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A report by the Democratic staff of the House Committee on Natural Resources

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Executive Summary

In late June of 2015, Puerto Rican government officials warned investors that the island's municipal authorities could no longer pay the interest owed on a variety of bonds, many of which had already been downgraded to junk or near-junk status. The announcement generated calls for bankruptcy reform – the island's governmental authorities are currently barred from Chapter 9 protection – and prompted fresh scrutiny of Puerto Rico's unique financial situation.

This report examines the role of hedge funds in this crisis. It finds that certain hedge funds are attempting to rewrite recent financial and political history in order to capitalize on the island's financial difficulties at the expense of the residents of Puerto Rico, who are American citizens.

Various Puerto Rican government-issued bonds were downgraded to junk or near-junk status over the course of several years leading up to the June announcement. During that time, certain hedge funds bought these bonds precisely *because* they were risky. It is a basic economic principle that higher risk investments generally carry higher potential returns. In this case, certain hedge funds incorrectly believed the risk to be lower than was indicated by a number of professional ratings agency assessments. As this report will show, they had no excuse for not knowing the risks of buying Puerto Rico municipal bonds. Rather than absorbing the occasional investment losses that are expected as a matter of course when assessments are wrong, even by the most successful investing firms, these hedge funds are now working to pad their profits by cutting off relief options for families in the territory.

The unfortunate reality is that hedge funds that are heavily invested in Puerto Rico bonds will get higher returns if the government of Puerto Rico imposes dramatic budget cuts on its population and if the territory remains barred from Chapter 9 bankruptcy protection. Some hedge funds have taken aggressive action to prevent Puerto Rico municipalities from being able to declare bankruptcy, and have attempted to impose a radical agenda that will further harm Puerto Rico's economy. They are now pushing teacher layoffs, pension cuts and other quality-of-life reductions for Puerto Ricans as the "solution" to the crisis in a self-serving attempt to enlarge their profits.

There are a variety of potential policy responses, including a federal financial assistance package and a bill before Congress (HR 870) that allows Puerto Rico's municipalities to adjust their debts in federal bankruptcy court.

Puerto Rico is facing a debt and economic crisis

The amount Puerto Rico owes now exceeds the size of its entire economy.[1] The majority of the debt is held by publicly owned agencies.[2] Puerto Rico's governor, Alejandro García Padilla, declared on June 29 that the $72 billion debt "is not payable." A full interest and principal payment on bonds issued by Puerto Rico's Public Finance Corporation due in early August was not paid. In order to make further payments, Puerto Rico is likely to need to borrow further. However, market interest in new Puerto Rican bonds may be diminishing. In late August, the island's water and sewer agency delayed indefinitely the planned issuance of $750 million in new revenue bonds.

The causes of the crisis are manifold. According to the Congressional Research Service, "[p]revious analyses have pointed to low employment and labor participation rates, high rates of outmigration leading to a decline in population, an economic structure shaped more by tax advantages than comparative advantages, and the effects of intensified global competition, among other factors."[3]

Hedge funds own between 20 percent[4] and 50 percent[5] of Puerto Rico's public debt.

Hedge Funds in Puerto Rico

A hedge fund combines several individual investments into a private investment vehicle that is largely unregulated. The investors are wealthy. Hedge funds are lightly regulated in part because the investors involved, who must have a net worth of at least $1 million, have already proven that they are sufficiently qualified to operate successfully in the financial sector without consumer protections.

Hedge fund managers are generally compensated with a guarantee of income – either a percentage of the assets or a flat fee – combined with a percentage of the profits, meaning that some managers make money even if they lose everything on a particular investment. In a more typical scenario, a hedge fund manager who makes 20 percent of profits as an incentive fee takes home $10 million if he or she makes $50 million in investment profit.

