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The acceleration of corporate bonds made by hedge funds

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Summary

Hedge funds have been a part of the financial markets since the 1940's. However, it is only during the last decade that they have gained the status as one of the more influential players on this market. Today hedge funds enjoy great interest from both investors and regulators. There is not really a generally accepted definition of the term hedge fund. What characterizes them, and what might be the reason for why people consider them to be special and a little bit mysterious, is the freedom they have in the markets. Their characterizing features are among other things that they have different investment rules and that they are using more aggressive investment strategies. Examples of these aggressive investment strategies are the use leverage, short selling and investing in derivatives.

The debate surrounding hedge funds has been constantly ongoing during the last couple of years. The fact that the hedge funds have been involved in a string of events that has gotten much attention from the mass media has only led to that the debate has increased even further. Lately, regulators have become more and more interested in the hedge funds. One aspect of the debate has therefore been whether or not the hedge funds should be allowed to keep their status as less regulated, or if more regulation is required, in order to reduce the market risks that some people believe the hedge funds to create.

The hedge funds have often been criticized for being greedy and for using investment strategies that balances on the edge of what is legal and what is not. In this thesis I have chosen to look at the hedge funds engagement as holders of corporate bonds. Lately the activist hedge funds have used the bondholder's rights in order to increase the yield of the bond. Previously many violations of bondholder rights have passed unnoticed. This is something that has changed due to the way activist hedge funds enforce the rights of the bondholder. Unlike previous investors, hedge funds are actively seeking out bonds where the companies either have, or are on the verge of, violating their contractual obligations. As soon as they find such an opportunity, they will acquire bonds in these companies.

The thesis is focused on the consequences of activist hedge fund activity in the corporate bond market. It investigates the rights of the hedge funds in the case of late filings made by bond issuers and the implications this has on the bond market and how indentures are written.

The conclusion of the thesis is that hedge funds have a weak case against the bond issuer, but the rulings are not absolute. History has shown that companies don't want to risk a court ruling against them as well as litigation costs, resulting in issuers settling with the hedge funds outside of court. The risk of loosing a large sum of money if the court rules in favor of the hedge funds, is often one that the companies do not dare to take. The conclusion is

that in order for this situation to be resolved, the language of the indentures needs to change. The thesis draws up a discussion on the subject.

Sammanfattning

Hedgefonder har varit en del av den finansiella marknaden sedan 1940-talet. Det är dock framförallt under det senaste decenniet som de har uppnått status som en av de mer inflytelserika spelarna på denna marknad, då de numera omgärdas av ett stort intresse från både investerare och lagstiftare. Det finns egentligen ingen allmänt vedertagen definition av vad som utgör en hedgefond. Det som dock karaktäriserar en hedgefond, och som även är vad som skapat hedgefondernas rykte av att vara speciella och kanske rent av lite mystiska, är den frihet de åtnjuter på marknaden. De kännetecknas bland annat av att de har friare placeringsregler samt att de använder sig av mer aggressiva investeringsstrategier. Exempel på dessa aggressivare investeringsstrategier är att de utnyttjar höggradig belåning i sina investeringar, utnyttjar blankning av aktier och investerar i derivat.

Debatten kring hedgefonder har de senaste åren varit ständigt pågående. Att hedgefonderna varit involverad i en rad händelser som uppmärksammats stort i massmedia har bara bidragit till att debatten ökat ytterligare. På senare år har även lagstiftarna fått upp ögonen för hedgefonderna. Det har framförallt diskuterats huruvida hedgefonderna även fortsättningsvis ska kunna vara relativt oreglerade, eller om en striktare reglering krävs. Många har ställt sig frågan om de metoder som hedgefonder använder sig av skapar en risk för den finansiella stabiliteten.

Hedgefonderna har ofta kritiserats för att vara giriga och för att många av de investeringsstrategier som de använder sig av balanserar på gränsen till vad som ligger inom lagens ramar. I denna uppsats har jag valt att titta på de aktivistiska hedgefondernas engagemang som innehavare av företagsobligationer. På senaste tiden har aktivistiska hedgfonder utnyttjat företagsobligationsinnehavarens rättigheter för att öka avkastningen på obligationen. Tidigare har eventuella brott av innehavarnas rättigheter ofta passerat obemärkt förbi. Detta har ändrats i och med hedgefondernas nya sätt att förhålla sig till obligationsinnehavares rättigheter. Till skillnad från tidigare investerare så letar hedgefonderna nu aktivt upp företagsobligationer där företagen har eller riskerar att bryta mot de kontraktuella förpliktelserna, och sedan köper de obligationer i dessa företag.

Uppsatsen fokuseras på de konsekvenser som hedgefondernas existens på företagsobligationsmarknaden har inneburit. Den undersöker vilka möjligheter hedgefonderna har att driva igenom sina krav vid ett brott mot företagsobligationer och vilken påverkan detta har på lagstiftningen rörande dessa obligationer samt dess påverkan på hur innehållet i obligationerna författas.

Uppsatsen drar slutsatsen att det kan vara svårt för hedgefonderna att i en domstol få igenom sina krav vid ett brott mot företagsobligationer, men inte alls omöjligt. Det har också visat sig att många företag inte vågar riskera att

förlora i en domstol, vilket innebär att de förliknar med hedgefonderna. Risken för företagen att förlora stora summor pengar vid ett eventuellt brott mot företagsobligationerna har gjort dem mycket oroliga. Det är därför givet att hedgefondernas involvering i denna marknad kommer att leda till en förändring av hur villkoren i obligationerna författas. En diskussion som denna uppsats föranleder är därmed hur denna förändring kommer att se ut.

Abbreviations

CEA	The Commodity Exchange Act
CFTC	The Commodities Future Trading Commission
GAO	The United States General Accounting Office
HFWG	Hedge Fund Working Group
IRS	Internal Revenue Service
IOSCO	The International Organization of Securities Commissions
NSMIA	National Securities Market Improvement Act of 1996
PWG	Presidents Working Group
SEC	Securities and Exchange Commission
SIFA	The Swedish Investment Funds Act (2004:46)
SFSA	Swedish Financial Supervisory Authority
The 1934 Act	The Securities Act of 1934
The Advisers Act	The Investment Advisers Act of 1940
TIA	The Trust Indenture Act of 1939
The 1933 Act	The Security Exchange Act of 1933
UCITS	Undertakings for Collective Investments In Transferable Securities EG
QEP	Qualified Eligible Participant

1 Introduction

"Most people want to make friends. I just want to make money."
---Andrew Redleaf, Whitebox Advisors

Greed, that is the intense and selfish desire for wealth, is one of the most notorious motivators in the financial market, and the hedge fund industry might be greed's best friend. In December 2008 a hedge fund manager named Bernie Madoff made the news when he was arrested for operating the largest Ponzi schemes to-date. A Ponzi scheme is one of the most classical fraudulent investment operations. The scheme is pretty simple in it's implementation. In order to improve returns on investments, money is taken from new investors and paid to old investors. The pyramid scheme, as it is also called, can show great returns as long as the number of investors keeps growing.

The greed of hedge fund managers became the focus of regulators after the 2007 Subprime Crisis. In this thesis we look at a certain activity by a certain type of activist hedge fund that have not gotten as much attention from media or regulators. Instead of the obvious fraud cases, like Bernie Madoff's ponzi scheme, this thesis is focused on the more delicate subject of accelerating bonds when companies failed to file their financial statements.

Corporate bonds are an important way for companies to raise capital. Large public corporations can offer billions in bonds to fund the building of a new factory or other large-scale products. It is an old practice that has been around for a long time. Since its inception bonds have been created with protective covenants for the bondholders. These are added to the bond as a security so that their financial standing is protected from certain behaviors made by the company.

After the burst of the Internet-bubble major flaws in the US accounting regulations were revealed. After the collapse of Enron and WorldCom, the regulators moved swiftly and introduced the Sarbanes-Oxley Act of 2002. This act among other things imposed stricter accounting requirements for companies. Shortly after the introduction of Sarbanes-Oxley a practice called option backdating came under fire. Options backdating is the practice of granting an employee stock option that is dated prior to the date that the company actually granted the option. This practice raises a number of legal and accounting issues. The practice of backdating itself is not illegal, nor is the granting of discounted stock options. What is illegal is the improper disclosures, both in financial records and in filings with the United States Securities and Exchange Commission (SEC). Hundreds of companies were discovered to have wrongfully disclosed their options programs and as a result companies started to investigate their old stock option programs as a precaution. This led to delays with their SEC filings.

What some hedge funds discovered was that these delays were creating an unclear legal situation with some of the companies corporate bonds. The 1934 Securities Exchange Act require companies to timely file their financial statements and the corporate bonds had covenants that required the company to follow these requirements.

Whitebox Advisors was one of these hedge funds. They collected a database of companies that issued corporate bonds and wrote an algorithm to calculate the chance of a company to be late with their filings. When they found a company that was at risk of late filing they bought a majority of the bonds. Once the company was late with their filings they called the trustee and asked them to declare the company in default. Since they were a majority owner the trustee had no choice but give a notice of default. Default litigation is very bad for the company, not only does it cost a lot of money but they can also be forced into bankruptcy.

1.1 Subject and purpose

The subject of this thesis is to describe how hedge funds employ activities that could cripple financially stable companies, by using loopholes created by the introduction of new accounting regulation combined with old and outdated securities regulation. The thesis present a review of the regulation and describes how hedge funds use these loopholes to accelerate bonds of companies who are late with their financial filings, but in other respects are financially healthy. It also makes parallels, regarding these topics, to the situation in Sweden. The thesis also provides a general review of the regulation of hedge funds and corporate bonds.

1.2 Delimitation

Both the hedge fund and the corporate bond markets are vast and constantly changing. This means that without any delimitation, this could be a thesis with no end. To provide a complete narration of these two markets and all factors relevant to these would be impossible, so I have therefore delimitated the study in some aspects.

The thesis will discuss both American and Swedish law. However the main focus will be on the American law, and the Swedish law will be used to provide a comparative aspect of the issues that will be discussed throughout the thesis. This means that the Swedish sections are shorter and not as in depth as the ones concerning the American market.

The main purpose of this thesis is to examine the issue of acceleration of bonds. In order for me to fully describe and analyze this issue I have also included a rather large section regarding the regulation of hedge funds and the risks that hedge funds poses. This is done in order to provide the reader

with a full understanding of the implications that hedge fund activities can have on the financial markets.

1.3 Disposition

This thesis will give a brief description of the hedge fund industry as a whole and look at the implications of hedge fund activity on financial markets (Chapter 2). The thesis will also present the current status of the corporate bond market and its importance to companies' capital structure (Chapter 3). These chapters will be the introduction of the core part of the thesis, the chapter about acceleration of bonds (Chapter 4). The analysis is built on the recent court rulings in four cases concerning the acceleration of corporate bonds. I then take the current legal issue in the US and look at the situation in Sweden to see if there is a risk for this kind of activity to occur in Sweden. The thesis ends with some conclusions on the subject and a commentary of risks of this happening in Sweden (Chapter 5).

1.4 Method and material

The method used when writing this thesis is a traditional dogmatic method. The sources used have primarily been legislation, case law, doctrine and commentaries. Due to the fact that the area of hedge funds and corporate bonds are relatively unconventional and the regulation is frequently changing many recently published articles have also been used.

When it comes to the subject of hedge funds it can be hard to separate the economical aspects from the legal aspects. This has meant that many of the articles used for this thesis are written from an economical standpoint. The thesis also uses some of the economical facts found in these articles, in order to provide information regarding the hedge fund and the bond market.

2 Hedge Funds

2.1 What is a hedge fund?

2.1.1 A brief history of hedge funds

The term "hedge fund" dates back to 1949.[1] At this time almost all investment strategies took only long positions. Alfred Winslow Jones, a reporter at Fortune magazine, published an article[2] pointing out that investors could achieve higher returns if hedging was implemented into an investment strategy. This was the beginning of the Jones model of investing. The strategy Winslow pioneered is known today as the long-short equity investment technique. His theory was that while no investor could predict the future direction of the market, superior stock selection was possible. Jones combined two investment tools, short selling and leverage. Short selling involves borrowing a security and selling it in anticipation of being able to repurchase it at a lower price in the market, at or before the time it must be repaid to the lender. Leverage is the practice of using borrowed funds. Both of these investment strategies are thought to be risky when practiced in isolation. What Jones did was to see how these instruments could be combined to limit market risk. What Jones realized was that there were two distinct sources of risk in stock investments, risk from individual stock selection and risk of a drop in the general market. He sought to separate these two from each other. He maintained a basket of shorted stocks to hedge against a drop in the market. Thus controlling for market risk, he used leverage to amplify his returns from picking individual stocks. He went long on the stocks that he considered to be "undervalued" and short on those he thought "overvalued". The fund was considered "hedged" to the extent the portfolio was split between stocks that would gain if the market went up and stocks that would benefit if the market went down. Thereof the term "hedge funds".

