buttonwood tree located down the street at 68 Wall. These brokers agreed that they would not negotiate commissions and that they would only deal with each other. While business continued to be conducted under the tree for sometime, the erection of the Tontine Coffee House created a place for meetings, an alternative to the "street" when the elements were too severe for all traders whether commodity of security oriented.

For the next twenty years, business went on with little or no fanfare. It would not be until 1815 that the price of twenty-four securities was quoted on a regular basis in the daily paper. The list of company's whose stocks were traded in New York were primarily in the banking and insurance industries with a mixture of tollroads, tollbridges and canals making up the rest of the list. While stocks were not considered of great importance in New York, Philadelphia had created an extremely structured organization and was becoming very successful. A one-man delegation representing the equity brokers from New York was dispatched to Philadelphia to find out what they were doing wrong.

His report led to the formation of the New York Stock and Exchange Board which rented space at 40 Wall Street. Along with its new quarters, the fledgling exchange also created a constitution covering all facets of trading on the exchange and established an initiation fee of $25. This formalization did not immediately help business and the prime example of how

lethargic trading was occurred on March 16, 1830 when only 31 shares changed hands, a record that has never been approached again.

However, a change was occurring and the country was starting to vibrate. People began believing in the nation's future and were looking for ways to participate in its growth. The railroads were expanding from east to west, opening up large chunks of the country as the expanded. Speculators were buying land the banks were financing their purchases. An awakening had occurred and Wall Street was going along for a speculative ride that would never end.

Along the way though, there were countless bends in the road and as a result of crop failures in the middle 1830s, land prices collapsed. If that wasn't enough, the Exchange burned down and had to move into a barn. In spite of the temporary setbacks, the trend was solid and sometime in the early 1840s, New York surpassed Philadelphia the center of the nation's now burgeoning securities industry. As evidence of its achievement, the New York Stock and Exchange Board hired a full time president, established telegraphic trading and saw its membership increase to 75.In 1848, the Exchange earned $1,079.

In 1854, the value of publicly traded securities surpassed $1 billion for the first time. The gold rush added to the carnival like atmosphere that the financial markets became accustomed to and without sound banking regulations, the market was soon flooded with money that added fuel to the fire. As with all booms there are the ever lurking busts and it occurred with gusto and for the first time and only time the Exchanges existences was threatened because thing became so bad. The underlying economic strength of the country remained intact though and the ship was soon righted. Railroad earnings were soaring and land values had recovered.

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A CHANGE OF PACE

From despair, Exchange Memberships came into great demand. Not wanting to share their hard won victory with outsiders, the members determined to make it the most exclusive club in the world. It soon became *de rigiour* for members to dress most elegantly while executing their brokerage transactions on the floor of the New York. The old guard circled the wagons, raised the dues and initiation fees, brought in the black ball system and pranced like a bunch of peacocks enjoining their newfound and hard won respectability. During 1856, the trading surpassed 1 million shares in one month for the first time.

In the midst of the Civil War, in 1863, the exchange adopted its current name, The New York Stock Exchange (NYSE). Speculation during the war years was rampant and three new exchanges opened during that period all feeding in one form or another on the NYSE. One of those embryonic competitors was the open-air progeny of the American Stock Exchange and it began by trading the same stocks as the NYSE except at different hours.

During the War, for some reason, speculation ran amuck, and people from all walks of life engaged in its pursuit almost to the exclusion of other interests. Yet during this same period the value of currency substantially declined against the price of gold and greenbacks sold at a discount when the government refused to redeem them. Gold became the prime vehicle for speculation and exceeded securities trading volume on the NYSE for a period. Ultimately, members of the Exchange determined that their continued support of gold trading was hindering the war effort and banned it. Trading in the precious metal was immediately commenced in the "Coal Hole" as the predecessor to the "Gold Exchange" was called. Trading in gold remained at a fever pitch during the entire Civil War and even after it had ended. Systemically, confidence in the Greenback had almost evaporated and efforts by the government to reverse this trend were fruitless.

THE ROBBER BARONS

If the western part of the United States was truly the "Wild West in the 1800s because of it’s lack of laws and law enforcement, the eastern part of the United States should have been known as the "Wild East". The East had laws and they also had people to enforce their regulations, unfortunately the problem was that, for a price, the laws could be shaped to conform with the needs of the highest bidder.

The term "robber barons" probably originated by virtue of the fact that they were able to flaunt the law by paying to have it twisted into a scenario that accommodated the current environment. These were tough-minded individuals, who once having set their sights on a target, were not particularly concerned with what obstacles stood in their way. Their tactics were fearsome to many, but yet the American industrial frontier was not to be scaled by the faint of heart, and ultimately many of them were instrumental in the unparalleled growth of the United States. They were attracted to many sectors of commerce, but nowhere was financial war waged in a more brutal fashion than in their battles for control of the nation’s railroads. Names such as Drew, Fisk, Gould and Vanderbilt became synonymous with the times.

Railroads were of particular interest because the government would grant generous right's of way to the fledgling carriers to help them augment their risk. Thus, as the roads spread westward and towns grew up around their tracks, success became self-fulfilling as the people settled in and purchased their land from the 'line' that served them. Wall Street was unable to provide all of the funds necessary for this breakneck expansion so that these additional revenue sources became critical to the country's manifest destiny.

Vanderbilt, being a pioneer in both the shipping and railroad businesses, understood the economics better than most, often expanded by acquiring one road and then another. Commodore Vanderbilt took a fancy to the Erie Railroad, which he thought, would fit in nicely with the properties that he had already acquired. He showed little concern for the fact that an unholy alliance of Daniel Drew, Jay Gould and Jim Fisk already were of the opinion that the "road" belonged to them. In spite of the fact that these gentlemen had reputations for taking no prisoners in financial warfare, the Commodore began acquiring stock in the open market at a fearsome pace.

Not missing a beat, the evil trio began printing new shares, thus diluting Vanderbilt's purchases. The more shares the Commodore bought, the lower his percentage interest in the Erie became, and the more elusive potential victory. Ultimately, the Commodore, not known for unlimited patience, became crotchety and evened the odds by having his adversaries declared criminals by a friendly federal judge. An arrest warrant was duly issued and Erie Management fled New York, one step ahead of the police.

As the story goes, they landed in boats in Jersey City, New Jersey and set up what amounted to a militia within the City limits.

; Jersey City's Chief of Police furnished, at their request, a squad of police to augment the force of railroad detectives who patrolled the streets and wharves, new "Fort Taylor"; three twelve-pound cannon were mounted on the piers; and Jim Fisk, at the head of a squad of four dozen men, equipped with Springfield rifles and lifeboats, strutted about, bursting with pride: he was now "Admiral" Jim Fisk" ()

In spite of their hasty retreat, they had had the presence of mind to retain the printing press and continued to thwart Vanderbilt's plans. The fact that they were now on the lam, and residing in Jersey City, was not a major consideration when the Commodore determined to even the score. He offered $25,000 to anyone that could kidnap the trio and bring them to justice in New York City. A literal navy of toughs set sail for Jersey City, bristling with arms. Alas, this was not to be the Commodore's day. The toughs were beaten back by the Jersey "Militia" and Fisk, Gould and Drew remained free and still in control of the Erie.