If Congress allows Puerto Rico's public corporations to file for Chapter 9 protection under the federal bankruptcy code, all debtholders, including hedge fund managers, will cede

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[1] Austin, D.A. (2015, August 8). Puerto Rico's Current Fiscal Challenges: In Brief. In Congressional Research Service. Retrieved August 27, 2015

[2] Austin, D.A. (2015, August 8). Puerto Rico's Current Fiscal Challenges: In Brief. In Congressional Research Service. Retrieved August 27, 2015

[3] Austin, D.A. (2015, August 8). Puerto Rico's Current Fiscal Challenges: In Brief. In Congressional Research Service. Retrieved August 27, 2015

[4] Long, H. (2015, August 6). Who Owns Puerto Rico's Debt? . In CNN Money. Retrieved August 19, 2015, from http://money.cnn.com/2015/07/01/investing/puerto-rico-bond-holders/

[5] Arbasetti, J. C. (2015, April 9). Vulture Funds Have Puerto Rico Cornered. In Centro de Periodismo Investigativo. Retrieved August 23, 2015, from http://periodismoinvestigativo.com/2015/04/vulture-funds-have-puerto-rico-cornered

financial control to a bankruptcy judge who would oversee any future negotiations. While it is likely that most or all investors would lose some money, a bankruptcy proceeding offers the benefit of a structured process overseen by an independent entity with the public's interest in mind.

If Puerto Rico's debt restructuring happens outside the bankruptcy process, as some hedge funds are strongly promoting, hedge fund managers would have more leverage to influence the outcome in a way that directs more money toward them instead of the people of Puerto Rico – a community where unemployment tops 12 percent, higher than any state in the nation.

No bankruptcy means more hedge fund profits, less for Puerto Rican families

Some hedge funds have offered to buy Puerto Rico's debt in exchange for extraordinary financial guarantees. To take just one example, many hedge funds reportedly offered to lend Puerto Rico $2.9 billion that would be backed by a new fuel tax.[6] A report by Hedge Clippers[7] provides further examples:

> (Hedge funds have) pushed Puerto Rico to take on more debt at extremely generous terms for creditors. In April 2015, they proposed backstopping the island's proposed $3 billion debt issuance, but only if it was made "bulletproof" in a way that protected creditor interests.[8] They requested "acceleration rights," for instance, which would mean that the entire amount would be due if the government defaulted. They also proposed requiring the government to hold proceeds from the debt in escrow in case proposed tax reform was not enacted in advance of the issuance – essentially using their participation in the debt deal as leverage for securing austerity measures.

Similarly, hedge funds have tried to maximize their returns at the expense of Puerto Rican families by pushing extreme funding cuts for Puerto Rican social services. A group of investors known as the Ad Hoc Group paid for a report in June that advocated a series of devastating measures such as firing teachers, cutting Medicaid benefits and reducing financial assistance to the University of Puerto Rico in order to increase bond repayments.[9]

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[6] Corkery, M., & Stevenson, A. (2015, June 30). Hedge Funds Fight to Save Puerto Rico Investments. In The New York Times. Retrieved August 19, 2015, from http://www.nytimes.com/2015/07/01/business/dealbook/hedge-funds-fight-to-save-commonwealth-investments.html

[7] HedgePapers. (2015, July 10). #HedgePapers No. 17 – Hedge Fund Vultures In Puerto Rico. In Hedge Clippers. Retrieved August 19, 2015, from http://hedgeclippers.org/hedgepapers-no-17-hedge-fund-billionaires-in-puerto-rico/

[8] Wirz, M. (2015, April 14). Puerto Rico's Creditors Push for New Bulletproof Debt . In The Wall Street Journal. Retrieved August 19, 2015, from http://blogs.wsj.com/moneybeat/2015/04/14/puerto-ricos-creditors-push-for-new-bulletproof-debt/

[9] Jose Fajgenbaum, J., Guzman, J. & Loser, C. (2015, July). For Puerto Rico, There is a Better Way. In Centennial Group. Retrieved August 19, 2015, from http://www.centennial-group.com/downloads/For%20Puerto%20Rico%20There%20is%20a%20Better%20Way.pdf