There were two other notable characteristics of Jones' fund that are still in use today. He used an incentive fee of 20% of the profits he made and he also put his own money in the fund. This ensured that his personal goals were in alignment with the goals of the investors.

2.1.2 What do hedge funds do?

Hedge funds have proven to be very difficult to define. The term does not appear anywhere in the federal securities law. Even industry participants do

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[1] Lhabitant, p 7, 2002
[2] Jones, 1949

not agree upon a single definition.[3] The term is commonly used as a catch all for "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.".[4] At its most basic, a hedge fund is an investment vehicle that pools capital from a number of investors and invests in securities and other instruments. It is a privately held, privately managed investment fund. The funds are designed to maximize their freedom in order to employ complex trading strategies by minimizing their regulation under various federal statues.[5] The goal of the hedge fund is to remit to their investors a high rate of return on their capital contributions. This is to be achieved through sophisticated trading strategies in securities, currencies and derivatives. If the fund manager is successful for the fund investors, the fund manager is also very well paid. The fund manager takes a one to two percent management fee and twenty percent of the fund's profits. A hedge fund is careful to avoid classification as a financial market player that is specifically regulated in the federal legislation.[6]

Even though there is not an existing universally accepted definition of hedge funds, they usually share most, if not all of the following characteristics.

- PRIVATE NATURE - In almost all cases, a hedge fund is a private investment vehicle. This means that that it is typically not registered under federal or state securities law.

- THEY SEEK ABSOULUTE RETURNS – Hedge funds seek to limit risk and volatility while at the same time providing positive returns under all market conditions. Hedge funds are also sometimes called "absolute return funds", because their success is measured by their ability to generate profits in all markets. This is a contrast to the more traditional investment products such as mutual fund, which are measured against a benchmark.

- THEY HAVE GREATER INVESTMENT FLEXIBILITY –Hedge funds have a greater flexibility in the investments that they can make and generally they are not constrained or restricted in their investment activities by the diversification requirements applicable to mutual funds. One example is that many hedge funds do not just purchase securities, they also often sell them short. Hedge funds often uses wide array of instruments to achieve their returns or reduce risk.

- LEVERAGE – Most, but not all hedge funds use leverage as part of their investment strategies, Leverage allows hedge funds to magnify their exposure and, as a direct consequence of this, to magnify their

[3] The US Securities and Exchange Commission, 2003
[4] The President's Working Group in Financial Market, 1999
[5] Baums, p 32, 2004
[6] Baums, p 32, 2004

risks. The only limit in hedge funds use of leverage is the willingness of creditors and counterparties to provide it. The hedge funds typically operate with the balance –sheet leverage of less than 2-1, but it is not uncommon to have higher balance-sheet leverage.[7]

- PERFORMANCE FEES OR ALLOCATIONS – Performance based fees represents a strong incentive for risk taking.[8] Hedge fund management fees typically include a base management fee along with a performance component. The base management fee is usually a percent of the hedge fund's assets (e.g. 1% annually). The performance component is usually a percentage of the increase in the fund's value (e.g. 20% of positive returns). The performance component can be paid as a fee or as an allocation of profits. It often comprises a major portion of the fund manager's overall compensation for managing the fund. Performance based fees encourage investment strategies that emphasize the probability of exceeding the return threshold. The use of these strategies invariably entails greater risk of loss. However, the investment stake that fund managers usually have in the fund would tend to mitigate incentive for excessive risk taking.[9]

- SUBSTANTIAL INVESTMENT BY ADVISERS AND PORTFOLIO MANAGERS - In most cases, the hedge fund managers and individual portfolio managers become "partners" with their clients by investing large sums of their own assets in the fund. This is an approach that has sometimes been called "eating your own cookie".

2.2 Benefits of Hedge funds

2.2.1 Benefits to investors

Many hedge funds offer attractive mechanisms for portfolio diversification because their returns have little correlation to those of more traditional stock and bond investments. Due to this, many hedge funds categories tends to outperform stock and bond investments when the latter are performing poorly. The hedge fund growth since the 1980s can be attributed to the increasing recognition by institutional investors that the funds are an alternative asset class that can help diversify risk and at the same time reduce risk of an investment portfolio. Hedge funds provide the opportunity to:

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[7] The President's Working Group in Financial Market, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*,1999
[8] The President's Working Group in Financial Market, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*,1999
[9] The President's Working Group in Financial Market, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*,1999

- reduce portfolio volatility risk
- enhance portfolio returns in economic environments in which traditional stock and bond investments offer limited opportunities
- participate in a wide variety of new financial products and markets not available in traditional investor products.

2.2.2 Benefits to the Global Financial Market Place

Many hedge funds are highly active participants in the market they trade. Because of this they can change their investment positions as the circumstances warrants, which allows them to move quickly and flexibly in order to respond to changes in market conditions. The fact that hedge funds are actively participating and the fact that they are often well informed allows them to perform a number of important roles in the global financial market place, including the following:

- Many hedge funds can act as “shock absorbers”. Hedge funds are often ready to put capital at risk in volatile markets, at times when other investors might choose to stay on the sidelines. The investment strategies that they employ, such as arbitrage or hedging approaches help to absorb market shocks and can act as a buffer for other market participants. Thereby they can inject needed liquidity into markets irrespective of market direction. This can provide stabilizing influences, which in turn can reduce the severity of price fluctuations in severe market conditions.
- Hedge funds can enhance market liquidity and provide depth. As active trading participants in international capital markets, hedge funds provide systemic benefits by adding depth and liquidity to financial markets.
- Hedge funds help to refine the pricing system, contributing to efficiencies in pricing and market stability. Hedge fund trading is based on extensive market research, which also provides the market with price information, which translates into pricing efficiencies. Hedge funds can, by targeting temporary pricing inefficiencies and market dislocations, effectively help to minimize market distortions and eliminate these dislocations.
- Through short selling hedge funds indirectly act as “whistle blowers”. There have been some recent cases where hedge funds have been among the first market participants to see that there might be trouble with certain issuers and where their trading activity

[10], weeks before Enron filed for bankruptcy. One research firm made the recommendation that "Investors should absolutely look at short interest because short sellers do better homework than buyers of stock".

- Certain hedge funds act as market and risk management innovators

- The employment of state-of-the-art trading and risk management techniques by certain leading hedge funds foster financial innovation and risk sophistication among the market participants that they deal with.

- Many hedge funds act as a counterbalance to "herding". The investment strategies used by hedge funds can serve as a valuable counterbalance to "herd" buying behavior. This type of behavior means that market participants are taking positions similar to those of other market participants without reasonable justification. [11]

2.2.3 Who invests in hedge funds?

Domestic and foreign insurance companies, university and charitable endowments, pension funds, banks and other investment funds are some of the most significant investors in U.S hedge funds. Hedge funds are not registered for public sale and because of this they are required by law to limit their U.S investors to those that satisfy special qualifications under the U.S securities laws.[12]

2.2.3.1 Why has investor interest in hedge funds grown in recent years?

Many hedge funds provide attractive mechanisms for portfolio diversification because of the fact that their returns have little or even no correlation to those of more traditional stock and bond investments. The result of this is that many hedge fund categories tend to outperform these investments during periods of poor market returns. The fact that hedge funds has grown extensively since the 1980s can be attributed to the increasing recognition by institutional investors that hedge funds are an attractive alternative asset class that can help diversify returns. By doing so they can reduce the overall risk of an investment portfolio. Other reasons that can account for this increased interest in hedge funds includes the

[10] Gaine, 2003
[11] Becker, p 91, 2000
[12] http://www.hedgefundfaq.com

decline in mutual fund returns and also the movement of talented investment professionals to trading on behalf of hedge funds.

2.2.4 How is a hedge fund different from a mutual fund?

Unlike hedge funds mutual funds are widely available to the general public. Because of this they have an obligation to register under the Investment Company Act of 1940 and the U.S Securities Act of 1933. A result of this is that they are subject to rigorous SEC oversight and regulation. Mutual funds are also limited by regulation in the strategies that they can use, they are limited in their ability to engage in short sales and use leverage.[13]

2.2.5 The retailization of hedge funds

The Commission has expressed concern about the growth of what is called "retailization" of hedge funds. This is the increasing ability of less qualified investors to access hedge fund investments. This is happening in three different ways. First, the wealth threshold that prevented investor access to hedge funds, such as the "accredited investor standard in 3(c)(1), have eroded due to a general increase in income and wealth levels. For example, the American households with a net worth of $1 million or more, grew from 5.2 million in 2002 to 8.9 million in 2005. These numbers did not include the principal residence. If that had not been excluded the number would have been two or even three times greater. This means that a fare larger segment of the investing public is probably now able to meet the $1 million "accredited" investor requirement needed to invest in hedge funds, than what was the case when this standard was established. The issue that is raised by these facts that concerns investor protection is whether someone with $1 million today is less financially sophisticated than in the past. The answer to this question is by no means obvious. But it is possible that there are more unsophisticated investors that are able to invest in hedge funds than there has been in previous years. This may also be a source to the growing fraud problem that as been observed by the SEC. The underlying assumption when it comes to the accredited investor rule is that there is a reasonable close correlation between an individual's financial wealth and his or her financial sophistication. This might however not always be the case.

2.2.6 Funds of Hedge Funds

The rapid increase of funds of funds in the business has had great impact on the industry. They have grown dramatically both when it comes to numbers and assets. In 1990 it was estimated that there were fewer than 50 funds of funds worldwide. Today that number is approximately 3000. The growth in

[13] http://www.investopedia.com

assets has been just as dramatic, from a few dollars in 2000 to $400 billion.[14] This equals 40 percent of industry assets.

There are a number of reasons for this increase, including their well known advantages such as diversification, built in due diligence, access to closed funds and professional optimization. Another reason is that institutional investors have realized that they could have performed better during the bear market if they had invested more money in hedge funds. Event though funds of funds on average produces lower returns than individual hedge funds, the diversification of investing in funds of funds also reduces the risk. In the future it is possible that the number of funds of funds will be even greater than the number of individual funds.

2.3 The US hedge fund market

Hedge funds have existed in the US for more than 50 years as unregulated investment pools. If you look at the hedge fund industry you will see that it has experienced a phenomenal growth, especially over the last fifteen years. In 2005 there were an estimated 8000 hedge funds, up from only 500 in 1990, and in 2007 that number had grown to be more than 9000.[15] Assets under management have also grown during this fifteen-year period, from an estimated $50 billion to $1.5 trillion. This growth has made the industry an increasingly important part of the U.S national economy. Due to the increased number of large institutional investors the total assets level continues to rise. The 2008 Hedge Fund Asset Flows and Trends Report estimates that total industry assets reached $2.68 trillion in Q3 2007.[16]

Analysts predict that the size of the industry will have doubled by the end of the decade, but that the number of funds will have stabilized. It is also possible that profit opportunities may diminish as the industry becomes more crowded. Returns in 2005 and 2006 were down from previous years, and the rapid inflows of capital could reflect a bubble in some parts of the industry. Hedge funds increasingly depend upon others to provide services. The most significant of these service providers are the counterparties in a hedge fund transaction, in particular investment banks and securities broker dealers offering “prime brokerage” services. They provide services such as consolidation and settling trades, managing risks and provide leverage trough loans, providing leverage through loans, securities lending, and derivatives trading. The large investment banks are also leading the institutionalization of hedge funds by becoming the managers themselves.[17]

Hedge funds are key players in many financial markets. They account for 40 percent of the trading volume in the U.S leveraged loan market, for more

[14] Red Herring 2001
[15] United States Government Accountability Office, 2008
[16] http://www.iialternatives.com/AIN/fundflows08/default.asp
[17] Shadab, 2007

than 85 percent of the distressed debt market, and for more than 80 percent of certain credit derivatives markets.[18]

Individual investors are the largest source of hedge fund investors. However, institutional investors seeking to diversify risk and increase returns, are participating more and more.[19] Today only about 1 per cent of U.S pension assets are invested into hedge funds. This is expected to change within the coming years. The number of pensions and their allocation to hedge funds are expected to increase substantially.[20]

Moreover, the "fund of funds" business has slowly become the preferred way of investing in hedge funds. This is especially true when it comes to institutional investors.