Gould came up with a most grandiose plan. If Vanderbilt could buy a federal judge, he and his associates could buy the New York Senate, and they did. Spending enormous amounts of money, the fearsome trio paid anyone and everyone that could vote. The conviction was renounced; the Erie remained outside of the Commodore's empire.

JAY TRIES AGAIN

This aberrant trading frenzy created the environment for the first major attempt by someone to corner a market in this country. Legendary Jay Gould, who had as his partner, President Grant's son-in-law, assumed logically that as long this relationship existed he could buy gold until he had it all, ultimately corner the market and make anyone who needed it, pay through the nose. And buy he did, two, three four times what existed in the marketplace with a little always set aside for Grant's heir. When Gould's buying continued unabated, Grant's son-in-law panicked and ran to papa with the news that the gold market had been corned. Gould, who wasn't born yesterday, figured out that the jig was up and unloaded his holding on his dubious associates. When the U. S. Government started dumping the precious metal, Gould was long gone, leaving his cohorts holding his worthless paper. Gould walked away with millions in profits, his partners with bankruptcy. A failed attempt some might judge, but by Gould's twisted logic, a great victory. Friday September 24, 1869 was to go done in financial history as "Black Friday".

During this period volume on the Exchange continued to rise and the concept of "calling" securities was abandoned in favor of a continuous market. Technology was changing rapidly and the stock ticker appeared during this period followed shortly thereafter by the telephone. The Exchange merged with the Open Board of Brokers and the Government Bond Department bringing membership to 1,060 seats, all of which became negotiable for the first time. The Exchange sold additional 40 seats with the proceeds used for expansion. For the next 50 years, no new memberships were created. As speculation increased, it seems as though morality dropped in direct proportion. The age of the so-called "Robber Barons" had arrived with a vengeance; it brought with it avarice, greed and unknown creative forms of larceny. Stock certificates were printed at will, or at least until the presses gave out, pools were formed to manipulate securities prices both up and down and misinformation was publicly conveyed whenever it suited the issuers fancy.

In an attempt to put an end to this over-issuing of shares, the Exchange mandated requirements that listed companies maintain transfer agents and registrars to police the system. Along with these new listing regulations, the Exchange also attempted to control member's floor conduct and instituted a series of fines to restore lost decorum, $10 for throwing a paper dart or for standing on a share were at th **BACK TO EARTH AGAIN IN A HURRY**

In 1927, the Fed had embarked on any easy money policy; margin loans were made available by the brokerage houses of the time for almost 100% of the value of underlying securities. This obviously substantially added to the ultimate problem of margin calls during the 1929 crash. Pools could make stocks do almost anything they wanted them to do, but an era was at an end and as we have seen, prosperity eventually begets collapse. This disintegration was legion and only the nation's gearing up for another bigger and better war softened the economic gloom that had become pervasive.

As opposed to other stock market calamities, the public got caught in this one. It was really the first time that they had entered the markets and it didn't take long for them creamed. As opposed to having some speculators wiped out, these were voters and investigations were started. Everyone got into the act and as expected they found fraud, fraud and more fraud. As a result of these findings, the government created the Securities and Exchange Commission (SEC) so that it would never happen again, at least for a while. The Securities Act of 1933 became law as did the Banking Act of 1933, the Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935. The Government for the first time was committed to policing the securities industry. Recommendations and regulations flew thick and fast. Among the causalities brought about by the collapse was an SEC mandated reorganization of the New York Stock Exchange. These changes included outside representation on an entirely new Exchange Board, a full time president along with paid executives to run the overall operation and an overhaul of the old-boy committee setup. Old-line members played hardball and felt that they could outwait an inevitable change in the system. Just when it appeared that they may be right, Richard Whitney and Company was suspended from the Exchange. A former president of the New York Stock Exchange, Richard Whitney. Whitney in 1938 was found guilty of stealing virtually everything in the account of the prestigious New York Yacht Club, his firms funds (Richard Whitney & Company), the customers accounts of Richard Whitney and Company and still not satisfied, he emancipated whatever funds were in the New York Stock Exchange’s Gratuity fund as well. The game was over and the old guard gave up in disgrace. A new Exchange emerged from the ashes.

Another Bite at the Apple

World War II was now raging in Europe and the market saw America in the same role that had worked so well for it in World War I. The possibility of becoming a supplier without getting too dirty. For a while the market rose based on this thinking, but Europe was totally overrun and it began to appear that there may not be anyone left to supply unless we acted. That caused blips in the system and prices became erratic until the overall course of the war became more clear. As it appeared that ultimately we would be victorious, a rally ensued an lasted until 1946 when economists began predicating another depression. The early shock of a war in Korea was eclipsed by the lack of a depression. The markets started to roar again for the first time since the Great Depression and in 1952 began closing on Saturdays to accommodate a bookkeeping backlog. In 1953 the exchange bowing to the changing environment allowed member firms to be incorporated and today, it is rare indeed to find a large New York Stock Exchange firm that deals with the pubic that is still a partnership.

The rally continued unabated with the exception of a major slip brought on by President Eisenhower's heart attack in 1955. The new securities rules worked for the most part and prosperity existed to the point of concern. Obviously, this could not continue without a depression or market crash or something. Committees were formed and investigations begun literally to determine why all this prosperity was occurring. The investigations eventually disintegrated without comment for the most part when people determined that it was better to enjoy what was going on then to try and throw a monkey wrench into it.

In 1970, the Securities Investors Protection Corporation (SIPC) was mandated by Congress and its implementation started a trend by investors to leave securities in their brokers electronic account as opposed to taking physical delivery. This substantially furthered the course of automation; an unexpected benefit that had not been anticipated when the Corporation was created. The first paid Chairman of the NYSE was installed in 1972 along with the elimination of the 33member Board of Governors, which was replaced by a Board of Directors. The Securities Acts Amendments of 1975 were signed by then President Ford bringing the most sweeping changes to the securities industry since 1935.

Major changes that effected the industry were the demise of fixed commission rates and the creation of the Central Market System. Because the industry had been plagued by nepotism for so many years, the negotiation of commissions caused severe dislocations within the industry. The Central Market and Quote Systems were nonevents to the degree that whatever stock had their primary markets on the New York Stock Exchange prior to "D" day also had them there after "D" and still have them there today. As time went on a composite quote system came into being which showed best market information and ultimately it came to include transactions in the Over the Counter markets as well.