Their efforts are paying off. The Puerto Rico House of Representatives and Senate recently passed a budget for the fiscal year beginning July 1, 2015 that increases the sales and use tax from 7 percent to 11.5 percent and reduces public investment by $674 million. While Puerto Rico already cut 10 percent of its government workforce between 2010 and 2013,[10] the 2016 budget for most agencies reduces funding by another 2-3 percent and for essential social services provided by nonprofits by up to another 10 percent.[11] One hundred fifty public schools have already been shuttered in the last five years.[12] Governor Alejandro García Padilla has also increased the retirement age and required a heftier pension fund contribution from public sector workers.[13]

Cuts of this kind have already done major damage to several European nations, as noted in the *New York Review of Books*:

> Clear evidence on the effects of economic policy is usually hard to come by. [. . .] The turn to austerity after 2010, however, was so drastic, particularly in European debtor nations, that the usual cautions lose most of their force. Greece imposed spending cuts and tax increases amounting to 15 percent of GDP; Ireland and Portugal rang in with around 6 percent; and unlike the half-hearted efforts at stimulus, these cuts were sustained and indeed intensified year after year. So how did austerity actually work?
>
> The answer is that the results were disastrous—just about as one would have predicted from textbook macroeconomics. [. . .] [T]he countries forced into severe austerity experienced very severe downturns, and the downturns were more or less proportional to the degree of austerity.[14]

Despite the damage this will do to Puerto Rican families and their economy, some hedge funds are going to great lengths to make sure it remains the only possible outcome. BlueMountain Capital Management in July filed the lawsuit that prevented the government of Puerto Rico from implementing a law allowing public municipal authorities to restructure

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[10] Fletcher, M. A. (2013, November 30). Puerto Rico, With at Least $70 billion in Debt, Confronts A Rising Economic Misery. In The Washington Post. Retrieved August 19, 2015, from http://www.washingtonpost.com/business/economy/puerto-rico-with-at-least-70-billion-in-debt-confronts-a-rising-economic-misery/2013/11/30/f40a22c6-5376-11e3-9fe0-fd2ca728e67c_story.html

[11] Valentin, L.J., (2015, Jun 30). Puerto Rico lawmakers pass fiscal 2016 budget. In Caribbean Business website. Retrieved September 3, 2015, from http://www.caribbeanbusinesspr.com/news/puerto-rico-lawmakers-pass-fiscal-2016-budget-112823.html

[12] Coto, D. (2015, May 14). Puerto Rico Closes Dozens of Schools as Economic Woes Deepen. In Yahoo News. Retrieved August 19, 2015, from http://news.yahoo.com/puerto-rico-closes-dozens-schools-economic-woes-deepen-144525966.html

[13] Rodrigues, V., & Bullock, N. (2014, January 23). Puerto Rico: Harbour of Debt. In Financial Times. Retrieved August 19, 2015, from http://www.ft.com/cms/s/0/cefd9c14-834c-11e3-86c9-00144feab7de.html#axzz3jjyLtnyi

[14] Krugman, P. (2013, June 6). How the Case for Austerity Has Crumbled. In The New York Review of Books. Retrieved August 19, 2015, from http://www.nybooks.com/articles/archives/2013/jun/06/how-case-austerity-has-crumbled/

their debt.[15] Hedge funds like BlueMountain, Angelo, Gordon & Co., Knighthead Capital Management, D.E. Shaw Galvanic Portfolios, and Marathon Asset Management have spent heavily on lobbyists in Washington, D.C., to oppose HR 870, a bill introduced by Puerto Rico Resident Commissioner Pedro Pierluisi to treat Puerto Rico as a state under Chapter 9 of the federal bankruptcy code. Each state currently has the authority to allow their municipalities to file for bankruptcy.[16,17,18]

Hedge fund managers were told of the risks of debt restructuring

Investments carry risks. Even the most profitable investors are certain to lose money on some investments. Taking greater risks can lead to earning greater potential rewards and greater potential losses – indeed, this remains a core principle of finance.