2.3.1 Current regulatory scheme in the US

Both hedge funds and other "private" pooled investments generally seek to minimize the extent to which they are regulated in the United States. Usually they rely on exemptions from registration under the major U.S securities and commodities laws applicable to pooled investment vehicles and their sponsors. The following is an overview of the regulatory scheme that is in place today and how hedge funds together with their managers are exempt from regulation.[21]

The exemptions create a two tier regulatory structure. On one hand, the activities of investment companies, ownership that are limited to a small number of sophisticated investors, are exempt from federal regulatory intervention. On the other hand, transactions between investment companies and the general public are highly regulated.[22]

2.3.1.1 The Securities Exchange Act of 1933

The main purpose of the 1933 Act is to protect investors. Its primary concern is the initial distribution of securities, rather than subsequent trading. To achieve this goal there is a requirement to register with the SEC and dissemination of certain information concerning the securities before they are publicly offered for sale. To avoid registering their securities most private funds, including hedge funds rely on the private placement exemption in section 4 (2). This section exempts "transactions by an issuer not involving any public offerings" from the 1933 Act.[23] This means that they will be exempt from registration if the interests are sold in a transaction that does not involve "public offering". Generally it will not be considered

[18] United States Government Accountability Office, 2008
[19] United States Government Accountability Office, 2008
[20] Shadab, 2007
[21] Baums, p 61, 2004
[22] Hanlon, 2002
[23] Baums, p 63, 2004

"public offering" as long as the investment manager does not advertise the offering, and as long the offering is available only to a limited number of sophisticated investors.[24]

The rationale behind this was that it was believed that protection was not needed because the potential investors can protect themselves. However, because it can be hard to know what "public offering" really means, many hedge fund managers rely on the regulatory safe harbor in Regulation D under the 1933 Act.[25] Regulation D offers a way to establish that you have not made a public offering for purposes of section 4(2). Most hedge funds are relying on Rule 506 under Regulation D to meet the "no public offering" exemption. According to this rule no public offering has taken place if the issuer has not engaged in a general solicitation of its securities and are offered to more than 35 non-accredited investors. The rule permits offering to an unlimited number of "accredited investors", such as most financial institutions, any natural person who at the time of purchase has a net worth in excess $1,000,000, and any natural person who during the preceding two years had an income exceeding $200,000.[26]

2.3.1.2 The Securities Advisers Act of 1934

While the 1933 Act focuses mainly on the initial distribution of securities, the Securities Act of 1934 governs subsequent trading. Among other things the 1934 Act gives the SEC power to require registration and periodic reporting of information by issuers of publicly traded securities. Section 12 (g) requires an issuer to have 500 or more holders of a class of equity securities and more than $10,000,000 in assets to register the class of equity securities. Under rule 12h-3 an issuer with over $10,000,000 in assets, which would otherwise be subject to the reporting requirements under section 15(d), is exempt from providing reports if fewer than 500 persons hold its securities on record. In general hedge funds try to keep the number of recorded owners under 500 persons. This is done in order to avoid falling under these registration and reporting requirements.[27]

2.3.1.3 The Investment Company Act of 1940

This act is the principal U.S securities statue governing investment companies. It regulates virtually every aspect of an investment company's operations, including its structure, governance, leveraging by issuance of debt and other senior securities, investment and concentration limits, sales and redemption of shares and dealings with service providers and other affiliates.[28] It also contains a prohibition from defrauding clients due to a fiduciary duty to act in the best interest of the client.

[24] http://www.moneymanagerservices.com/tour/sales.cfm
[25] http://www.moneymanagerservices.com/tour/sales.cfm
[26] Baums, p 64, 2004
[27] Baums, p 64-65, 2004
[28] Baums, p 61, 2004

The most important regulatory exemption for hedge funds is found in this act. Private hedge funds are, unlike regulated investment companies such as mutual funds, exempt from 1940 Act restrictions on engaging in investment strategies such as leverage, short selling or taking concentrated positions in a single industry, firm or sector. Also, they are not subjected to valuation requirements applicable to registered investment companies, which must price their portfolio securities daily at market value.[29]

Hedge funds rely on one of two statutory exclusions in the definition of an investment company. These "private" investment company exclusions are found in Section 3(c)(1) and 3(c)(7). Theses exclusions exempt certain pooled investment vehicles from falling under the definition of "investment company", which means that they are also exempt from substantive regulation under the Investment Company Act.

To qualify for the exemption under Section 3(c)(1) the fund must comply with two basic conditions. First of all they must have less than 100 beneficial owners. Second of all they must not be making or proposing to make a public offering of its securities.[30]

Section 3(c)(7) is available to funds who only sells its securities to persons that, at the time of acquisition of such securities, "are qualified purchasers", and that is not making and that does not at that time propose to make a public offering of such securities.[31] "Qualified purchasers" are individuals who own over $5 million in investments or companies with at least $25 million in investments. It is important to note that in order for a fund to be able to rely on one of the exceptions above, the fund's securities must be sold in a "private placement" under the 1933 Act.[32]

Section 3(c)(1) has been amended in order to reflect the current fewer of 100 beneficial owner exception, and section 3(c)(7) was added to the 1940 Act pursuant to the National Securities Market Improvement Act of 1996. Before the enactment of NSMIA private investment pools such as hedge funds were limited to less than 100 investors. The SEC found this to be an arbitrary restriction.[33]

2.3.1.4 The Investment Advisers Act of 1940

The Advisers Act has several basic requirements for certain investment advisers that meet established thresholds, such as registration with the SEC, maintenance of business records, delivery of a disclosure statement to client and also a prohibition from defrauding clients due to a fiduciary duty to act in the best interest of the client. However, there are some exemptions from these rules. In Section 203(b)(3) it is stated that those investment advisers

[29] Baums, p 61, 2004
[30] Hanlon, 2002
[31] Baums, p 64, 2004
[32] Baums, p 62, 2004
[33] Baums, p 62, 2004

who have had fewer than fifteen clients during the preceding twelve months, do not hold themselves out generally to the public as investment advisers, and are not advisers to any registered investment company (15 U.S.C.A § 80b-3(b)(3) (2002)). Those who are eligible for the exemption still must comply with the SEC's antifraud provisions, but they do not need to file registration form identifying themselves, maintain business records in accordance with SEC rules, adopt compliance programs or code of ethics or subject themselves to SEC oversight.[34]

2.3.1.4.1 Hedge Fund Rule

In December 2004, the SEC adopted a new rule (203(b)(3)-2) and rule amendments under the Investment Advisers Act 1940[35]. In these new rules the SEC attacked the problems outlined by the report published in 2003.[36] The rule, called the "Hedge Fund Rule", sought to bring hedge fund advisers under the registration requirements of the Act. This was to be done by expanding the meaning of the word "client" used in the Act. For the purposes of the fifteen-client exemption, until this rule was adopted, the fund itself counted as a single client for an advisor (and an advisor was its own client). This meant that a single hedge fund manager could advise fourteen different funds, each with multiple investors, and still stay within the exemption.[37] The "Hedge Fund Rule" expanded this meaning of the term "client" to include the shareholders, the limited partners, members or beneficiaries of a hedge fund. Most hedge fund advisers that had more than fifteen clients under the new modified definition and did not otherwise fit within the limited exceptions to the rule were required to register. In turn these investment advisers were required to appoint a chief compliance officer and to set up a compliance program in order to meet the new regulatory requirements.

2.3.1.4.2 Goldstein vs. SEC[38]

The ink had not even dried before complaints were raised against the "Hedge Fund Rule" and the SEC's authority to regulate hedge fund advisers in this manner. In December 2005 Philip Goldstein, Kimball & Winthrop (An investment advisory firm, co-owned by Goldstein) and Opportunity Partners L.P. (a hedge fund in which Kimball & Winthrop was the investment advisor) filed a petition for review of the SEC's Hedge Fund Rule. The arguments the plaintiffs made was that the new regulations failed to follow Congressional intent, and that the SEC had exceed their statutory authority when it redefined the term client in rule 203(b)(3)-2. Furthermore they argued that the language in the text was unreasonable and arbitrary. The plaintiffs made three cases where the SEC had failed to follow reason.

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[34] http://www.sec.gov
[35] http://www.sec.gov/rules/final/ia-2333.htm
[36] The US Securities and Exchange Commission, 2003
[37] Oesterle, 2006
[38] http://pacer.cadc.uscourts.gov/docs/common/opinions/200606/04-1434a.pdf

First, the SEC had fail to provide evidence indicating a change in the relationship between hedge fund investment advisers and clients of funds making the new interpretation of client necessary. Second, the SEC had failed to provide any reasons why the term client should mean something different for hedge fund advisers compared to other advisers under the same act. The plaintiffs' reasoning was that the hedge fund adviser does not have a direct and personal relationship with a security holder. That would lead to a situation where the adviser owed fiduciary duties to both the entity and the security holder of that entity. This would create a conflict of interest. Finally, the plaintiffs stated that if the SEC whished to increase regulation of hedge fund advisers or reinterpret the term client, it must do so by appealing to congress to amend the Advisers Act.

The SEC challenged these allegations and the U.S. Court of Appeals, District of Columbia Circuit, brought it up. The court reviewed the SEC's Hedge Fund Rule and especially SEC's interpretation of the term client. In the end the court unanimously vacated the rule. The court came to the conclusion that just because the congress had not clearly defined the term client when it approved the Advisers Act, it didn't give the SEC the freedom to define the term in any way they liked. Rather, the court argued, the terms needed to be viewed in context and for the purpose it was implemented in the act. The court found no evidence that it had been the intent of the Congress to regulate hedge fund investment advisers. The Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities". The point the court made was that in the case of hedge fund advisers the investors receives no advice from the hedge fund advisor on how to invest his or her money, because the investor has already made his investment in the fund and makes no investments after that. The fiduciary relationship is instead between the advisor and the fund. So, if the advisor is advising the investor he cannot be a client to the advisor. The court also pointed out that the SEC had previously come to the same conclusion and that it had arbitrarily departed from it's own reasoning. Also, the court doomed the SEC's argument that the Hedge Fund Rule was in line with the Congress policy goal of the Advisors Act. The SEC made the case that the congress had left the hedge funds unregulated because they were not of national scope. The court held that this could be argued and that it was not clear what had been the intent of the Congress. But even if this was the case it was not the number of clients that defined the national scope but rather the amount of assets in the fund.

2.3.1.4.3 Antifraud rule

On July 11, 2007 the SEC unanimously adopted a measure intended to curb fraudulent conduct by investment advisers with respect to "pooled investment vehicles", which includes hedge funds. On August 3, 2007 they presented its final release adopting the new rule 206(4)-8 under the Investment Advisers Act of 1940. The rule prohibits investment advisers

from making false or misleading statements to prospective or actual investors in pooled investment vehicles. It also prohibits them from otherwise defrauding those investors. According to the SEC, this rule will provide them with an important mechanism to regulate the hedge fund market. This new rule is the first response the SEC has made in regard to the Goldstein decision. Under this rule the SEC has the possibility to bring enforcement actions against any investment adviser to any pooled investment vehicle within the scope of the rule. Part of why, the SEC adopted this rule was in order to remove any doubt that might have been raised by the Goldstein case regarding the SEC's ability to bring enforcement actions under the Advisers Act against an adviser to a hedge fund or other pooled investment vehicle, based on allegations that the adviser defrauded the pool's investors or prospective investors.[39] The rule shows that the SEC are very focused on policing the activities of advisers and managers of hedge funds and other private investment funds. It also shows that the SEC still focuses intently on the fund activities of registered and unregistered investment advisers, in particular with respect to their unregistered funds.

The rule applies to actual investors a well as potential investors in the fund. Since it applies to prospective clients as well it is broad enough to prohibit misleading statements made in offering circulars or private placement memoranda. The new rule for example prohibits materially false and misleading statements regarding investment strategies that the investment vehicle will pursue, the experience and credentials of the adviser and its associated persons, the risk associated with certain investments, the performance of the pool or other funds under advisement, the valuation of the pool or the investor accounts in the pool and practices the advisers are using. The practical impact that this will have on the advisers will be to require careful attention to the information they provide to the investor. This can be done through better monitoring of oral, electronic and written communications with investors. This rule can be violated even if the adviser is not acting knowingly or deliberately. The SEC said that they thought the use of negligence standard is appropriate as a method to prevent fraud.[40]

2.3.1.5 The Commodity Exchange Act

Hedge funds that trade in futures, options on futures or commodities options are deemed "commodity pools" for purposes of the CEA and they are subject to regulation by the CFTC. Hedge funds whose interests are offered exclusively to QEPs may qualify under CFTC rule 4.7 as exempt pools. The definition of QEP is quite flexible and includes most institutional investors that are subject to other regulatory schemes (i.e. banks, insurance companies) as well as investment professionals, knowledgeable employees, qualified purchasers under the 1940 Act, non U.S. persons and accredited

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[39]http://www.goodwinprocter.com/~/media/2C1061D436514A9AB31DDEE24094372F.ashx

[40]http://www.goodwinprocter.com/~/media/2C1061D436514A9AB31DDEE24094372F.ashx

investors under Regulation D, who have securities portfolios of at least $ 2 million. The commodity pool operator and the commodity trading adviser of a hedge fund that is sold in a non-public offering under Section 4(2) of the 1933 Act, and that qualifies as an exempt pool under CFTC rule 4.7, is subjected to reduced reporting, recordkeeping and disclosure requirements.[41]

2.3.1.6 Sarbane-Oxley Act of 2002

The legislation, that came into force in 2002, set new or enhanced standards for all U.S public company boards, management and public accounting firms. The SOX Act of 2002 is mandatory. This means that all organizations, large and small, are forced to comply. The SOX Act does not apply to privately held companies.