As commission income per transaction eroded, brokerage firms found alternatives to try to replace the lost profits. Private partnerships were set up on the "street" for tax shelters and real estate. For some time, these areas provided much needed

revenue to the industry but numerous problems evolved and both customers and firms suffered substantial losses. Insurance sales were also attempted with hardly meritorious results as well. Overall, the primary palliation for the industry occurred from the increased volume that was driving the market as new investors flocked in.

High Tech and Wall Street

Automation hit the NYSE with force when the Designated Order Turnaround System (DOT) was introduced in 1976. Designed to automatically execute small transactions, the system grew to the point, where today over 50% of all NYSE transactions are handled by it. A system designed to handle 100 share market orders has now evolved in SuperDot and executes five figure trades literally at the speed of light. When combined with The Opening Order Automated Report Service (OARS) it aids the specialist in mathematically determining opening prices which at times in years passed had to be handled by governors of the exchange. Today, stocks open at the bell that would not have traded until noon under the old system when prices had to figured manually.

In 1977, with apparent reluctance, non-Americans were allowed membership on the Exchange, but the restrictions were severe and few qualified. As time has gone by most barriers have been eliminated and most of the legitimate foreign individuals or companies that desire membership find no particularly difficult obstacles to access. It is of particular note though, that with the advent of negotiated rates, it is probably more expensive for many of these operations to set up housekeeping in New York then it would be to arrange for a substantial discount on commissions. In reality the game really was the fact that membership on the Exchange was extremely prestigious and brought with it substantial improvement in stature. Cost was not particularly an impediment to this group.

The Exchange traded over 130 million shares on August 1, 1982, which was slightly under the daily average for 1987. On October 19th 1987, the Dow Jones Averages fell a record 508 points in one day. This drop was more than the averages stood at just 20 years earlier. The following day another record was set when the volume exceeded 600 million shares. In October of 1997, 10 years later, NASDAQ (OTC) volume exceeded 1 billion shares for the first time. The effects of the 1987 debacle lasted for several years.

Mutual funds had become intensely popular as a passive way of playing the market and putting away a little something for the future. As more people desired entrée' into the stock market funds became monolithic and almost unwieldy. The larger ones had billions of dollars in their portfolios and as long as time was on their side everything was OK but without it, disaster was courted. On October 18th, 1987, Fidelity Funds in Boston had received notices of substantial liquidation of the funds by investors. The only way to pay the redemption was to sell securities, but there really wasn't quite enough time as they had to some degree been caught off guard. To save a day the fund entered orders to sell in London Market overnight, and when the majority of the orders were unfilled, they hit the NYSE on the morning of 19th. This set off a technological disaster as bells and whistles went off all over town. You see, everyone had a system and each system seems to have been violated simultaneously. Thus, a rush for the door. Not everyone could get out at once so that wave upon wave of selling bombarded the crippled market. Telephones went unanswered at brokerage house because it "may be another sell order", and panic ruled the day. Fidelity had become Mrs. O'Leary's cow.

Various economic events came together simultaneously to cause the collapse but its violence was much more the effect of new products that acted more like commodities than securities. Derivatives had made their appearance and it was not a pleasant debut. Since that time, many regulations have been put into effect that are designed to temper the effect of these instruments

In summary, we believe that three dramatic trends have occurred as a result of trading in derivative index products. First, stock index futures have supplemented and often replaced the secondary stock market as the primary price discovery mechanism for stocks. Second, the availability of the futures market has spawned institutional trading strategies that have greatly increased the velocity and concentration of stock trading. Third, the resulting increase in index arbitrage and portfolio insurance trading in the stock market has increased the risks incurred by stock specialists and has strained and at time exceeded their ability to provide liquidity to the stock market."

e upper limit of offenses while the member was only assessed $.50 for knocking off an associates hat.

THE AGE OF DERIVATIVES

Many of the financial debacles of the recent past are a direct result of the tendency of financial institutions to place too much authority in the hands of literally unsupervised traders. Nick Leeson, a 28 year old purported whiz kid, engineered the demise of Barings PLC, the oldest merchant bank in Great Britain (founded in 1762), devising a flawed electronic trading system and covering it up through forgery and lies. () Initially, Lesson's primary interest was speculatively arbitraging the 10year Japanese Government Bond against the highly volatile Nikkei225 stock index futures and options. As time went on, he

graduated to unhedged bets on the direction of the Tokyo Stock Exchange. Leeson lost almost immediately and had accumulated a loss of almost $4 million within several months.

In addition to supervising the trading department of Barings' Singapore operations, Leeson was also responsible for overseeing settlements. Thus, in his dual role, he could manufacture fictitious reports. By the end of 1994, his losses already exceeded Barings' profit. For the most part, Leeson was brought down by the Kobe Earthquake, which decimated the Japanese Stock Market. In his final trading hours, at one point, he was able to control over 88 percent of the open interest in the June Contract for Japanese Government bond futures. Leeson gave the market adequate warning by being the central figure in other contracts as well.

Even massive margin calls did not create concern on the part of Barings' management (). It was only the fact that irregularities appeared on the Singapore Settlement's books that the home office became concerned. When these discrepancies could not be resolved, and Leeson was asked to explain, then and only then, did the roof collapse. Barings' loss, a staggering $1.4 billion. The markets became erratic, prices fell, margins were raised and the aftershock produced dislocations all over the globe.

Toshihide Iguchi, when in his formidable years, was regarded as a wunderkind. Like Leeson, Iguchi developed a global reputation as the "King Midas" of copper while at Sumitomo and established a department in which his reporting requirements to his superiors was minimal. He was able to continue his charade for many years through forgery and lies while inspiring losses of $2.6 billion for his employer. His Japanese firm has been banned from the United States not only for committing the crime in the first place, but also for attempting to cover it up by corporate criminal actions.

Mr. Iguchi is no longer trading copper but his legacy has succeeded him. In spite of The London Metals Exchange (LME) along with the New York Mercantile Exchange (the major markets in which cooper is traded) institution of constructive reforms, primarily dealing with the market’s transparency, volume has floundered and leadership has unearthed greener pastures. Other metals have replaced cooper as "big ticket" items () and it will probably be years before the copper markets regain their luster of old.

Joseph Jett, a young trader at Kidder Peabody, an old line Wall Street Company, was directly responsible for sending his firm into oblivion. A series of nonexistent electronic transactions threw Kidder’s books into such disarray that auditors still have not been able to trace his transactions with any degree of assurance. This incident may be of critical interest to those who come from "it can’t happen here university". General Electric, a company that is considered by securities markets to be the most valuable company on earth, owned kidder. The financial community is convinced that they achieved this distinction due to the extraordinary management talents of their senior people. As opposed to others, General Electric operates in a "hands on" mode and theoretically could get away with it only because their controls were believed to be almost flawless. Why then, if we are not looking at a major problem, was General Electric forced into a position to write off over $2 billion in losses? What makes this case even more critical is the fact that General Electric not only overlooked what Jett was doing, but was also negligent in evaluating the machinations of his superiors as well. At the time these traders received the authority to bet the house in the biggest electronic crap game on earth, their average age was 23 ().