Many of the Puerto Rican institutions selling these bonds would be subject to Chapter 9 bankruptcy protections should Congress approve HR 870. The risks of these investments were well known in advance of their sale – indeed, in publicly available documents, clear warnings were offered to investors that profit was not guaranteed and that the bonds carried significant potential for investor losses. Each analysis below covers a Puerto Rican public corporation that was well known to face potential Chapter 9 protection should HR 870 become law. In some cases, the financial risk involved in purchasing the bonds was directly attributed to the potential for some kind of future debt restructuring. Hedge fund managers had every reason to proceed cautiously.

Highlights of these public warnings are available below. All emphases are added to demonstrate the clarity of the language.

Puerto Rico Electric Power Authority (PREPA)

In late June of 2014, Fitch Ratings highlighted both the risks of buying Puerto Rican electric authority bonds and the "probable" upcoming debt default.

> Fitch Ratings has downgraded the rating on $8.7 billion of Puerto Rico Electric Power Authority (PREPA) power revenue bonds to 'CC' from 'BB'.

[15] Delavingne, L. (2015, July 22). Hedge fund sues Puerto Rico over new bond law. In CNBC.com. Retrieved August 24, 2015, from http://www.cnbc.com/2014/07/22/hedge-fund-sues-puerto-rico-over-new-bond-law.html
[16] Clients lobbying on H.R.870 : Puerto Rico Chapter 9 Uniformity Act of 2015. (n.d.). In OpenSecrets.org Center for Responsive Politics. Retrieved August 19, 2015, from http://www.opensecrets.org/lobby/billsum.php?id=hr870-114
[17] Ho, C. (2015, July 2). Competing Lobbying Campaigns Clash Over Puerto Rico Debt Crisis. In The Washington Post. Retrieved August 19, 2015, from http://www.washingtonpost.com/news/powerpost/wp/2015/07/02/competing-lobbying-campaigns-clash-over-puerto-rico-debt-crisis/
[18] Arbasetti, J. C., & Minet, C. (2015, July 14). Out in the Open, Hedge Funds in Puerto Rico. In Centro de Periodismo Investigativo. Retrieved August 19, 2015, from http://periodismoinvestigativo.com/2015/07/out-in-the-open-hedge-funds-in-puerto-rico/

> The downgrade reflects Fitch's view that, based on its reading of newly proposed legislation, *a debt restructuring or default by the Authority is probable* in light of the legislation, and given the near-term liquidity demands brought on by maturing bank lines of credit and the required repayment of outstanding loans due in July and August 2014. [. . .]
>
> On June 25, 2014, the Governor of Puerto Rico introduced the Puerto Rico Public Corporation Debt Enforcement and Recovery Act in order to establish a debt enforcement, recovery and restructuring regime for the public corporations and instrumentalities of the Commonwealth of Puerto Rico during an economic emergency. The bill is intended to introduce a bankruptcy-like process and provide an orderly recovery regime for public corporations that may become insolvent. *The bill is expected to be signed by June 30, 2014.* [19]

<u>Puerto Rico Aqueduct & Sewer Authority (PRASA)</u>

In an April 2015 document accompanying the offer of a water and sewer bond, Standard & Poor's Ratings Services offered a clear warning that Puerto Rico's debts were "unsustainable":

> Standard & Poor's Ratings Services lowered its rating on all Puerto Rico Aqueduct & Sewer Authority (PRASA) debt two notches to 'CCC+' from 'B'. At the same time, we placed the ratings on CreditWatch with negative implications. The downgrade reflects a similar action Standard & Poor's took on the commonwealth's general obligation (GO) and related ratings on April 24, 2015.
>
> The actions were based on our view that the commonwealth's market access prospects have further weakened and its ability to meet its financial commitments is increasingly tied to favorable business, financial, and economic conditions. *Absent economic improvement, GO debt and other financial commitments will be unsustainable*.[20]

Standard & Poor's offered another warning about the same bond in early July:

> Standard & Poor's Ratings Services lowered its rating two notches to 'CCC-' from 'CCC+', on Puerto Rico Aqueduct & Sewer Authority's (PRASA) senior-lien revenue bonds and removed it from CreditWatch with negative implications. The outlook is negative.