This act introduced major changes to the regulation of financial practice and corporate governance. Named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, it also set a number of deadlines for compliance.[42] The act was created as a reaction to a number of major corporate and accounting scandals including Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom.

The Act was said to represent the most important securities legislation since the original federal securities laws of the 1930s. The purpose of the act was to enforce a dramatic change across the corporate landscape, in order to re-establish investor confidence in the integrity of corporate disclosures and financial reporting. The Act also provided new enforcement tools to combat corporate fraud, punish corporate wrongdoers and deter fraud with the threat of stiffer penalties.[43]

Some of the principal objectives that are addressed in the SOX are to:

- strengthen and restore confidence in the accounting profession;
- strengthen enforcement of the federal securities laws;
- improve the "tone at the top" and executive responsibility;
- improve disclosure and financial reporting; and
- improve the performance of "gatekeepers”.

Its provisions affect areas such as email retention, integrity and oversight. Below are some important provisions included in the SOX Act:

- **Section 802** presents a possible fine of up to $1,000,000 dollars or a prison sentence of up to 20 years for any person who destroys, alters, mutilates or conceals any electronic document in an official investigation. Sarbanes-Oxley specifies minimum retention periods

[41] Baums, p 67, 2004
[42] http://www.soxlaw.com
[43] Donaldson, 2003

for all accounting records, work papers, communications, file attachments and documents whether transmitted via email, instant messaging or other message modes.

- **Section 302** requires that CFO's and CEO's personally certify and are held accountable for their firms record retention policies and financial reports.

- **Section 404** requires auditors to certify the underlying controls and processes that are used to compile the financial results of a company. Email is a critical component in being able to achieve this certification.

- **Section 103(a)** and **801(a)** requires that companies maintain all documents. This includes electronic documents that form the basis of an audit or review. These documents are to be kept for seven years.

2.3.2 Ownership

2.3.2.1 Domestic partnership

When it involves managing the assets of persons residing in the United States, a hedge fund is ordinarily organized as a limited partnership. By purchasing an interest in the partnership an investor becomes a limited partner of the partnership. The manager of a domestic fund usually forms an entity to provide advisory services to the partnership. This is done as an attempt to limit personal liability. This entity serves as the general partner of the partnership. The hedge fund manager then organizes the general partner as a limited liability company, corporation or limited partnership. Which one of these that are chosen depends on the laws of the state in which the general partner will maintain its office. In certain cases the manager will form two entities, one to serve as the general partner and the other to serve as a management company. However, using an entity as the general partner or management company, will not protect an individual manager from personal liability for fraud and other claims under the federal securities laws.[44]

2.3.2.2 Offshore funds

Funds that are structured under foreign law or that is located outside the United States are called offshore funds. These types of funds are usually structured as a corporation and organized in a tax haven jurisdiction, such as Bermuda, British Virgin Islands or Cayman Islands.[45] Offshore hedge

[44] http://www.hedgefundlaw.com
[45] http://www.hedgeco.net/hedgeducation/hedge-fund-articles/offshore-hedge-funds.htm

funds have traditionally attracted investments from U.S. tax-exempt entities, including endowments, charitable trusts and pension funds. Also, private investors have looked to offshore hedge funds because of the IRS's favorable tax agreement of these funds. Some of this changed in 1997 when Congress enacted the Taxpayer Relief Act of 1997. The result of this act was that the U.S. government extended its reach over offshore funds. Nevertheless offshore hedge funds have remained popular with investors for other reasons. One reason for its popularity is that, unlike their onshore counterparts, offshore hedge funds are able to keep the identities of their investors confidential to the U.S. government. Another reason is that U.S. exempt investors, including pension funds and charitable trusts, prefer offshore funds because they are organized as corporations and thus do not expose these investors to taxation. By contrast, the onshore funds are ordinarily structured as limited partnerships, which means that the investors are exposed to taxation.[46]

2.3.3 The Securities and Exchange Commission

SEC is the name of the federal agency that has the principal responsibility for enforcement and administration of federal securities laws and supervision of the securities markets. The authority provided by federal securities laws permits the SEC to adopt rules and interpret statues. The federal securities laws calls for the SEC to make sure that the market is transparent, prohibit fraud, impose fiduciary obligations and encourage formation and efficient allocation of capital and participation of investors in capital markets. Conversely, several commentators have argued that the SEC should have worked with the PWG on financial markets as a collaborative effort as opposed to unilaterally requiring the registration of hedge fund advisers.[47]

In June 2002 the SEC requested an internal investigation into the activities of hedge funds and hedge fund advisors. The call to action stemmed from the growing size of the hedge fund industry as mentioned above. The SEC felt that the hedge fund industry had reached a critical point where the growth rate and size could soon affect the stability of the securities market, for which the SEC are responsible. Another concern within the SEC was the growing number of cases where hedge fund advisors defrauded hedge fund investors, which had surfaced to the SEC's attention in a short time span. Lastly, the SEC were uneasy with the growing clientele-base that invested in hedge funds, not just the wealthy few who had invested in hedge funds historically. The goal of the investigation was to find out if these concerns were in fact real and if the investors wealth and the market as a whole was at risk. To further get insight in the, up till then, secretive industry, the SEC hosted a Hedge Fund Roundtable discussion on May 14-15, 2003. The event drew leading participants and thinkers from the whole hedge fund industry to discuss the future of hedge funds. These activities together with a vast number of letters from the community, gave the SEC investigators enough

[46] PriceWaterhouseCooper, 2006
[47] Verret, 2007

data to publish their report, *Implications of the Growth of Hedge Funds*, in September 2003.[48] The report addressed the three issues of the SEC.

2.3.3.1 Growth of Hedge Fund Fraud

The report found that the expansive growth of the market in general was coupled with a "substantial and troubling growth in the number of our hedge fund fraud enforcement cases". The report stated that during the last five years 51 cases brought forward by the SEC accounted for defrauding investors of $1.1 billion[49]. Of the different cases, the cases involving late trading and inappropriate market timing of mutual fund shares, were of the most concern to the investigators[50][51][52] .The report estimated that the defraud cases involved almost 400 hedge funds and at least 87 hedge fund advisors.[53]

2.3.3.2 Broader Exposure to Hedge Funds

The biggest concern of the SEC leading to the report was that of broader exposure of hedge fund to others than the wealthy community. The report acknowledged three developments that had contributed to this concern. First was the concern that hedge funds were opening up to investors living outside of the US and not meeting the minimum requirements of a qualified investor. This could put pressure on the domestic market as hedge funds try to adapt to the competitive landscape[54]. Also the introduction of "funds of hedge funds" opens the hedge fund world to a lot of new investors, who by themselves do not qualify[55]. But of most concern to the investigators were the introduction of pension funds as well as universities, endowments foundations and other charitable organizations as investors in hedge funds. These institutional investors have huge pockets and the estimated growth of this kind of investor was to $300 billion before 2007. Obviously these types of investors are very attractive for the hedge fund advisors, but the fact that they have literally millions of beneficiary's results in a delicate situation. The potential loss of the hedge fund would affect, not just wealthy individuals, but a multitude of different social classes.

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[48] http://www.sec.gov/news/studies/hedgefunds0903.pdf
[49] Hayes, 2007
[50] *In the Matter of Invesco Funds Group, Inc., AIM Advisors, Inc., and AIM Distributors, Inc.*
[51] *SEC v. PIMCO Advisors Fund Management, LLC*
[52] *In the Matter of Banc One Investment Advisors Corporation and Mark A. Beeson*
[53] U.S. Securities and Exchange Commission, 2003
[54] Murray, 2004
[55] Quinn, 2003

2.4 Hedge funds in Sweden

2.4.1 History

The Swedish fund regulation dates back to the 1970s when the Equity Fond Act was introduced. Up until then, no special regulation regarding this area existed. [56] The Equity Fond Act was mainly based on guidelines given by the European Council and OECD in the beginning of the 1970s.[57] This law remained in force up until 1990, when it was replaced by the Mutual Fond Act (1990:1114). Parallel with the national development in Sweden, the EG issued the so-called UCITS directive.[58] This directive was also based on guidelines made by the European Council and the OECD. At this point Sweden was not part of the EG, and the ES-agreement between EG and EFTA did not come in fore until 1994. Therefore Sweden was technically not bound by this directive, but despite this fact Sweden were still willing to adjust the Swedish legislation with that of the EG. This is what laid the foundation for the Mutual Fond Act. The purpose of this law was to open up the Swedish market to foreign funds. Also, regulators wanted the law to be modernized and in harmony with the international regulations. [59] The new legislation did not cause any drastic changes, but it did mean a development of the regulations regarding information requirements and risk diversification. In 2002 two changes that modified the original UCITS-directive were adopted. The modifications in the directive meant that the Swedish legislation also needed to be updated. The result of this update was a whole new set of regulations, SIFA, which replaced the Mutual Fund Act.

2.4.2 The Swedish hedge fund market

Hedge funds are a phenomenon that is relatively new to the Swedish market. However, in recent years the hedge fund market in Sweden has developed rapidly. Brummer & Partner were first with establishing their hedge fund Zenit in the summer of 1996. Soon after, a hedge fund called Nektar followed them. Originally, Nektar followed the ideas introduced by Jones completely.[60] In the years between 2001 and the first quarter of 2006 the number of registered hedge funds rose from 17 to 50.[61] The amount of capital that is managed by these funds has also increased during these years. In 2006 the hedge funds accounted for six percent of the capital managed in Swedish-registered funds. This is a percentage that has more than doubled over the past ten years, and in 2006 corresponded to just over SEK 85 billion. The size of Swedish hedge funds varies substantially. At the end of

[56] Beckman, 2003
[57] Prop 1989/90:153, p 33
[58] 85/611/EEG
[59] SOU 2002:56, p 165
[60] Nyberg, 2006
[61] Sveriges Riksbank, *Financial Stability Report, 1/2006*

June 2005 the largest hedge fund in Sweden had a market value of SEK 26 billion. That is a sum that is thought to be substantial even from an international perspective. The smallest fund at that same time had a negative market value of around SEK 225 million. [62]

2.4.3 The current Swedish Regulation

All fund activities in Sweden must be conducted in accordance with SIFA,[63] as well as the Swedish Financial Supervisory Authority's rules regarding investment funds.[64] The rules given by the SFSA are mandatory to the financial operations. The goal of the SFSA is that they by issuing permits, forming rules and providing supervision, will contribute to financial stability and consumer protection.[65]

Funds established under SIFA are classified as investment funds. The law divides investment funds into two different categories, harmonized funds (*Värdepappersfonder)* and non-harmonized funds *(Specialfonder).* Hedge funds falls under the classification of non-harmonized funds. Non-harmonized funds include several different fund types. This means that there is no special legislation governing just the hedge funds, it is just considered as one type of non-harmonized funds.

In order for a non-harmonized fund to be called a hedge fund, it is required that they obtain exemptions from some of the rules provided by law. These exemptions are decided by the SFSA on a case-by-case basis. The case-by-case method differs from the way that this procedure is done in the U.S., where they have standardized requirements that a fund must fulfill in order to qualify for the exemptions. If a hedge fund receives permission from the SFSA to be classified as a hedge fund, it allows them to employ more aggressive trading strategies, such as the use of derivatives and leverage.[66] The most common exemptions that hedge funds registered in Sweden apply for with the SFSA are higher leverage and the possibility to sell short as well as greater exposure to derivatives.

When SIFA was introduced it meant that the hedge funds became more in charge of their own operations, with less detailed regulation. It also meant greater requirements regarding risk spreading, and an increased obligation to provide information from the managers to the investors. The requirement regarding risk spreading has been left open for the SFSA to determine whether they think that the funds levels of risk spreading are acceptable. [67] When it comes to the regulations regarding the investments, the idea is that

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[62] Nyberg, 2006
[63] Chapter 1:4 SIFA.
[64] Swedish Financial Supervisory Authority, *FFFS 2008:11*
[65] http://www.fi.se
[66] Odell, 2007
[67] Chapter 6:2 SIFA.

the SFSA are able to issue exemptions for all the rules applicable to the harmonized funds. [68]

SIFA does not contain any boundaries regarding which type of financial assets a hedge fund is allowed to invest in, as long as the SFSA gives its approval. A hedge fund is allowed to have special entry requirements regarding their investors. The only limitation to this rule is that the requirements can't be applicable only to a very few people. Hedge funds also have the option to limit the entry and exit to a hedge fund, however the funds must allow for entry and exit at least once per year. [69]

As of January 2006 the SFSA introduced new regulations regarding hedge funds. A stricter model of supervision was introduced. The changes meant a greater focus on the level of risk and key ratios of the funds. The purpose of the new regulations regarding fund reporting was to get a better picture of the amount of risk that the managers are taking while managing the funds.