The fact that these gentlemen were young and unsupervised when they started down their path to electronic theft is not the only common ground they shared. In each case, the transactions were highly complex (derivative based) and unless a key was available to unlock the code, it would have been nearly impossible to decipher what had transpired. () Maybe of even greater importance, substantial bonuses await the successful traders that rack up big profits for their employers. The prestige and wealth that accompany top rate performance are as addictive as an opiate.

These examples are only a few among many: Peter Young of Deutsche Bank easily held his own when it came to unauthorized losses that he illegally racked up to the tune of $600 million; Colin Armstrong, fund manager for Hong Kong operations of Jardine Matheson, created transactions that allowed him to directly pocket untold millions of his client’s money; and, in a case similar to the Jet fiasco, National Westminster Bank is still trying to sort out its books after finding that a trader adjusted his transactions at bonus time to the tune of well over $100 million.

Another young man who successfully cooked another set of books was Kevin Wallace, former Merrill Lynch & Co. all-star. Mr. Wallace’s legitimate income from Merrill was probably in access of $10 million. His claim to fame was a winning personality, excellent sales skills and some knowledge of the market place. His methodology was simplistic; no derivatives or currency spreads for our Mr. Wallace. Just two sets of books, one sent out to clients by Merrill and another fashioned by Wallace, which showed sensational profits in his client’s accounts. When asked about the discrepancies between the two highly differing accounts of customer activity, our hero would respond that Merrill wasn’t really very good a bookkeeping and that their computer was usually out of order. His figures were "accurate and could be relied upon". Inexplicably, almost to a person they accepted the highly credible Wallace’s bizarre story.

For Wallace, if he is ever found, things could become difficult, for Merrill, the affair is a powder keg. Wallace's client's represented a substantial part of the wealth in Southeast Asia. Not only that but Wallace was fired for other reasons some time ago and the affair only came to light when he was retired from the "bookkeeping by mail business" and his client's were left with only one set of books to rely upon. Merrill never noticed the problem until it was called to their attention by what soon became a chorus of wounded investors. What made matters even worse is the fact that many of the investors, not satisfied with Merrill's offer of the return of principal and interest, are requesting the profits that Wallace had promised as well.

Supervision at Merrill has been a substantial question, in any event, after the ill-fated Orange County fiasco, and when you raise additional questions as to Merrill's internal controls, you are making an excellent case for avoiding them like the plague. We are not sanguine about Merrill's future role in this part of the globe if they can't get their act together.

The potential for economic damage from derivative trading knows no national boundaries. () Metallgesellschaft Refining and Marketing (MGRM) the American subsidiary of Metallgesellschaft AG (MG), actualized a nearly $2 billion fiasco as a result of a sound business concept that, because of its complex nature, had to be converted into a derivative to function. Ultimately, the sheer complexities of the transaction became unfathomable to the participants, who prematurely unwound positions that have been characterized by some as sound. ()

The scheme was simple, "In 1992, MGRM began implementing an aggressive marketing program in which it offered long-term price guarantees on deliveries of gasoline, heating oil, and diesel fuels for up to five or ten years. This program included several novel contracts, two of which are relevant to this study. The first was a "firm-fixed" program, under which a customer agreed to fixed monthly deliveries at fixed prices. The second, known as the "firm-flexible" contract, specified a fixed price and total value of future deliveries, but gave the customer some flexibility to set the delivery schedule. Under the second program, a customer could request 20 percent of its contracted volume for any one-year period, with 45 days' notice. By September 1993, MGRM had committed to sell forward the equivalent of over 150 million barrels of oil for delivery at fixed prices, with most contracts for terms of ten years." ()

Two additional elements of the program were that they received a premium of $3 to $5 per barrel over the then spot price and prices, at the time, were historically low. Management of MGRM and its customers were convinced that prices would rise in the ensuing years and that the premium represented a small insurance premium on future prices. MGRM insured its ability to make delivery by purchasing oil in the forward markets in quantities comparable to its customer purchases. MGRM would acquire a large clientele on a very profitable basis while insuring that it had optimized its total return.

The Company's optimum scenario failed for all of the wrong reasons: oil did not immediately rise, it collapsed. MGRM's poorly constructed hedge contained dissimilar elements and when liquidation of the position was commenced the derivatives () lost their collateral value. Margin calls were issued and it was the determination of MG that unless the positions were immediately unwound, they would go bankrupt. The end result was the largest loss ever suffered by a business to that point in time, the near dismantling of MG, disorientation and the collapse of the oil markets as the positions were liquidated. This occurred in a situation that only became calamitous because it could not be understood.

Derivatives' trading is not for the faint of heart or the uninformed. Without total knowledge of the markets and particular objectives, without proper supervision and controls, and without finite ability to determine risk reward, it is a fool's game. In spite of this, early in the 1990s, Bankers Trust, a "wholesale banker" began preaching the "derivative gospel". Effectively they were telling large multinational corporations such as Procter and Gamble (), Gibson Greeting Cards (), Air Products, Sandoz, and Federal Paperboard the derivative hedges could be set up to level peaks and valleys in various aspects of these company's business. () The aforementioned clients of Bankers Trust purportedly wound up losing substantial sums as a direct result of this derivative trading. ()

The behind the scenes scenario was played out somewhat differently. Consider, for example, oral references by Bankers Trust (BT) staff to a "rip-off factor" that was attached to complex deals involving leveraged derivatives. One BT salesman describes how he would "lure people into that total calm and totally fuck them." Perhaps worst of all, a video shown to new employees includes a telling description by a BT instructor of how a swap works: he says that BT can "get in the middle and rip the [the customers] off". Remembering that cameras were rolling, the instructor then apologized. BT says the episode was a poor and inappropriate attempt at humor." ()

Well if you can't trust Bankers Trust, then who can you trust? The World is spinning at an ever-increasing crescendo, the European Markets could shortly be merged as will be their currency. The markets in Asia are in free-fall, Japan looks like it is in some serious trouble, Hong Kong is part of China and the world has become attached at the waist by a thing called Internet that seems to convey information at the speed of light. Computers are outperforming Moore's Law and if you don't have a scorecard, you really don't know where you are. Exchanges are going global and the regulations that took so long to evolve are going out the window. Even the Securities and Exchange Commission says that they are going to leave the electronic market place alone, for now. As if they could do anything about it anyway. Times were a lot simpler under the Buttonwood tree even when people weren't buying stocks.