[19] Fitch Downgrades Puerto Rico Electric Power Auth's Rev Bonds; Maintains Watch Negative. (2014, June 26). In Fitch Ratings. Retrieved August 19, 2015, from https://www.fitchratings.com/site/fitch-home/pressrelease?id=836809

[20] Chapman, T. A., & Panger, J. M. (2015, April 27). Puerto Rico Aqueduct & Sewer Authority; General Obligation Equivalent Security; Water/Sewer. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/SPdowngPRASAabril2515Summary.pdf

> PRASA has approximately $3.5 billion in senior-lien revenue bonds. The bonds are secured, as per the terms of the 2008 master agreement of trust and as amended in 2012, by a first lien on the gross revenues of PRASA's retail waterworks and sanitary sewer system. The rating action is based on our June 30, 2015, downgrade to 'CCC-' of the Commonwealth of Puerto Rico's general obligation (GO) and related issuers' debt. *That action was based on our view that a default, distressed exchange, or redemption of the commonwealth's debt appears inevitable within the next six months absent unanticipated significantly favorable changes in the issuers' circumstances*.
>
> *We believe that the Puerto Rico government's embrace of a report, released June 29, 2015, that recommends a restructuring of the commonwealth's debt, among other options, indicates that such a move is a significant possibility* over the next six months in light of the commonwealth's fiscal struggles. A restructuring could include public corporations such as PRASA. Currently, Puerto Rico faces a diminished liquidity position, constraints on external market access for cash flow financing, and a delay in enacting a budget for the new fiscal year that began July 1.[21]

<u>Puerto Rico Highways and Transportation Authority (HTA)</u>

In July 2014, Standard & Poor's offered a clear warning about the risks of Puerto Rico Highways and Transportation Authority bonds.

> Standard & Poor's Ratings Services has lowered its rating on the Puerto Rico Highways and Transportation Authority (HTA) to 'B' from 'BB+' and was removed from CreditWatch and assigned a negative outlook.
>
> *The rating actions follow the enactment of the Puerto Rico Public Corporation Debt Enforcement Act (the Act), which allows certain Puerto Rican public corporations and other instrumentalities of the commonwealth to seek protection from creditors through a debt restructuring.* Although the Act specifically excludes GO, general fund appropriation secured, and COFINA [a subsidiary of the Government Development Bank that offers Puerto Rico Sales Tax Revenue Bonds] secured debt, we believe it could potentially limit the demand for liquidity and budgetary support to the public corporations from the commonwealth and the Government Development Bank. *We also believe that the enactment of the bill is indicative of the mounting economic and fiscal challenges for the commonwealth as a whole, which could lead to additional liquidity pressures in the long term, and enactment of the legislation itself signals a potential shift in the commonwealth's historically strong willingness to*

[21] Chapman, T. A., & Panger, J. M. (2015, July 2). Puerto Rico Aqueduct & Sewer Authority; General Obligation Equivalent Security; Water/Sewer. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/SPDowngPRASAjul-2-15-1.pdf

> *continue to meet its obligations to bondholders, particularly in the event of constrained market access.*[22]

Puerto Rico Employees Retirement System (PRERS)

In July 2012, Standard & Poor's offered clear warnings about PRERS bonds.

> Standard & Poor's Ratings Services revised its outlook on the Employees Retirement System (ERS) of the Government of the Commonwealth of Puerto Rico's $2.9 billion in senior pension funding bonds, series A, B, and C to negative from stable based on *our opinion of the ability of the leading participating employers* including, but not limited to the commonwealth, *to continue to make their required contributions to the system in full and on a timely basis.* At the same time, Standard & Poor's affirmed its 'BBB-' rating on the bonds.[23]

Puerto Rico Infrastructure Financing Authority (PRIFA)

Standard & Poor's downgraded PRIFA bonds in July 2014 with a reference to a more in-depth analysis published separately.