2.5 The risks of hedge funds

The exempt regulatory status that hedge funds enjoy in the United States is premised on the philosophy that wealthy or "qualified" investors should be allowed to make their own decisions without interference from government regulation and its associated cost. In return for this freedom the individual should have to bear the full consequences of their investment decisions, good or bad. The rational for this way of reasoning is that this group of people would not benefit from paternalistic protection and would therefore be better off if they are allowed to invest their money as they see fit. The regulatory exemptions draw a line, or several lines, between those investors that qualify for the exemptions and those who do not. There are several reasons to why some investors are allowed exemptions from the securities laws. Investors in this group, if properly defined, should have enough resources to be able to afford the losses that may occur in a particular exempt investment. They should have enough information about the market to be able to make sound investments. This group can also hire experts on accounting, tax, law or any other area in which they feel that their own skills are not sufficient to evaluate an exempt investment. Another reason is that many of these people would be able to invest in hedge fund products by establishing offshore investment vehicles, and in that way avoid rigid regulation.[70]

In practice the exemptions means that wealthy individuals and institutional investors are able to access non-traditional investment strategies that may provide superior returns but with possibly greater risk. Less well off investors, or unqualified, investors are protected by being excluded from participating in these investments.

[68] Chapter 5 SIFA.
[69] Chapter 6:1 SIFA.
[70] McCrary, p 128, 2002

Despite the fact that hedge funds investments are open only to wealthy individuals it has been widely discussed whether this is enough, or if greater regulation is needed. This debate is mainly generated by three concerns. First there is a concern that hedge funds may contribute to destabilizing financial markets and that it could cause a systemic meltdown. This is an issue that was primarily triggered by the near collapse of LTCM in September.

Another concern is that recent hedge fund innovations have eroded investor protection by making it possible for less wealthy individuals to be a part of hedge fund investments. Some observers have gone even further and said that a greater government protection is needed even if the market is only open to wealthy, qualified individuals. It has been argued that even though the investors have much money they might not have the requisite financial sophistication to be able to understand and assess the risks associated with hedge funds.

The third concern revolves around market integrity and ensuring that markets are fair, efficient and transparent.[71]

2.5.1 Government intervention

2.5.1.1 Why is it necessary for the SEC to intervene?

Hedge funds can, and they do fail, although it has been shown that many of these failures have not entailed systemic risk. There are other reasons for comfort as well. Market practices have improved since the LTCM incident. The banking system today is cushioned by more risk-adjusted capital. In US tier-one risk-based capital ratios have stabilized at about 8.5 percent, well above the 6.5 percent levels that prevailed in the early 1990s.

Hedge fund risk management has been improved by efforts of bank supervisors, banks and securities firms, the involvement of institutional investors and the institutionalization of hedge funds.

Bank supervisors have been promoting best practices in risk management among the banks that lend money to hedge funds. In turn, the banks have promoted better risk management at the funds. And as the institutional investors have increased their allocations to hedge funds, the issue of risk management has become more and more important to the investors. A recent survey of hedge fund investors found that sound risk management is now among their biggest concerns. The emergence of larger institutional investors has also lead to a greater alignment between the interests of hedge fund manager and the investors.

[71] Baums, p35-36, 2004

It has been debated whether or not the role of hedge funds in financial crisis has been exaggerated. Not all hedge funds use leverage, and some use very little. In an August 2005 report by service provider Van Hedge Fund Advisors it was shown that approximately 20 percent of hedge funds used no leverage while 50 percent did use leverage of less than 1- to-1. The fact that there has not been a major crisis since 1998 has been seen as an encouraging sign that risk management has improved.

2.5.2 Risk

2.5.2.1 Systemic risk

Hedge funds, just like other financial institutions, poses two types of risks to investors and to the financial marketplace as a whole, systemic and non-systemic. Systemic risk is just like the term ”hedge fund” loosely defined. It does however refer to the risks that one financial institution’s failure to meet its financial obligations will cause other institutions to fail to meet theirs as well. In extreme cases, a financial crisis could ensue, destabilizing capital markets and the real economy. One way that this might occur is if a failing hedge fund causes the collapse of a large financial institution with direct exposure to it. This could in turn cause further financial system disruption.[72]

Systemic risk arises because hedge fund losses can spread to third parties, for example banks and securities traders. Exposing third parties to such a risk is a market failure to the extent that the third parties are unable to act upon such risk, by for example requiring better credit terms with a bank that is acting as hedge fund counterparty. Hedge funds does not just create systemic risk, they also play a substantial role in reducing some systemic risk, for instance short selling stock during price bubbles. This however cannot alleviate concerns about systemic risk generally. Because the very same activities that reduce some risks may increase others. While talking about systemic risk it is worth noting that it hardly is unique for hedge funds. All financial institutions carry a degree of this risk. For the policymakers it is a question of whether hedge funds’ systemic risk is socially undesirable and remediable by lawmaking.[73]

The fact that hedge funds could pose a systemic risk has been a central concern for policymakers. Systemic risk has traditionally been of greater concern to regulators than non-systemic risk. As hedge funds have become significant market participants, the worry that they may contribute to systemic risk has also increased.[74]

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[72] Ferguson, 2007
[73] Hanlon, 2002
[74] Ferguson, 2007

Besides causing the failure of a major counterparty a failing hedge fund can also disrupt the financial markets indirectly.

After LTCM the Basel Commission stated that they believed that the hedge funds potential to disrupt markets indirectly was of greater concern than the possibility that hedge funds would have a direct impact on financial institutions.

2.5.2.2 Non-systemic risk

Many of the risks that a hedge fund is exposed to are specific for that fund. Risks such as operational risks and the risk of fraudulent behavior directly affect the investors of a hedge fund, and also the bank lending to the fund. In many countries, and especially the U.S. and the U.K., regulators have taken the approach that since hedge funds are restricted to qualified investors it is the responsibility of the investors to conduct due diligence on the funds that they are investing in. This is not deemed to be the responsibility of the government. During the last couple of years there have been a number of incidents that has lead to hedge funds loosing hundreds of millions, or even billions, of dollars. Out of 21 reported incidents two fund categories, global macro and fixed income arbitrage, together was accounted for 46 percent of the reported episodes, and for 63 percent of assets loss. This is well above their 16 percent combined share of assets. These findings are consistent with the fact that these two types of fund strategies have among the highest attrition rated in the hedge fund industry. Out of 21 cases 43 percent of them were fraud related.[75]

2.5.2.3 Long-Term Capital Management

The implosion, the federal bailout and the ultimate folding of LTCM is what fueled the fears about hedge funds' systemic risk.[76] Even though many public and private sector commentators have acknowledged that LTCM was unique, both when it came to its size and the levels of leverage it employed, the market turbulence that followed the near-collapse of LTCM in 1998 led both the public and the private sector to focus on possible ways to reduce systemic risk.[77]

LTCM, founded in early 1994, operated a hedge fund led by a team of highly respected and experienced people, which included two Nobel laureates.[78] LTCM used trading strategies that involved very high leverage and massive amounts of complex derivatives positions. The principals of LTCM had developed complex mathematical models for predicting the relative price of different securities. Throughout 1998, the model showed indications that US Treasuries were overvalued relative to other bonds, and

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[75] Ferguson, 2007
[76] Shadab, 2007
[77] Gaine, 2003
[78] Baums, p73, 2004

in particular to corporate bonds. The model also indicated that share prices had fallen by an abnormal amount. LTCM used many different techniques and in particular it sold short treasuries and bought corporate bonds, posting the corporate bonds as collateral. LTCM also entered swap agreements in which they received premiums in return for guaranteeing to pay the difference between the current price and any future price of share and share indices. LTCM thought that the share price would not fall any further and that they then could pocket the premium. Russia then defaulted on its bonds, which led to investors buying even more treasuries. This widened the price gap with corporate bonds to levels that LTCM's model never had predicted. Similarly shares continued to fall even further. LTCM's prime broker, lenders and swap counterparties demanded cash as margin payment to offset the difference. But at this point LTCM's positions were so big that they could not close out positions to raise cash without pushing prices lower, thus aggravating its problems.

In September 1998 LTCM ran out of money to make margin payments.[79] At this point they had lost 50 percent of its equity and was in danger of not being able to meet collateral obligations on its derivatives positions. What was of even greater importance was the fact that if LTCM had failed to meet a collateral obligation, or missed a required debt payment, its derivatives counterparties would have had the legal right to terminate or liquidate its positions with LTCM. This they could have done in order to protect themselves from incurring even greater losses. Not even a decision to file for bankruptcy protection could have prevented this. It was only the intervention of the Federal Reserve, who organized a $3.6 billion creditor bailout in September 1998, which prevented a "counterparty run" on LTCM's derivative positions. The rush of more than 75 counterparties to close out simultaneously hundreds of billions of dollars of derivatives contracts would have adversely affected many market participants even without a connection to LTCM. This would have resulted in a tremendous uncertainty about how far prices might move.

The creditor consortium that recapitalized LTCM and took over the responsibility and obligation of managing LTCM's portfolio and resolving its financial difficulties consisted of 14 large banks and securities firms.[80] If they had not organized this bailout, 17 counterparties, most of which were large banks, would together have lost somewhere between 3 and 5 billion dollars.[81]

2.5.2.3.1 Amaranth

Amaranth was a highly regarded multi-strategy fund with assets of 9 billion dollars. In less than two weeks the fund had lost 65 percent of that money.

[79] Hanlon, 2002
[80] Baums, p 40-41, 2004
[81] Ferguson, 2007

Amaranth lost 35 percent of its value during the week of September 11 2006; due to some investments employing a highly leveraged natural gas spread strategy. Over the weekend of 16-17 September they tried to sell its positions to other financial institutions but failed to do so. On September 20 Amaranth sold its positions to JP Morgan Chase and Citadel Investment Group at a 1.4 billion discount from the prior day's market-to-market values.

These losses were unnerving to the market, but did not have the same impact as LTCM, and posed little systemic risk. This biggest reason for this was that the Amaranth episode played out in a relatively small and isolated market, while LTCM's problems played out in the US Treasuries market. Both funds were undermined when pursuing strategies that could conceivably have been profitable during certain scenarios. In both cases the failure was one of risk management. The trades were taken at such a large scale that when the market moved towards them they were not able to exit their positions without moving the markets. Many researchers have said that Amaranth is proof that a large hedge fund can fail without causing systemic risk.

2.5.3 Failure of market discipline

It is impossible to predict what would have happened if the Federal Reserve had not intervened in the LTCM situation. When defending this unusual action, William McDonough, the president of the Federal Reserve Bank of New York, said that it was the Federal Reserve's judgment that the "abrupt and disorderly close out of LTCM's positions would cause an unacceptable risk to the American economy". He also said that "there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle, lending to further liquidations and so on".[82]

As mentioned above, the near-collapse of LTCM galvanized regulators throughout the world to examine the operations of hedge funds to determine if they posed a risk to investors and to the financial stability in general. Due to this concern almost every major central bank, regulatory agency and international "regulatory" committee, such as the Basel Committee and IOSCO, undertook studies. Reports on the issue were presented, by among others, The PWG, GAO, the Counterparty Risk Management Policy Group, the Basel Committee on Banking Supervision and the IOSCO.[83]

The PWG produced a report called *"Hedge Funds, Leverage, and the lessons of Long-Term Capital Management"*.[84] This report included a number of different recommendations. The first recommendation was that

[82] Evanoff, p 353, 2005
[83] Baums, p 31, 2004
[84] The President's Working Group in Financial Market,1999

more frequent and meaningful information on hedge funds should be made public. They also suggested that public companies should publicly disclose additional information about their material financial exposures to significantly leveraged institutions. The third recommendation made was that financial institutions should enhance their practices

It is generally agreed that it was a failure of market discipline that enabled LTCM to use excessive amounts of leverage to assume huge positions in certain financial markets. LTCM's banks and derivatives counterparties failed to appreciate the magnitude of the risks they were taking in their dealings with LTCM. They also consistently failed to enforce even their own risk management standards.

An obvious implication of these events has been to strengthen the regulation and supervision of banks and securities firms, which were LTCM's primary creditors and counterparties. This has, to a large extent already been done. In addition to this, banks and securities firms have tightened their credit standards with respect to hedge funds and have demanded greater disclosure for hedge funds.