This remains to be seen and we are far from sanguine of how good these will be.

ANOTHER DAY ,TIME TO DECIDE. CAN THIS BE THE END.......

On October 19th, 1987, what was then the largest information system in the world became stultified. As you may recall, this was the day the Dow Jones Average plunged 508 points or 22.6 percent on a volume of over 600 million shares on the New York Stock Exchange alone. Information was arriving from all over the world simultaneously into circuits that were not setup for such an extraordinary experience.

Traders were in a state of panic as they fought to get the securities orders executed in the various markets. Traders not having up to the minute information were afraid to make markets and unanswered phones rang off the hook in brokerage trading rooms. () Data could not be collated or visualized for a substantial time after transactions had occurred. Margin calls were too early or too late because updating could not be kept in tune with a system in chaos. Customer's securities were sold erroneously for collateral when there was no deficiency and others were not sold out because the computers were in a constant state of hyperventilation.

> 'As a threshold matter, the system simply ceased to provide an effective pricing mechanism for many leading NASDAQ securities, due to the inordinate number of locked and crossed markets coupled with the large number of delayed last sale reports. Moreover, the collapse of the pricing system either led to, or was part of, the problem associated with some market makers' unwillingness to provide reliable liquidity in reasonable size. From this standpoint, we think it is irrelevant whether market makers were unreachable due to inadequate staff to cover increasing demands or consciously avoiding their market maker responsibility. The point is that not only were machine generated quotes unreliable, it was often impossible to verify quotations by telephone, or to effect inter-dealer trades. Finally, the abandonment of small order execution systems (both the NASD's SOES and firm proprietary systems) led to increased strains on market maker capacity and order execution facilities." ()

Portfolios that had previously been updated and evaluated electronically, with each variation in price of the components, were now attempting to digest non-homogeneous data arriving from varying sources substantially after the transaction had occurred. The problem was pervasive in that all global and domestic marketplaces were inundated to varying degrees. Thus each contemporaneous market was supplying information on similar securities, trading in alternative markets, (General Motors, for example, trades on the New York Stock Exchange, the Boston Stock Exchange (), the Philadelphia Stock Exchange, the Pacific Coast Stock Exchange, the Chicago Stock Exchange, the Third Market, Instinet and others) various events that had occurred at similar points in the past transmitted data at differing speeds. Thus, data transmission on the New York Stock Exchange was running 30 minutes late while many parts of NASDAQ were inoperable and some markets were no longer operative.

Floor brokers on the exchanges were tied up in crowds () executing orders and couldn't leave the earlier arriving orders to execute the new ones coming in. Thus, the fact that customers could not even tell whether their trades had been executed or not, created even more pandemonium. Frenzied customers used their phones to call brokerage compliance departments, legal departments, executive departments, execution departments, brokers, newspapers, the SEC, attorney general and more, thus causing telephone overload as well. Haggard clerks stopped answering their phones, as they could not give raving customers something they didn't have.

Thus when valuing portfolios, the computers by picking up the last known sale on any market of similar securities, could not even come close to a dependable pricing assessment. Essential decisions were fabricated from erroneous data costing investors billions of dollars. Exchanges in Singapore and Hong Kong () plunged 50% before the smoke had cleared and London, () Paris and Amsterdam dropped over 30% of their value as the chaos continued to reign supreme in New York. Globally (), there was literally no where to hide. Even the marketmakers were at a loss. For the most part they are always the stabilizing influence of last resort and in chaotic times their obligations to maintain order can be strained to the limit.

The more the market declined, the more the chaos intensified. Hoping to stem the tide, specialist units poured ever-increasing amounts of money into attempts at stabilization. Their bankers, unaware of what the economic condition was intra-day for each unit, were weary of extending additional credit to marketmakers (). As a result, some markets sustained more damage than others did. When the smoke had cleared, units that had made money for decades without fail were bankrupt, others, who had disobeyed their marching orders for the sake of survival, were unceremoniously sacked. Still others, who were still bailing while the ship was going down, were ultimately sued for taking advantage of customers during a panic. All did not go well this day.

And the wild card that insured that no one would sleep well that night, the derivative (). These were those strange instruments that were supposed to do everything for everyone relative to their investment needs. One thing these programs did was to create alarms that went off if certain events happened. When the alarm rang, portfolios were liquidated, no matter what the price. These were not odd-lot accounts. Each one that reacted to some secret signal allowed the fund to robotically shoot itself in the foot creating another wave of selling. No amount of analysis could dissuade the computer from doing its deed. Prices had gaped on the downside so greatly that to sell would be financial suicide, but that was not part of the software equation. One computer program feed upon another, as the downward spiral became more viscous.

When the smoke had cleared, a catharsis of unbelievable proportions had occurred with staggering loses suffered by all the member of the global financial community. The highly touted system that had every bell and whistle known to man and was impervious to fiasco had collapsed. Many lessons were learned that day and the next, and the next, but we will never learn them all or remember everything we have learned. The next time October 19, 1987 occurs, it well could send us back into the financial Stone Age.

In a meticulous evaluation of the causes and effects of the October 19th 1997 crash, the United States Securities and Exchange Commission summarized its conclusions in part:

> "In conducting our analysis, we have adopted the fundamental assumption that extreme price volatility, such as occurred during the market break, is undesirable. We recognize that in one sense volatility is a neutral phenomenon: a measure of how quickly prices react to new information. Moreover, during periods of increased economic uncertainty, it is not surprising that increased volatility occurs. Nevertheless, when price swings reach extreme levels, they can have a number of adverse consequences. First, such volatility increases marketmaking risks and requires market intermediaries to charge more for their liquidity services, thereby reducing the liquidity of the market as a whole. Second, if such volatility persists, securities firms are less able to use their available capital efficiently because of the need to reserve a larger percentage of cash-equivalent investments in order to reassure lenders and regulators. Third, greater volatility can reduce investor confidence in investing in stocks. As a result of these effects, we believe substantially increased price volatility could, in the long run, impact the ability of United States corporations to raise capital efficiently through the sale of equity securities."

The SEC was not finished. It indicated that the crash had a substantial effect upon international capital formation and new underwriting. In January 1987, there was $120.8 billion in international debt offerings, in October 1987 the total was $9.6 billion, one thirteenth of the January amount. Equity offerings dropped an equal percentage, from $6.6 billion in September 1987 to $498 million the following month, a staggering drop. In a related activity, privatization efforts were canceled in France, Germany and the United Kingdom (these three had accounted for two-thirds of all privatization to that point) and did not resume again until a year later.

In summation the SEC stated:

> "The events of October, 1987, compellingly demonstrated that the world's securities markets have become inextricably linked. That trend is irreversible and requires that securities regulators around the globe cooperate to ensure the integrity of our markets, while at the same time remain adaptive to changes that will be needed to accommodate the increasing sophistication of those markets."