> Standard & Poor's Ratings Services has lowered its rating on Puerto Rico Infrastructure Financing Authority's series 2011B and 2011C revenue bonds, issued for the port authority project, one notch to 'BB-' from 'BB'. [. . .] For further information, see the article titled, "Government Development Bank for Puerto Rico Long-Term Issuer Credit Rating Lowered To 'BB-'; Outlook Negative", published July 11, 2014, on RatingsDirect.[24]

That article states in part:

> We believe that the recently passed legislation allowing certain Puerto Rican public entities, including the Puerto Rico Highways and Transportation Authority (HTA), to restructure their debt obligations could lead to a potential shift in the

[22] Hitchcock, D. G., & Aldrete-Sanchez, H. G. (2014, July 11). Puerto Rico GO Rating Lowered One Notch To 'BB' Following Debt Legislation; Outlook Negative. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/SPdowngradeJuly112014.pdf

[23] Aldrete-Sanchez, H., & Hitchcock, D. G. (2012, July 26). Puerto Rico Employees Retirement System Outlook Revised To Negative From Stable Based On Budget And Pension Challenges. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/2012-08-21-us.pdf

[24] Ardolina, L., & Souffront, S. (2014, July 30). Puerto Rico Infrastructure Financing Authority Series 2011B And 2011C Bond Rating Lowered To 'BB-'; Off Watch Negative. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/SPdownPRIFA-PortsJul282014.pdf

> Commonwealth's historically strong willingness to continue to meet its obligations to bondholders.[25]

Puerto Rico Municipal Finance Agency (PRMFA)

Standard & Poor's warned of the risks of PRMFA bonds in September 2012.

> Standard & Poor's Ratings Services has revised its outlook on the Puerto Rico Municipal Finance Agency's (MFA) bonds outstanding to negative from stable and affirmed its 'BBB-' rating. *The outlook revision is based on our assessment of the pledged revenues securing the bonds, including revenue derived from the commonwealth's pledge to appropriate funds for the repayment of debt service*. MFA has approximately $1.1 billion in bonds outstanding.[26]

Puerto Rico Sales Tax Financing Corp (PRSTFC)

In October 2013, Standard & Poor's downgraded its outlook on PRSTFC.

> Standard & Poor's Ratings Services has revised its outlook on Puerto Rico Sales Tax Financing Corp.'s (COFINA) first and second-lien bonds to negative from stable.[27]

Puerto Rico Public Finance Corp. (PFC)

In July 2015, Standard & Poor's downgraded PFC.

> Standard & Poor's Ratings Services has lowered its 'CCC-' rating on Puerto Rico Public Finance Corp. (PFC) series 2011A and B and series 2012 A bonds to 'CC' following non-appropriation of debt service by the legislature in the fiscal 2016 budget. We see default for this debt on its next debt service date, Aug. 1, 2015, as a virtual certainty. The rating outlook is negative.[28]

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[25] Standard & Poor's. (2014, July). Government Development Bank for Puerto Rico Long-Term Issuer Credit Rating Lowered To 'BB-'; Outlook Negative Jul 14. Retrieved Aug. 24, 2015, from http://www.researchandmarkets.com/reports/2885783/government-development-bank-for-puerto-rico-long

[26] Aldrete-Sanchez, H. B., & Hitchcock, D. G. (2012, September 6). Puerto Rico Municipal Finance Agency; Miscellaneous Tax. In The Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/2012-09-07-PuertoRicoMunFinAgyReview2012-09-06-2012.pdf

[27] Hitchcock, D. G., & Aldrete-Sanchez, H. G. (2013, October 1). Puerto Rico Sales Tax Financing Corp; Sales Tax. In Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/2013-10-07-RatingsDirect_Analysis_COFINAOct113.pdf