It has been debated whether increased transparency of hedge funds really is necessary in order for market discipline to be effective. One example is the IOSCO report that concluded that increased transparency is necessary to achieve effective market discipline and contain systemic risk. They also recommend increased public disclosure by hedge funds in order to increase transparency. There is however the question of why banks and counterparties, when dealing with hedge funds, would not themselves demand whatever information they would feel is necessary in order to assess their risk exposure and monitor hedge funds. To protect themselves generally would be in their best interest.[85]

It is unlikely that mandated public disclosure by hedge funds would meet the needs of banks and securities firms. The information that would be provided in accordance with typical public disclosure requirements will probably not be informative enough or timely enough to serve the needs of creditors and counterparties. Another aspect to consider is that creditors and counterparties already have a strong incentive to demand sufficient information to protect them. They have the power to force the hedge funds to give them this type of information, because otherwise they can deal with the hedge funds that do provide it. This means that hedge funds actually have a reason to voluntarily provide this type of information to creditors and counterparties, in order to get access to credit and other services. This could mean that mandated public disclosure seems unnecessary and unlikely to provide the kind of information that creditors and counterparties need to be effective monitors of hedge funds.[86]

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[85] Baums, p 37-38, 2004
[86] Baums, p 38-39, 2004

2.5.4 Investor protection

Investor protection falls largely under the purview of the SEC, and to a lesser extent under the CFTC.[87] The purpose of having investor protection regulation is to make sure that small investors receive the necessary amount of information about the risks of their investments.[88]

In most countries investor protection can be described as either “top down” or “bottom up” regulatory regimes. A “top down” regime involves a requirement that investment products or schemes be authorized together with rules about what a scheme can or cannot do. For example, investment companies in the US primarily have a “top down” structure. The regulatory regimes for listing and authorization of investment funds in the UK, as well as in the rest of Europe, are also predominantly “top down”. In contrast, a “bottom up” regulatory regime is basically a disclosure-based regime. Greater reliance is placed on rules that require providers of investment products to accurately describe the nature of their investment products and their potential risks. Investors are given more responsibility to assess the risks and to determine if the investment suits them. Investor protection in the U.S might best be characterized as a patchwork of exemptions from various investor protection laws, rather than as being a thoughtfully crafted top-down or bottom-up regulatory scheme.

2.5.4.1 Arguments for increased investor protection

Many who argue that more regulation is needed to protect even financially sophisticated investors point to the lack of transparency of hedge funds as a reason for government-mandated public disclosure requirements. What these requirements should be exactly is not clear. One possibility is that hedge funds would be required to periodically disclose their positions, the same way that mutual funds do. However that type of disclosure may be both impractical and uninformative. For example LTCM had over 60,000 trading positions on its books and many of these were complex derivatives positions. It is not likely that even financially sophisticated investors would be able to decipher these positions. Also, hedge fund managers are reluctant to provide position information that could reveal their investment strategies to rival managers, If this type of information was to be revealed it could erode their returns. There has also been arguments that what is needed is greater “exposure” transparency instead of “position” transparency. Hedge funds could then disclose information about the overall portfolio risk associated with their strategies without revealing proprietary information. For example a hedge fund could provide quantitative measures of value-at-risk for its portfolio and the results for stress tests for given assumptions, together with a description of its methodologies for computing these statistics.

[87] Fung, 2006
[88] Eichengreen, p 11, 1998

At the same time there is a strong argument to be made that government-mandated disclosure is not needed and that it might actually be counterproductive Hedge fund investors already have a strong incentive to demand information from the funds and at the same time, the hedge funds have a strong incentive to disclose the information that is requested by the investors.

2.5.5 Transparency

The hedge fund industry has always been surrounded by secrecy. This reputation mainly stems from the fact that they are not forced to disclose their activities to a third party. During the last few years it has been discussed whether a legislation forcing them to disclose a greater amount of their business should be implemented. Many investors want more insight in what they are investing in and how their investments are being handled. Especially after scandals such as Enron, WorldCom and Tyco, investors have called for a greater influence of corporate governance. Greater transparency would give the investor an opportunity to review how the hedge fund manager is investing their money, minimize their exposure to certain investments and gauging if they are performing well on a risk – adjusted basis. Greater transparency would also reduce the risk of fraudulent activity. In 2008, two committees appointed by the Treasury Department called for greater accountability and pressed the hedge fund manager to detail more of their investment activities, Such a move was thought to help the troubled financial markets. Hedge fund managers prepared one set of the recommendations and investors who use the funds put the other together.[89]

[89] Cho, 2008

3 Corporate Bonds

3.1 Introduction to bonds

A bond is a debt security, in which the authorized issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest and/or to repay an amount at a later date.

The issuer of the bond can be seen as borrower of capital to the holder. The holder can in similar terms be viewed as the lender of capital to the issuer. Thus the bond functions as a loan. Through the bond the issuer gets access to external funding, this is the purpose of the bond from the issuer's point of view. The holder gets coupon payments or a principal on the purchased bond, this is the purpose of the bond from the holder's point of view.

Bonds and stocks are both securities, but the major difference between the two is that stockholders have an equity stake in the company (i.e. they are owners), whereas bondholders have a creditor stake in the company (i.e. they are lenders). Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks may be outstanding indefinitely. An exception is a consol bond, which is a perpetuity (i.e. bond with no maturity).

All bonds are, as described above, a contract between the issuer and the holder. This contract is called the indenture. The indenture sets forth all the obligations of the issuer. The nature of the issuer defines the classification of the bond. In the US for example, there are three issuers of bonds: the federal government and its agencies, municipal governments and corporations. Within the municipal governments and corporation bond markets there is a whole flora of different issuers, each with different ability to satisfy their contractual obligations to lenders.[90] When a bond is issued one or more securities firms or banks, forming a syndicate, will act as underwriters. When acting as underwriters the bank or syndicate will buy an entire issue of bonds from an issuer and re-sell them to investors. This is true for most bonds except government bonds that are sold through auctions.

The principal value (or simply principal) of a bond is the amount as defined in the indenture that issuer agrees to repay to the holder at the maturity date. This amount is also referred to as the redemption value, maturity value, par value or face value.

The maturity date is the agreed upon termination date of the bond. The maturity of the bond is simple the number of year left before the maturity

[90] Fabozzi, 2006

date. This is also called the term to maturity, term or maturity. At the time of the maturity date the issuer is contractually bound to repay any outstanding principal. In some cases the language in the indenture can give the issuer or the holder the right to alter the maturity date.

Depending on the maturity of the bond, the bond can be classified as short term (usually a maturity of 1 to 5 years), intermediate term (usually a maturity of 5 to 12 years) and long-term (a maturity of more than 12 years) bonds. The maturity of the bond is important for three reasons.

- It defines the time period over which interest on the bond can be expected.

- The maturity is also important to the yield of the bond. The shape of the yield curve (a representation of the yield over time) is dependent of the maturity.

- The volatility of the bond is also a function of maturity, as a bond with a longer time until maturity date has a higher volatility than one with a shorter.

The coupon rate is the interest rate that the issuer agrees to pay each year. The annual amount being paid is called the coupon. Usually the coupon is fixed throughout the life of the bond. It can also vary with a money market index, such as LIBOR, or it can be even more exotic. The name coupon originates from the fact that in the past, physical bonds were issued which had coupons attached to them. On coupon dates the holder would give the coupon to a bank in exchange for the interest payment.

The indenture also specifies the trustee. The trustee is a financial institution with trust powers, such as a commercial bank trust department or trust company, given fiduciary powers by a bond issuer to enforce the terms of the bond Indenture. The trustee sees that bond interest payments are made as scheduled, and protects the interests of the bondholders if the issuer defaults.

3.2 Default risk

For any bond, default by the issuer is always a risk. When an issuer defaults, it has breached some part of the indenture. If this happens it will have serious consequences for both the issuer and the holder of the bond. The most serious violations are non-payment of coupon and principal, but there are other reasons for default. If the violation is significant then the holder may force the issuer into bankruptcy. For bonds issued by the US treasury the risk of default is very low. The main reason for this is that the US treasury can always borrow more money from the Federal Reserve and the Federal Reserve has the power to create money. This is not the case for municipal governments or corporations.

3.2.1 Default of corporate bonds

A bond indenture contains protective covenants, which are prohibitions on the action of the issuer. The basic idea of the protective covenants is to protect the holders from possible firm or stockholder actions that might be harmful to the holder. If the issuer violates any part of the indenture and its covenants, it triggers a default and the trustee is required to act on behalf of the holders. After the default, one possibility is a renegotiation of the contract. A second possibility is to force the firm into bankruptcy.

3.2.1.1 Protective covenants

The role of the management of a corporation is to act in the best interest of its shareholders. In this role, the management can be expected to seek out ways to benefit the stockholders at the cost of the bondholders. One way for the bondholder to protect themselves against the stockholders is to require the inclusion of protective covenants. The protective covenants are added to the indenture to make it difficult for the stockholders to expropriate the wealth of the bondholder. In the U.S., the American Bar Association has prepared a document entitled Commentaries on Model Debenture Indenture Provisions. This book lists standard bond indenture provisions. These protective covenants are written by legal experts and are based upon previous case law. The protective covenants outlined in Commentaries on Model Debenture Indenture Provisions are widely used by corporate bonds.

Four types of protective covenants are quite common, restrictions on:

1. the issuance of additional debt,
2. dividend payments,
3. mergers,
4. disposition of assets.

All these actions could clearly put the bondholders in a precarious situation and would result in the devaluation of the bond.

3.2.2 Remedies in case of default

The key feature of the remedy scheme available for bonds in the event of a default is the right to accelerate the bonds. This means the right to accelerate the payment of the outstanding principal together with all accrued interest. The effect of acceleration is that it ends the lending relationship and the bondholder gets his money back. Acceleration is the principal remedy in the case of default. It is actually the only remedy specifically stated and the only one that is regularly sought. Technically, there is an opportunity for the trustee of the bondholders to seek different types of remedies, such as damages for breach. This is rarely done, and one of the reasons for why this remedy is almost never used is that damages typically are very hard to prove. The threat of the acceleration is what forms the negotiations between

the company and the bondholders regarding the terms on which bondholders will consent to waivers and amendments that eliminates the default. Whether acceleration is attractive to bondholders and whether the threat of acceleration can be used by the bondholders in order to extract consent payments or other concessions from the company depends on the hypothetical value of the bonds assuming that bondholders had no right to accelerate (the non-accelerated bond value). When acceleration occurs, if the company has sufficient assets to pay, bondholders gain the difference between the non-accelerated bond value and the principal amount of the bonds (par). From an economic standpoint the acceleration remedy resembles a liquidated damages clause where the amount of liquidated damages is equal to the difference between par and the non-accelerated bond value. Therefore the acceleration is only attracted in the cases where par exceeds the non-accelerated bond value. Acceleration becomes increasingly attractive as the non-accelerated bond value decreases. The more attractive acceleration is for bondholders, and the more costly it is for the company, the more leverage the bondholders have to extract concessions from the company in exchange for a waiver of the default.[91]

3.3 The Corporate Bond Market in the US

The U.S. corporate bond market is enormous. Outstanding principal in corporate bonds at the end of 2006 was $5.37 trillion, which was larger than either U.S. Treasury obligations or municipal bond obligations, though not quite as large as mortgage-related bonds. Corporate bonds are a principal source of external financing for U.S. firms, new corporate bond issues during 2006 amounted to $470 billion, up from $222 billion a decade earlier.

3.4 The Corporate Bond Market in Sweden

The things that have distinguished the Swedish market for corporate bonds in the past, is its illiquidity and the difficulty to retrieve market information. The majority of the transactions have taken place between institutional investors, such as banks, mutual funds and pension funds.

In the beginning of the 1950s the Swedish government introduced a stricter control of the bond market. The result of these new regulations was that the market on both the investor and the issuer side became entirely dominated by a few participants. The issuers were regulated as well as the investors were controlled in terms of investment obligations as well as liquidity requirements. The Swedish Central Bank also introduced restrictions on the pricing of the bonds. This was a time when the need to finance companies seemed to come in third hand. The government needed financing and the

[91] Kahan, 2009

housing sector had to be fulfilled before the companies were allowed to issue bonds.

In the 1970s the regulation regarding the bond market was somewhat loosened. The authorities then kept relaxing the regulations all through the 1970s and the 1980s. During this time period there was a great increase in the outstanding stock of bonds (government, housing and corporate bonds). In 1990 it had increased so much that the Swedish bond market was similar to that of the US bond market.[92]

From the late 1980s until the late 1990s the corporate bond market experienced a relatively low growth. Then between 1998-1999 the market started to grow significantly. The cause for this growth was the booming economy. Event though the market decreased as the IT-bubble burst in 2001, the bond market remained on historically high levels. The total volume issued on the corporate bond market 2005 was 132 billion SEK, which was an increase of 55 percent from 2004.[93]

3.5 Swedish bond market v US bond market

In Sweden only a minor share of the entire bond market consists of corporate bonds. This is due to the fact that government and mortgage bonds comprise a majority of the outstanding bonds. A reason for this is that the market itself is only open to large companies that can afford to obtain credit rating. In the U.S. medium companies and even rather small companies issues bonds. This has meant that corporate bonds dominate the U.S market.

[92] Peterson, p 4, 2006
[93] Peterson, p 6, 2006

4 Acceleration of bonds

4.1 Background

”As soon as Vitesse Semiconductor Corp. said it was under investigation for securities law violations that may delay routine regulatory findings, the Camarillo, California, maker of computer chips also learned it was about to be held up for ransom in the bond market.”