TEN YEARS LATER

The United States led world markets down the tube in 1987; ten years later Hong Kong led the parade and for good reason. The excesses in Southeast Asia had concerned global financial watchdogs for some time but when it came to putting an end to the many abuses that abounded in the countries, the governments just couldn't cope. In many instances it was caused by financial interrelationships with those that had financed election campaigns and were being repaid. In other countries, family ties became the economic undoing of the infrastructure. Most of all, global traders seized upon the U.S. Dollar as the adhesive.

Thailand defended their currency and lost ultimately suffering a stock market reversal of 70% from its highs. The economies ground to a halt not only in Thailand but also in Malaysia, the Philippines, and Korea and even Singapore. They were literally toppled one at a time like a row of dominoes each taking their turn to collapse. They all shared the same fate, stock markets, currencies, building; imports and infrastructure were all effected as though they had been injected with quick acting poison.

The world turned west to Hong Kong. If it held as its government has said it would, there would not be a global effect caused by what had been only a regional problem to that point. The pressures mounted against its currency and its markets and ultimately broke as well. It collapsed in almost classic fashion and on October 27, 1997. The market fell 5.8%. In sympathy

the Dow Jones fell a record 554 points on legendary volume. Exchanges all over the world were effected by the plunge, but hardest hit were those in Brazil 15%, Argentina 13.7% and Mexico 13.3%. Already battered, Asia fell as well, but many of the excesses had already been eliminated from the system by wave after wave of selling that had previously taken place. With markets at a fraction of what they had been at only months before, the percentage losses were not in the class with Latin America.

In the United States there were very interesting differences from what had occurred in 1987. Computers were more powerful, failsafe programs had been installed with backups, few people were undermargined and the hurdles the Exchange had establish seemed to work (the exchange stopped trading twice during the day, once near the close and it did not reopen). Although the loss was similar in terms of Dow Jones points, the percentage drop was infinitely less, (7% versus 22.61% on October 19th, 1997). As a matter of fact in terms of percentage drop, the correction was only the 12th largest on record.

The effects of these events action will have ripple-like effects on economies throughout the world. Speculate fervor will be dampened and thus the waves of reckless speculation that had infected global securities trading will. Trillions of dollars have already been lost in the world's stock markets and those economists who indicate that this loss of spendable income will not cool off the global business are smoking some kind of weed that they shouldn't be. So often when crises occur, gray haired gentlemen are lifted from their rocking chairs by desperate governments and told to tell the public assuaging things. They have already been trotted out in each country that has been effected by the blight. Their speeches have been eloquently given and received with the same result, collapse. We have indeed become a global village and the village chain is a composite of its links. Some of the links have been detached and there will be hell to pay.

As a postscript to the Monday Massacre, we find it interesting how differently economies and governments react to similar stimuli. While the markets were plunging, the SRO's (self-regulatory agencies) in most of the world were tightening up on speculative requirements. The Japanese felt the best way out of the problem was to throw money at it. They lowered margin requirements (which many have said was the reason for the American crash of 1929) and expanded credit. To keep the record straight, although they followed a course that many believed was suicidal, the strategy worked and the recovery of the Japanese marketplace was much faster than in the rest of the world. We can only give the analogy of the Kamikaze pilots that the Japanese used against the Americans near the end of World War II, they would give their pilots some sake for courage and send them off to blow themselves up, hopefully along with an American Warship. They sent their banks on a Kamikaze mission and miraculously for their country, they returned unscathed. (At least, so we hear)

HEDGE FUNDS REVISITED

A number of years ago we were asked to advise congress on certain aspects and characteristics of Hedge Funds as certain types of these non-generic species we playing havoc with emerging companies by selling them short and then spreading information about them, sometimes true and sometimes not, causing the stocks to fall and ruining any chance the company may have had to get funding for their growing needs. Naturally company management cried long and hard and among other visits, they went to see their local congressmen to complain about these terrible people.

Irate Congressman got in touch with the Securities and Exchange Commission and said to them in essence, "That the hell is going on here?" The SEC replied, that the information that the short's were disseminating was for the most part accurate and therefore, it being a democratic country with free speech, there was not a lot that could be done about the matter.

One of the Congressional Committees that was hearing the matter got in touch with us and said, literally, what is a hedge fund? That was about seven years ago and in answer there question we wrote the following memorandum. Later, we testified as to the effect hedge funds were having on the overall marketplace and received substantial press at that time. Today, Congress knows exactly what hedge funds are, at least those that looks for small disparities to invest large amounts of highly leverage funds. But these animals come in many forms and we thought that this was an opportune time to revisit our article that we wrote back then.

ROBERT A. SPIRA
45 WALL STREET JUNE 4, 1992
NEW YORK, NEW YORK

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

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

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

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

Contrary to popular regulatory misconceptions, a Hedge Fund does not necessarily have to be a limited partnership to be recognized as one by "The Street". This inadequate definition is the consequence of insufficient knowledge regarding the scope of activities engaged in by sole proprietors performing similar functions.

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

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

Before proceeding further let us define this amorphous creature that we refer to in this article as a "Hedge Fund", understanding that the term is applied by "The Street" to any entity that acts in mysterious ways. My definition of the term would be: a pool of aggressively managed funds whose scope of investment in financial instruments is limited only by the terms and conditions of its charter (most of the time) and the ego of its management.

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

Further complicating the investment decision, unregistered Hedge Funds with less than one hundred investors are exempt from a public reporting requirement. When superior results are attained, the fund management will arrange press conferences to bombard the public with their results. under-performance is accompanied by evasion and silence. This lack of regulation and selective reporting fosters fraud. One manager broadcast substantial trading profits during a period when he had actually wiped out the majority of the Fund's investors. The "Alice and Wonderland" performance, though unverifiable, continued to attract gullible participants.

1. THE PURCHASE OF NEW ISSUES

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

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

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

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

Hedge Funds receive preferential treatment in underwritings because they are generally willing to step up to the plate, win or lose. Officially Wall Street is on record as abhorring almost everything the "hedgie" stands for, and ordinary brokers are advised to avoid them. This is particularly true in the new issue market, where they are historically perceived not as investors, but as "fast buck artists," whose allocated shares must be repurchased by the investment banker's clients at higher prices. In actuality, the syndicate manager maintains Hedge Fund accounts on his own personal books, thereby covertly controlling the ebb and flow of the IPO. In return for favorable treatment on hot IPOs, Hedge Funds can be counted on to take down chunks of poorly priced, ill conceived and under subscribed new issues, thus preventing the deal from aborting.

