

TO: Janet Yellen
FROM: Doug Elmendorf
DATE: April 14, 1999
SUBJECT: Draft "Conclusions and Recommendations" for Hedge Fund Study

Here is a brief overview of the draft.

Introduction

The first sentence states that "the central public policy issue raised by the LTCM episode is how to constrain excessive leverage more effectively." The next several pages describe how market discipline generally constrains leverage but "can break down," as in the LTCM case and other cases last year. At my suggestion, they have included several passages from the *ERP* about leverage increasing systemic risk and about no firm having "an incentive to limit its risk-taking to reduce the danger of contagion for other firms."

I think this discussion would benefit greatly by adding a brief paragraph saying: "The government now reinforces private market discipline in two general ways: one is ensuring well-functioning markets by preventing fraud, requiring that certain types of information be provided, etc.; the other is preventing excess risk-taking directly by regulating for safety and soundness. The former function applies to all financial-market institutions in some way; the latter is focused on institutions that have insured deposits or are central to the payments system." I've made this suggestion to Gary Gensler and he has ignored it. I do *not* think you should bother to make the point again, but if the subject comes up, I wanted you to know what I've said about it.

Recommendations

I think that all of the recommendations are sensible (although I admit to not understanding all of the details). I have complained to Gary that this draft does not summarize the actions that Congress needs to take (although it has some specific mentions along the way), but he has not altered the draft. Thus, I presume that he sees a tactical advantage in blurring the distinction between what the regulators can do themselves and what they need new legislation to do.

1. Disclosure
 - Hedge funds should file quarterly reports with comprehensive measures of their risk-taking, and these reports should be published. (Currently, reports are filed quarterly, have little information about risk-taking, and are not published.)
 - All public companies should report their exposures to highly leveraged financial entities in periodic public filings (such as form 10-K reports to the SEC).
2. Supervisory Oversight
 - Bank regulators should follow through on their recently issued guidance about risk management systems and interaction with highly leveraged institutions.
 - The SEC should ensure that investment banking firms follow similar prudential practices.

3. **Enhanced Private Sector Practices for Counterparty Risk Management**
 - As a group, financial institutions should draft and publish enhanced standards for risk management.
 - Maybe the private sector should create an international centralized credit database.
4. **Capital Adequacy**
 - The Basle Accord should be revised to align capital requirements more closely with actual risks, including greater differentiation among claims based on credit quality.
 - Counterparties should develop measures of potential future credit exposure, against which collateral might be assessed.
 - Regulators in offshore banking centers should be encouraged to impose international standards.
 - The SEC should consider more risk-sensitive approaches to capital for securities firms.
5. **Expanded Risk Assessment for Unregulated Affiliates of Broker-Dealers and Futures Commission Merchants**
 - Statutory changes should be made to give the SEC, CFTC and Treasury sufficient ability to monitor the risk posed by these institutions. This includes more reporting by institutions of their positions and risk-management procedures.
 - Note that this does *not* give the regulators the power to control these institutions' risk-taking.
 - Note that Chairman Greenspan does not endorse this recommendation but "defers to the judgment of those with supervisory responsibility."
6. **Bankruptcy Code Issues**
 - The Working Group reaffirms its support for last year's legislative proposal, the "Financial Contract Netting Improvement Act."
7. **Offshore Financial Centers and Tax Havens**
 - As noted above, regulators in offshore banking centers should be encouraged to impose international standards.
 - They should also not encourage tax fraud.
8. **Total Return Equity Swaps**
 - These are a tax dodge that should be prevented by new legislation and regulation.
9. **Additional Potential Steps**
 - These are not current recommendations, but matters that "could be given further consideration" if leverage remains a concern.
 - Consolidated supervision of broker-dealers and their currently unregulated

affiliates: The draft is pretty favorable about this step, which makes sense to me. I gather that one of the main disadvantages is that the SEC's current regulation of broker-dealers is not very sophisticated, so extending their regulatory net may have disadvantages.

- Direct regulation of hedge funds.
- Direct regulation of derivatives dealers.
- Vague mention of encouraging better regulations in emerging market economies.