In the last few years there have been some hedge funds that have been looking to extract bigger returns from the companies whose bonds they hold, when the companies fail to file an annual or quarterly report with the SEC on time.[94] Such a report is required, and if you do not hand this in it can lead to harsh consequences. Over the past years hundreds of companies have been forced to delay the SEC filings due to a severely discounted secondary debt market, together with an increasing level of internal investigation activity, resulting from amongst other things, requirements imposed by the SOX Act. The SOX Act provides that senior management, who must certify that the company’s financial statement is accurate as well as the adequacy of the company’s internal financial controls, must sign every Form 10 Q and 10K.[95] This increase in internal investigation has forced many bond issuers to delay their filings and reports to bondholders because the issuers are forced to investigate all matters that may have an impact on their financial statements, especially backdated employee stock option grants.[96] These types of internal investigation has to be overseen by special committees and their outside counsels and can take months to complete. The timing of the completion is often something that is outside the company’s control.[97] A delay can cause the companies much trouble, such as a risk for default under the reporting covenant in the indenture, which requires the issuers to make SEC filings available to bondholders within specific timeframes. [98] If the company is unable to timely file a quarterly or annual report with the SEC under the Exchange Act they must file a form called 12b-25 with the SEC. Through this form the investors are notified of the reasons for the delay. Rule 12b-25 then offers a 15-day extension for filing a form called 10-K and 5 days for a form called 10-Q, if the rule’s requirement for the extension is satisfied. When hundreds of financially sound companies started to miss the deadline for the SEC filings there were a number of hedge funds that sought to capitalize on these delays. The way that they did this was by accumulating a sufficient percentage of the company’s bonds to obtain standing under the indenture governing the bonds, in order to declare a default due to the company’s

[94] Schiller, 2008a
[95] *Sarbanes-Oxley Act of 2002*
[96] White and Case, 2009
[97] Schiller, 2008a
[98] White and Case, 2009

failure to comply with the 1934 Act's reporting requirements. They claimed that this failure constituted an event of default under both the indenture and the TIA. Such a default can lead to an acceleration of the company's publicly traded debt. An investor that has purchased a bond for the sole purpose of declaring default, pursue their claims for acceleration even if the company would continue to make regular interest payments and report current unaudited financial information. Most of the indentures have a 25 percent limit for the indenture trustee to be able to issue a notice of default. Once an event of default has taken place, the indenture calls for a cure period. This cure period is usually 60 days. Activist bondholders usually uses this time period to seek to negotiate new covenants, such as higher interest rate, thereby increasing the yield on the notes, which they might have purchased at a discount to par value. [99] Hedge funds had now become aware of the fact that they could profit from buying corporate bonds, declaring them in default and seeking a quick settlement. If successful, this meant that the hedge funds quickly could transfer wealth from the shareholders to the bondholders.[100]

A company that receives a notice of default due to the fact that they have been late filing their SEC report has a few different, all quite difficult options, to choose from:

1. they can engage in high stakes litigation. However, if they were to loose then it can trigger the immediate repayment of hundreds of millions of dollars of debt. It can also trigger cross defaults or accelerations of indebtedness in other loan agreements. This can potentially destabilize a company's entire capital structure and lead to the company being declared with bankruptcy. By contrast, a litigious hedge fund continues to receive interest payments on its bonds even if it looses in court. It is therefore no surprise that most companies decide to settle with the hedge funds;

2. they can settle with the holders by paying a consent fee and higher interest in exchange for a withdrawal of the default claim; or

3. they can seek consents from a majority of its bondholders to waive the alleged defaults. This is not an option in cases where the note holders seeking acceleration owns a sufficient percentage of the outstanding notes to defeat such consent. [101]

Between 2005 and 2006 at least 20 public companies received notices of default due to late SEC filings. Hedge funds were often the driving forces behind these notices. During 2006 a single hedge fund issued at least three acceleration demands.

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[99] Schiller, 2008a
[100] Giuffra, 2008
[101] Schiller, 2008a

4.2 Reporting requirements under the TIA

The TIA is a federal statue that applies to all ”notes, bonds, debentures and evidences of indebtedness” issued to the public in the United States, subject to statutory and regulatory exemptions. In 1936 the SEC conducted a study through which a widespread abuse in the issuance of bonds and indentures were shown. Prior to the enactment of TIA companies typically mailed copies of annual reports only to the stockholders and not to the bondholders. [102] The Congress then focused on making sure that the bondholders received the same information as the stockholders by introducing one of TIA's mandatory provisions, 314 (a) (1). This section automatically applies to all public indentures, whether this is expressly stated in the indenture or not, since this is a mandatory provision which cannot be contracted away. This provision requires that issuers are to deliver to the indenture trustee copies of annual reports and certain other reports required to be filed by the issuer with the SEC, after those reports are filed. However, the TIA does not contain any specification of when the SEC filings must be delivered to the trustee. The TIA does also contain a requirement that indentures are to contain a covenant implementing the ”delivery” requirement. [103]

The purpose of TIA was to place corporate bondholders on informational parity with stockholders, but has instead been used by the hedge funds in order to accelerate debt based on untimely SEC filings. [104]

4.3 Typical reporting covenants

There are a few commonly used forms of reporting covenants. The high-yield style bond indenture almost always contains an explicit requirement that an issuer file Exchange Act reports within the time frame specified by the SEC, in the SEC's rules and regulations. These types of bonds were then easy targets for the bondholders. However, there are many bonds that are not as explicit when it comes to the timing regarding when an issuer needs to file its Exchange Act Reports. Investment grade and convertible note indentures often contain an ambiguous version of the reporting covenant. Many have thought that this should be read to require only a ministerial filing with the indenture trustee of any Exchange Act reports that the issuer actually files with the SEC, if and when those reports are actually filed with the SEC. All the recent litigation concerning reporting covenant violations has focused on interpreting the ambiguity in these “broken” reporting covenants. [105]

One common version of this type of “broken” covenant is worded as

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[102] Giuffra, 2008
[103] Schiller, 2008a
[104] Giuffra, 2008
[105] Schiller, 2008a

follows:

> "The Company shall file with the Trustee, within 15 days after it files the same with the SEC, copies of the annual reports and the information, documents and other reports (or copies of those portions of any of the foregoing as the SEC may by rules and regulations prescribe) that the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall also comply with the provisions of TIA 314(a)."

Many bondholders have interpreted the phrase "reports (or copies of those portions of any of the foregoing as the SEC may by rules and regulations prescribe) that the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act" to imply that the issuer has an obligation to file such a report in a timely manner. The issuer has interpreted this differently and claimed that this means that a filing with the trustee is only required if and when a filing is actually filed with the SEC.

During 2006 cases involving default claims by bondholders arising out of the failure to file their SEC reports started to appear. The bondholders claimed that this type of reporting covenant require that the Exchange Act reports should be filed with the SEC on a timely basis. Another argument given by the bondholders was that Section 314 (a) of TIA imposes a similar requirement. The bondholders made the argument that their reporting covenant would be rendered meaningless if neither the text in the reporting covenant or Section 314 (a), TIA required a timely filing with the SEC. The issuers did not agree with this argument. The question that faced the court was the same in each of the cases regarding the issue of how the broken covenants should be interpreted. The question can be summarized as follows:

"Should a substantive timing requirement be read into Section 314(a) of the TIA or similarly drafted reporting covenants, or does TIA Section 314(a) and the reporting covenants patterned after that section require nothing more than the ministerial act of forwarding copies of Exchange Act reports (if filed, at all) to an indenture trustee? "[106]

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[106] Latham&Watkins, 2009

4.4 Recent case law

4.4.1 Bank of New York v. BearingPoint, Inc.

In 2006 the New York Supreme State Court issued a decision in favor of the hedge funds. The New York Supreme Court held that BearingPoint had acted in violation of Section 314 (a) of the TIA as well as in violation of the indenture itself. The violation consisted of the failure to timely file the annual quarterly reports with the SEC, as well as the failure to provide the trustee copies of those reports for its convertible subordinate bonds. In this case a group of hedge funds that had acquired more than 25 percent of BearingPoint's debentures brought an action for breach of the indenture. The action was based on BearingPoint's delay in filing its reports by approximately one year. BearingPoint defended themselves by claiming that they were not actually in default, since the indenture did not require them to file reports with the SEC within a specific time. It only stated that they were required to send reports to the trustee, if and only after it files them with the SEC. BearingPoint's indenture was governed by New York law. [107] The court held that the reporting covenant clearly stated that BearingPoint was obligated to timely file its reports with the SEC, and to provide copies of them to the trustee within 15 days of the date that they were required to be filed under the Exchange Act. The court chose to reject BearingPoint's construction of the indenture. The rejection was based on the fact that such a construction would make its obligation to provide the information to the trustee "contingent on whether or not it chose to file with the SEC". The court also held that Section 314 (a) (1) of the TIA states that a timely filing of periodic reports with the SEC is required. The court entered summary judgment in favor of the bondholders/trustee on their claim regarding breach of contract. Following this decision BearingPoint decided to settle with its bondholders, by agreeing to pay a higher interest rate on its bonds. [108]

4.4.2 Cyberonics, Inc v. Wells Fargo Bank National Association

This case was presented before a United States District Court in the Southern district of Texas. The applicable law was New York law. This dispute arose from an indenture agreement entered into by the parties. Cyberonics sought a declaratory judgment that it has not breached that agreement, while Wells Fargo made a counter-claim for breach of that agreement. The agreement provided that a breach of any covenant,

[107] Schiller, 2008b
[108] Schiller, 2008b

including the reporting covenant, would be considered an event of default. In the event of a default, the defaulting party was to be given 60 days after being served with notice to cure the default. Finally, the agreement allowed for Wells Fargo to accelerate the notes if Cyberonics defaulted and failed to cure the default within the 60-day period.[109] Due to the fact that Cyberonics had been unable to complete an internal investigation into its stock option grant, Cyberonics announced that they would be late filing its annual report. After this announcement a group of hedge funds that had acquired Cyberonics' acted and caused the trustee to issue a notice of default and sought to accelerate the company's $125 million of bond debt. Cyberonics sought a declaratory judgment that it had not breached its indenture. The court held that the reporting covenant "unambiguously requires that only that Cyberonics deliver copies of the annual reports and other documents to Wells Fargo (the indenture trustee) within 15 days after having filed those documents with the SEC". The court hereby rejected the analysis made by the court in BearingPoint. The court also rejected the bondholders' argument that Cyberonics violated Section 314 (a) (1) of the TIA. The court held that this section does not specify the time by which a company must provide the indenture trustee with copies of the reports filed with the SEC. Furthermore, the court rejected the bondholders' argument that because they can already obtain documents and reports filed with the SEC from the EDGAR system the reporting covenant is "meaningless" if read as only requiring copies of documents already filed with the SEC and not as an obligation to actually file with the SEC. The court found that such an argument overlooks the plain language of the provision.[110] If it had been the intent of the parties to require filing then they could have simply declared so. Instead, the parties agreed that the reports were to be delivered to Wells Fargo, when these had been filed with the SEC. The court considers the fact that the applicable indenture in this case is almost identical with the indenture at issue in the BearingPoint case and that New York law had been applicable to the case. However, the court stated that since BearingPoint was an unpublished decision from a state trial court and that decision was therefore not binding to the court in this case. The court did note that there was one important difference between the BearingPoint case and this case, and that was that in BearingPoint the company failed to file any reports with the SEC at all. Cyberonics continued to provide information about its operations, and did file its report although they were 6 months late, and did send a copy of this report to Wells Fargo within 15 days of filing.[111]

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[109] *Memorandum Opinion and Order*, United States District Court, Southern District of Texas Houston Division, p. 1,2
[110] Schiller, 2008
[111] *Memorandum Opinion and Order,* United States District Court, Southern District of Texas Houston Division, p. 1,2

4.4.3 Affiliated Computer Services Inc. v. Wilmington Trust Company

This case was presented before a United States District Court in the Northern District of Texas. The underlying facts of this case were that Affiliated Computer Services entered into an indenture agreement with the Wilmington Trust Company. Under this agreement Affiliated Computer Services served as the bond issuer and the Wilmington Trust Company served as trustee. The reporting provision of this indenture provided that Affiliated Computer Services Inc "shall file with the Trustee, within 15 days after it files the same with the SEC, copies of the annual reports and the information, documents and other reports that Affiliated Computer Services is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act". The reporting provision also stated that Affiliated Computer Services shall comply with Section 314 (a) of the TIA. Due to an internal investigation into Affiliated Computer Services' stock option practices, they were unable to timely file their report with the SEC.[112] Instead they filed a notification of late filing in order to explain the situation they were in. Shortly after this notification had been filed Affiliated Computer Services received a notice of default and a demand for acceleration from bondholders. Affiliated Computer Services then sought a declaratory judgment that it was not in default under the indenture. The trustee, acting on behalf of the bondholders, counterclaimed for a declaratory judgment. As the court was determining whether or not Affiliated Computer Services failure to timely file their reports constituted a breach of the indenture the court of course looked at the ruling in the BearingPoint case. The court found the court's analysis in the BearingPoint case to be unpersuasive. In BearingPoint, the court primarily focused on the purpose of the indenture "to provide information to the investors so that they may protect their investment". The court in this case instead chose to focus on the specific language used in the indenture.[113] The court found that the phrase "that Affiliated Computer Services is required to file" merely indicates which reports Affiliated Computer Services must file with the trustee, and that the wording "within 15 days after it files the same with the SEC" identifies the time in which the reports must be forwarded to the trustee.[114] The court also found that the language of the reporting provision makes clear that the duty to file reports with the SEC is imposed pursuant to Section 13 or 15(d) of the Exchange Act and not pursuant to the indenture. The court stated that the references made in TIA with regards to filings under the Exchange Act does not impose an independent obligation to timely file reports with the SEC, as found in BearingPoint. It rather serves only to identify which reports must be forwarded to the trustee. Thus, the court held that the TIA, like the reporting provision, only requires that those reports that are actually