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

The IPO climate that has existed since 1989 offers an example of such a feeding frenzy. In breaking down recent record "street" profits the financial press identify IPOs as their most substantive source. Incentives may be offered in return for purchasing securities that almost assuredly will decline in price. An incisive overview on incestuous relationship that often exists between brokerage firms and their more flexible clients. The details of this type of transaction will receive major press momentarily as the Alan E. Rosenthal trial unfolds. The Government's contention is that Rosenthal exerted control over funds under his management to purchase Drexel Burnham Lambert's (Michael Milken) underwritings that were not being well received by the "Street". In exchange for Rosenthal's generosity, Drexel, it is alleged, arranged $1.6 million in phony losses for him, thus reducing his income taxes. Although not a Hedge Fund, ($2 billion pension and benefits fund) the Rosenthal Case will be one of the first substantive public examples of this type of activity. This form of barter has infinite possibilities, some of which withstand scrutiny, while others might exceed accepted legal and ethical boundaries.

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

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

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

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

2. "DEAL" STOCKS

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

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

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

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

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

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

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

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

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

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

3. SELLING SHORT

Hedge funds whose primary purpose is selling short demonstrated exponential growth during the eighties. Profits are derived by identifying and short selling, ideally, a combination of thinly capitalized, theoretically overpriced securities, whose accountants may use questionable accounting practices. If there is something unsavory hiding in one or more of the corporate officers' background so much the better. Add to the foregoing an undercapitalized investment banker with a negative regulatory history along with a stock with a limited number of retail market makers, leaving only one ingredient left to be mixed into the brew; an SEC investigation followed by a negative public relations campaign. Under this scenario no matter how significant the company's product or how capable the management, the company would have little chance of raising additional public funding in the foreseeable future.

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

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

To prevent a recurrence of the market collapse of 1929 and to foreclose the possibility of "bear raids", it was determined that, on listed exchanges, securities could not be sold short unless the last previous different way trade was lower than the short sale. These regulations encompassed the perceived loopholes within the then existing market environment. The modifications did not include non-exchange traded securities. At the time, unlisted securities could not generally be sold short, as timely delivery was not possible. Fully paid for shares, which were the non hypothicatable property of their owner and could not be used for the settlement of a transaction. With the advent of margin eligible OTC securities, decades later, almost all securities became lendable and could be shorted with reasonable impunity. A regulatory door had unintentionally been left ajar in an environment that could not have perceived the dramatic changes that would occur decades later in over-the-counter marketplace.

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

The Committee on Government Operations of the Securities and Exchange Commission concluded: "The SEC has never, as far as the committee is aware, brought an enforcement case, or even sought seriously to investigate a case in which, the central allegation of abuse was the malicious dissemination of false or unverifiable negative reports about a public company, its officers, its products, or other matters that, if true or believed by investors, would be likely to influence negatively the trading price of the company's stock."

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

The committee's concern regarding this aspect of the SEC's enforcement program is further heightened by the prepared testimony of Mr. Sturc for the SEC's Division of Enforcement. In explaining why the SEC has not found it practical to bring enforcement cases against short sellers in most instances, he stated: "Finally, many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities and other laws. When there is an obvious economic justification for short sales, it is extremely difficult to prove:...(ii) the material false statement/omission and fraudulent intent requirements of Rule 10b5. This is particularly true in those situations where, for example, our investigation tends to show that at the time when short sellers were allegedly disseminating false rumors, in fact, the issuer was disseminating materially false financial statements."

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

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

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

Over-the-counter market makers have been indulged excessively by regulators, concerning the delivery of securities that they have sold short for their proprietary trading accounts. Within the over-the-counter market's "Alice In Wonderland" world of non-regulation, short sales are allowed on down ticks, marketmakers are not obligated to effectuate timely delivery, and reporting rules, in place for decades on the exchanges are not considered necessary. Even legal challenges have been hampered by anomalies in the securities laws governing unlisted trading. Self regulatory agencies, particularly the National Association of Securities Dealers, have been apathetic when it came to enacting the modifications essential for the protection not only of public investors, but of the companies listed within the marketplace. These regulatory flaws have continued to enable Hedge Funds to act with impunity.

The Securities and Exchange Commission expresses some frustration with respect to short selling when it states, "Restrictions on short sales (e.g., selling an index future without owning the underlying component stocks) have never been imposed on options and futures products. Moreover, the difficulties of extending such restrictions to options and futures products would be substantial. The Commission's short sale rule, Rule 10a1 under the Exchange Act prohibits persons from selling stocks short at a price below the last sale price (minus tick) or when the last trade involving a change in price was a minus tick.

A futures or options trader who sells short on a minus tick is simply responding to price declines in the cash index. A short sale restriction that takes into account movements in the underlying cash index would be extremely complicated and would impose substantial compliance burdens and risks on traders. Nevertheless, the absence of short sale restrictions, coupled with the greater leverage of futures arguably presents the potential for greater speculative selling than could occur in the stock market." (Nowhere does the SEC address the fact that one does not need to be hedging to sell indexes short. This represents a clear violation of the intent that regulators have applied to the listed exchanges.)

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

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

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

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

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

4. ACQUISITION OF COMPANIES

Many Hedge Funds have chosen the purchase of "deal stocks" as their milieu. Will the deal print? What is the probability of a higher offer? Acquisition oriented Hedge Funds have benefited from their own substantive internal research, industry forecasts, and in-house capability to evaluate the spectrum of elements comprising these remarkably complex transactions. The clout provided by the generation of enormous commissions, provides access to "the Street's" highly technical institutional research and sophisticated corporate finance generated analysis. The Hedge Funds' propinquity to financing and their capability of paying the massive success fees investment bankers require for the provision of capital, gives them access to any American publicly traded Company. Many of today's corporate Chief Executive Officers started out as Hedge Fund

managers, dominating assets that later allowed an orderly evolution into corporate raiding. As a result these CEO's now control many highly leveraged public and private companies. Some of the largest, most rapidly accumulated fortunes in America have been assembled by (and for) Hedge Fund managers.

On occasion, an acquisition may be the consequence of a miscalculation. A number of proxy battles have arisen from "greenmail", Wall Street's generic term for blackmail. By assembling large quantities of the securities in an ostensible target and simultaneously transmitting ominous signals, the Company's management will often pay a bounty to convince its unwelcome suitor to back off. Occasionally the bluff is called and the pseudo acquirer is obliged to proceed or suffer a substantial financial setback and, potentially more damaging, the loss of face. In these skirmishes the target is frequently critically injured even though the aggressor has been vanquished. The converse is also true; the Hedge Fund may have won a Pyrrhic victory. An inescapable consequence of this form of financial combat is a crippled target and a lower stock price. The Company may be left noncompetitive, saddled with debt and generally far less valuable. No matter what the eventual outcome, the reality is that the attorneys invariably profit while the stockholders assuredly will lose.