[112] United States Court of Appeal for the fifth circuit, Nr 08-10235, p. 1-6
[113] Seward and Kissel LLP, 2009
[114] United States Court of Appeal for the fifth circuit, Nr 08-10235, p. 16

filed with the SEC be forwarded to the trustee.[115]

4.4.4 UnitedHealth Group Inc. v Wilmington Trust Co.

This case was presented before a United States Court of Appeals for the Eighth Circuit on appeal from the District of Minnesota. The case involved an indenture under which Wilmington Trust served as a trustee. Pursuant to this indenture UnitedHealth Group issued US $850 millions of bonds.[116] A group of hedge funds accumulated over 25 percent of United Health's senior notes. When UnitedHealth delayed the filing of their quarterly reports with the SEC, pending the completion of an investigation into backdated stock option grants, the hedge funds caused the indenture trustee to issue a notice of default. After the time that the notice of default was issued, the hedge funds purchased an additional $55.8 million of notes. United Health filed a declaratory judgment action, seeking a ruling that they had not breached the following indenture covenant:

"So long as any of the Securities remain Outstanding, the Company shall cause copies of all SEC reports which the Company is then required to file with the SEC pursuant to section 13 or 15(d) of the Exchange Act to be filed with the Trustee and mailed to the Holder of such series of Securities… within 15 days of filing with the SEC. The Company shall also comply with the provision of the Trust Indenture Act ss, 314 (a)."[117]

Although UnitedHealth was not able to timely file its Form 10-Q they still filed a Form 12b-25 notification of late filing. This notification was filed on a timely basis and it explained the reasons for the delay accompanied by a 44-page appendix containing for the most part the same information that would have been provided if they had been able to file their Form 10-Q on time. Despite this bondholders caused the company's trustee to issue a notice of default, with the claim that the delayed 10-Q filing caused an event of default under the indenture.

The Eight Circuit stated that the language found in the indenture was unambiguous, and that the language only imposed on United Health to forward SEC reports that had been filed. It did not impose an independent obligation to file reports with the SEC on a timely basis. The Court noted the fact that both parties in this case were sophisticated and represented by a counsel. If they had wanted to they could have drafted the indenture to require that SEC filings be made on a timely basis.

[115] Seward and Kissel LLP, 2009
[116] White and Case, 2009
[117] [117] Schiller, 2008b

The court also discussed the requirements stated in Section 314 (a) of TIA, which was referenced in the indenture. The court found that the language in the indenture and in Section 314 (a) were close to identical, but without the 15-day requirement. The court found this Section of the TIA to be even less burdensome than the indenture requirements. In accordance with these findings the Eight Circuit concluded that TIA Section 314 (a) requires only that the debt issuer forward copies to the Trustee of such reports that have actually been filed with the SEC.

The Eight Circuit also rejected the argument claiming that the duty of good faith and fair dealing under New York law imposed an affirmative obligation on United Health to file its reports with the SEC on a timely basis. This claim was rejected on the basis that United Health continued to make payments on the bonds while its filings were delayed, and also that by filing preliminary financial data with its notification of late filing and up-dates on the backdating investigation through Form 8-K filings. According to the court's findings United Health were forced to do an internal investigation that lead to a delay with filing the reports. However, during this delay United Health provided bondholders with as much information as they possibly could while the internal investigation was being conducted. .The court stated that United Health acted, as prudently as was possible under the circumstances and that its failure to file the reports with the SEC on time breached no express or implied duty of good faith and fair dealing.[118]

4.5 Possible adjustments to bond indentures

There has been much discussion regarding the ways that adjustments should be made to the bonds, in order to reduce the problems of enforcement. Before the activist hedge funds became interested in the acceleration of bonds, many of the provisions in the bonds might have been harmless. This has however changed due to the hedge funds. Therefore it might be necessary to look at how the bond indentures are written and see what could be changed. This section will discuss two different changes and adjustments that might improve the situation.

4.5.1 Weaker covenants

One change that could be made would be to make the covenants found in bond indentures weaker. Tougher enforcement paired with weaker covenants would be one way to regain the balance in the market. This is a

[118] White and Case, 2009

change that has already been implemented by some companies. In recently drafted indentures the following wording has been incorporated

“upon a failure to file, the company has to pay additional interest to bondholders and that bondholders are not entitled to accelerate unless the failure lasts longer than a specific period of time.”

Other indentures provide for special, extended cure periods applicable to a failure to file reports with the trustee.

4.5.2 More carefully drafted provisions

One fact that the hedge funds have used in order to declare defaults is that they have carefully examined technical flaws or imprecision in indenture terms. These are flaws that previously probably would not even have been discovered, since no one was looking quite as carefully. With activist hedge funds examining them, the risk that such flaws can cost the companies a great deal of money, has become much more probable. This gives the companies a much greater incentive to make sure that they avoid such flaws when the indenture is being drafted. Another way to express this is that the hedge funds has made it much more important to be more precise and careful when drafting the indenture. [119]

[119] Kahan, 2009

5 Conclusions

5.1 General remarks

The market for corporate bonds has grown dramatically in recent years. If you look at two of the companies that hedge funds claimed to have defaulted on their debt due to their delay with filing reports with SEC, one is UnitedHealth which is the biggest U.S. health insurance provider and another is Vitesse Semiconductor Corp, a computer chipmaker. Together these two companies have as much as $36 billions of bonds.[120] This means that the actions of the hedge funds and the ruling of the courts could have great implications on the financial market as a whole.

The current events regarding hedge funds and their involvement in the acceleration of bonds raises several questions. One is the question of what implications the court rulings will have on the bond market as well as the regulation surrounding it. Another question is if this will have an influence on the way that the reporting covenants are written and also if it will influence the way of the bondholders. If the answer to anyone of these questions is yes, then the next question is how? In this thesis my goal is to analyze the questions mentioned above and to give suggestions on what could be done to improve the situation.

5.2 Analysis

The cases that have been introduced in Section 4.4 shows that there are some imperfections concerning the use of acceleration of bonds as a remedy when bondholders rights have been violated. It is a known fact that in times when treasury interest rates have increased or when the stock price of a company that has issued convertible bonds has declined, then the acceleration creates a kind of windfall. This means that bondholders receive a compensation that is not proportionate to the harm done by the violation that has been made. In these cases activist hedge funds have an incentive to spend a large amount of time and resources in order to find and to pursuit potential companies risking default. The companies, on the other hand, have excessive incentives to try to avoid potential notices of default. These types of incentives create an environment where activist hedge funds might actually like to find violations so that they can claim default. This in turn can lead to a very unbalanced situation, where we either will have over enforcement or under enforcement.

[120] http://www.bloomberg.com/apps/news?pid=20601103&sid=aehxkaA9qcwg&refer=us

When looking at the decisions made by the courts in the ruled cases to date (See Section 4.4), the court have only ruled in favor of the bondholders in one case, BearingPoint.

At a first glance it might then seem as if the issue is resolved, since the hedge funds have been unsuccessful in claiming default in most cases. However, that is not the whole truth. Even though the courts in a majority of the cases have ruled in favor of the bond issuer, there is still a possibility that a future court will decide to go with the ruling in BearingPoint instead. This leads to a high amount of uncertainty for the companies. The risk for a large company is that they might find themselves in a situation where a debt of millions of dollars might be accelerated. Such acceleration could be devastating, and could even jeopardize the entire capital structure of a perfectly healthy company. Many of the companies decide that they are not willing to take the risks. This has lead them to take actions such as agreeing to settle with the hedge funds, or they decide to pay the bondholders a certain amount of money in order to keep them from filing a claim of default. It has been said that hedge funds have been given millions of dollars in side payments in order to waive their default claims. Other reactions have been for companies to threaten to file for Chapter 11 Bankruptcy protection if bondholders would try to force it to repay its debt immediately.

None of the responses above are good for the companies or for the financial market. Of course it might lead to a great deal for the individual hedge fund, but was that really the purpose of the TIA and the reporting covenants found in the indentures? I do not believe this to be the case. Instead, I believe that the purpose of these provisions is to make sure that the bondholders receive the information that they are entitled to. You could say that by not filing the reports on time, they were denying the bondholders this right. However, when discussing this fact I think that it is important to point out that in the cases where the court have ruled in favor of the companies they did so because these companies had continued to report unaudited financial reports. Even though it is hard to tell exactly why the outcomes were different in the different cases, since the wording of the covenant was pretty much identical, it is thought that the fact that BearingPoint was the only one who did not file any types of reports made the court decide in favor of the bondholders in this case. All of the other companies continued to report unaudited financial information accessible to the bondholders. I believe that this is the right and the only reasonable standpoint to take. As long as the companies keep paying interest and providing the bondholders with financial information they should not be forced to accelerate its bonds. For a court to order a company to do so would be a very narrow interpretation of the language used in the indenture, and such a decision also fails to look at the big picture. In this case the big picture is that financially sound companies would risk going under because they did not file a report on time. I think that such an interpretation is quite unreasonable. Cases where the company fails to provide any information to the bondholders is a little different. In these cases we are no longer just discussing a formality because

in these cases it could actually result in financial harm for the bondholders, which is not as likely to happen when the companies release financial information to the bondholders. Therefore, I believe that the court made the right decision in each of these cases.

5.2.1 Implications on the bond market

One lesson that companies have learnt is the importance of continuing to provide the bondholders with financial information, even if they are late with their filings. They should also make sure that they have put effort into providing the bondholders the best possible information available at all times. Another aspect that bond issuers should take into consideration is the risk that they impose on themselves by including a restrictive covenant regarding the filing of reports with the SEC. As soon as some problem with the accounting arises it could mean that they have to delay their filings, which could mean that activist hedge funds would seek to declare them in default. The hedge funds main interest is to make money, and therefore they may declare the bond issuers in default even though they might be providing the best information available. If the case went to court it is probable that if the bond issuer has continued to provide information, then a court would reject the case of the bondholder. However, as discussed in the section above, the ruling of the court is a risk that many bond issuers does not dare to take so instead they settle.

Due to the fact that the bond issuers have started to feel a little bit nervous, there has been much discussion going on concerning the possible ways to solve this problem. Little evidence has been shown to support a change in the legislation. A more substantial case has been made for changing the ways that the reporting covenants are structured. Previously it has been common for a company to lift the reporting covenant from an already existing indenture and transfer it to a new indenture. Considering the circumstances this is no longer a wise thing to do.

From my perspective the best thing to do would be to try to find alternative ways of writing the covenants. There are different ways that the covenants could be made safer for the bond issuers. One way is to put the specific remedy that a default would mean into the covenant. Examples of remedies that could be included are a specified interest rate that the bond issuer would have to pay during the time when he has delayed the filings. Another example could be to specify a reasonable amount that the bond issuer would have to pay to the bondholder in the event of a delayed filing. This way the bond issuer would know exactly what such a default would entail, and there would be no risk for all the bonds to be accelerated. Such covenants would reduce the incentive for hedge funds to try to fund defaulting companies. At the same time it would give the bond issuers an incentive to file on time, in order to avoid paying interest rates or damages.

5.2.2 Could this happen in Sweden?

There are as I have previously stated in this thesis, several differences between the Swedish and the American corporate bond market. The American bond market is very large, while in Sweden only a small share of the entire bond market consists of corporate bonds. However, there could still be a lot of money made for an activist hedge fund seeking to accelerate bonds in Sweden. Despite this fact, I believe it to be highly unlikely that the situation that has arisen in the U.S. could arise in Sweden. The biggest reason for this belief is that there was a special situation that led up to these incidents. The large number of accounting scandals happening in the U.S led to the introduction of the SOX Act, which in turn led to, increased accounting requirements for the companies. The great number of changes to the accounting requirements made in such a short of amount of time put many companies in troublesome situations. The hedge funds could then take advantage of the predicaments that the companies were in. Sweden has not had the same issues and I therefore do not believe that the acceleration of bonds will prove to be a problem in Sweden.

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