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

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

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

5. HEDGING (ARBITRAGE)

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

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

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

There currently exists some type of financial instrument designed to prevent just about any conceivable market loss. Some derivative products have been designed to create portfolio insurance. The SEC when reporting on the effect of derivatives as they interrelated to the October, l987 market decline stated, "In reviewing the events of October 1987, it is important to emphasize that the increased concentration of trading in the derivative index products is not attributable only to portfolio insurers. While more difficult to quantify, we believe that low execution cost and margin requirements for derivative index products have encouraged a wider group of institutions to depend on the liquidity of the index futures markets to liquidate substantial portions of their equity portfolio more quickly than they would be able to through the stock market. As demonstrated on October 19, however, the assumed liquidity levels of the futures market became dramatically lower during a market plunge resulting in large futures price discounts and spillover stock selling."

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

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

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

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

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

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

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

6. EXEMPT SECURITIES

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

Until May 1991, the Government granted primary dealers impunity in connection with various types of trading irregularities. The perception by the Government was that this trade off would continue to aid in the maintenance of an extremely liquid marketplace for its securities. This was believed necessary

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

Three Hedge Funds, Quantum Fund, Tiger Fund and Steinhardt Partners, along with Salomon, bought $10.6 billion of the $11.3 billion, May 1991, two-year, Treasury note issue. This action effectively cornered the market, creating substantial trading loses among competing dealers. Simultaneously, it increased the cost to the Government and tax payers in floating this issue. Considering that the Hedge Funds which were embroiled in the recent Solomon scandal are neither the most aggressive nor the most accomplished in Government Securities trading, it is unlikely that this incident occurred in a vacuum. Professor John R. Coffee, stated: "Financing arrangements such as the kind the Steinhardt Partners is said to have requested from Salomon could serve as a vehicle for tacit collusion." This incident changed the manner in which the Government and the public perceived primary dealers. Whether regulators were compelled to take action due to the accusations lodged by disgruntled competition, or the feeling that the American public would no longer countenance the ongoing blatant disregard for regulation exhibited by dealers conducting business within the Treasury Markets, the incidents surrounding the May 1991 "Bill Auction", will cause the primary dealer community to straighten up their act, and play by the rules, at least for a time.

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

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

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

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

At least one source has laid the blame for the recent Government trading scandal upon Liberty Brokers, "A bond brokerage firm owned by Salomon and several other large primary dealers. It shows (the memorandum) how Liberty's favoritism, towards its joint venture parents, distorts the market to the detriment of the other participants therein. It demonstrates how the transmission of certain information can be used to increase the interest rate the Government pays, to provide profit making opportunities for large dealers who receive such information at the expense of other dealers and investors in the market, and otherwise to create anticompetitive distortions. It concludes that the current structure of the market, with Liberty being owned by the major primary dealers, encourages collusion and competitive distortions, and urges that the present investigation be focused on the conduct which the structure suggests is indicative of violations of the antitrust laws and portends future structural changes which will render the anticompetitive consequences even more dire." This memorandum of November 1,1991 to the Justice Department, suggests that Liberty engaged in improper transmission of information which gave an unfair advantage to its owners.

The peculiar element in the May 1991 transaction was only that, when the Government raided the chicken coop they accidentally caught a couple of turkeys that had made a wrong turn. The "Treasury" had suddenly changed the rules of the game at the most inopportune of moments. One would almost believe that Salomon dealer had somehow stepped on the

wrong toes, once to often and "The Street" fed the firm to the wolves at the most embarrassing time possible. Pure chance could not have produced these strange bedfellows. It is doubtful that the Hedge Funds involved in the deal either originated or orchestrated it.

All unregulated commodities create the same market-cornering opportunities that occurred in the Solomon matter. Hedge Funds will again strike in unfamiliar venues potentially reaping havoc as the Hunts did in the silver market. You can wager, however, that the plan for the transaction will have been created elsewhere. These people did not become extremely affluent by playing all their games on the road.

7. PRECIPITATING DECLINES IN FALLING MARKETS

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

The breed of Hedge Fund that primarily deals in over the counter securities does not traffic in broad market issues, but concentrates within a group of stocks that it has extensively researched. Hedge Funds would be more likely to use the over the counter market in a panic due to its lack of regulation, and illiquidity to legally cause margin calls and liquidations. In view of this, the overall October 1987 market collapse, should, perhaps, be blamed on the use of indexing, the failure of the specialist system, irregularities in the OTC marketmaking system, along with a generally dismal business outlook, rather than Hedge Fund activity.

8. CONFLICTS BETWEEN PROFITS AND REGULATION IN OFF SHORE FUNDS

Hedge Funds' extraordinary growth in the eighties was, in large measure, due to the enormous profits that they generated for their principals. Global Asset Management has over $4 billion under allocated management and is the largest of Multi-manager funds, using over 60 different managers. Many ceased accepting investors' funds, concerned that managing too much money could cause them to become unwieldy and unable to maintain the historically high returns that their investors had come to expect.

Hypothetically, the limited partner would receive a preferred return off the top. (i.e 8 1/2%) and a 50/50 split of the profits, or 20% of the profits and various assorted fixed management fees. Annual growth rates of the more successful types of these funds during the 80's were no less than 20% per year. Assuming a $100,000,000 fund earning $20,000,000, in the first instance it would throw off over 14% to the limiteds and almost $6.000,000 per year to the general partner. In the second more common example, the manager would receive $4,000,000 and the limited a 16% return. There are nuances in each example, attributable to variations in fees and the nonparticipation of managers in losses.

Should the size and/or activity of Hedge Funds be regulated? Assuming that these parameters can be defined, how are Hedge Funds to be prevented from moving offshore, in search of more lenient securities regulations? Some of the household names in fund management such as Fidelity, Scudder, Alliance Capital Management, Putnam and Merrill Lynch are advising and/or managing Off Shore Funds. Optima Fund Management successfully took their Fund of Funds concept overseas through a Bermuda based vehicle. Its twelve managers comprise the Who's Who of the American Hedge Fund Industry, including noted short seller James Chanos. His Optima Futures Fund, Ltd., another offshore vehicle, was set up solely to short American securities.

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

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

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

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

A shift towards the liberalization of our securities markets could imperil the investing public and eliminate the more level playing field enacted in the 30's. By not conforming to the world's more generally relaxed regulatory environment we are running the risk of perceptibly eroding this country's greatest resource, the American Securities Markets. The market's historic liquidity, coupled with the flexible approach essential to promptly respond to the investment community's ever-changing appetite for the indispensable financial products are essential in underwriting the continued growth of this country. The capitalism that separated us from the remainder of the world is no longer solely our province. In less then one decade we have witnessed a dramatic change within the global capital raising process. Stock markets, almost unheard of scant years ago, are now active throughout the Pacific Rim, Eastern Europe, and South America. They potentially offer to their own investment communities the economic muscle once peculiar to this nation, which facilitated the financial growth that made our country the economic power it has become.

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