[28] Hitchcock, D. G., & Petek, G. J. (2015, July 20). Puerto Rico PFC Rating Lowered To 'CC'; All Puerto Rico Tax-Backed Debt Placed On CreditWatch Negative. In Commonwealth of Puerto Rico Government Development Bank for Puerto Rico. Retrieved August 19, 2015, from http://www.gdb-pur.com/investors_resources/documents/SPRatingsDirectNews-PFC-Jul-20-2015.pdf

Hedge fund managers bet that the high risk was a chance for higher profits – and lost

Hedge fund managers did not just know the risk – they depended on it. Their profitability relies on accurately assessing exactly this kind of situation. They invested heavily in a 2014 bond offering, expecting an economic recovery, despite the warnings from ratings agencies.

> [In 2014 Puerto Rico offered] the largest junk deal ever for the $3.7 trillion municipal market. […] Most of the original purchasers were hedge funds, and first-day trading in the bonds exceeded $5 billion. […] Investors are buying junk-rated munis for their higher yields as a growing U.S. economy boosts confidence the debt will be repaid. High-yield issuers are rated below Baa3 by Moody's Investors Service and lower than BBB- at Standard & Poor's.[29]

A June 30 *New York Times* article provides a window into the assumptions and calculated strategy behind such bond purchases.

> Some hedge funds had invested in Puerto Rico debt, expecting a restructuring all along. Firms like Blue Mountain Capital have bought up bonds owed by the Puerto Rico Electric Power Authority at steep discount. On Tuesday, the utility was close to a deal that would avert a default and possibly allow some of its creditors to eventually profit from their investments in its $9 billion in debt.
>
> Until this week, a restructuring of general obligation bonds, which carry a constitutional guarantee to repay, seemed like an impossibility, making the hedge funds' investment look bulletproof.
>
> For the hedge funds, the idea was to lend the money at high interest rates, then flip the bonds to traditional municipal bond investors, like mutual funds, once the fiscal crisis on the island had passed. As part of that strategy, some of the hedge funds circulated research last summer arguing that Puerto Rico's problems were overstated.[30]

Immediately after the 2014 sale, one of the world's best known hedge fund managers sold his just-purchased $120 million holding.[31] Analysts began to declare large hedge fund investments in Puerto Rico a mistake. In February of this year, Bob DiMella, the co-head of

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[29] Kaske, M. (2014, March 23). Puerto Rico Luring Individuals as Trading Examined: Muni Credit. In Bloomberg. Retrieved August 19, 2015, from http://www.bloomberg.com/news/print/2014-03-23/puerto-rico-luring-individuals-as-trading-examined-muni-credit.html

[30] Corkery, M., & Stevenson, A. (2015, June 30). Hedge Funds Fight to Save Puerto Rico Investments. In The New York Times. Retrieved August 19, 2015, from http://www.nytimes.com/2015/07/01/business/dealbook/hedge-funds-fight-to-save-commonwealth-investments.htm

[31] Corkery, M., & Stevenson, A. (2015, June 30). Hedge Funds Fight to Save Puerto Rico Investments. In The New York Times. Retrieved August 19, 2015, from http://www.nytimes.com/2015/07/01/business/dealbook/hedge-funds-fight-to-save-commonwealth-investments.htm

MacKay Municipal Managers, reflected that many investors made the same errors. "[E]ven hedge funds got tripped up here."[32] Robert Donahue, a managing director at Municipal Market Analytics, said recently that "hedge funds miscalculated and they are feeling the pain."[33]

Puerto Rican families should not be required to pay the price of that miscalculation, in which they had no part.

HR 870

Puerto Rico's elected representative in Washington, Resident Commissioner Pedro Pierluisi, introduced HR 870 earlier this year to extend Chapter 9 protections to the territory. It has been endorsed in the *Washington Post* (twice), *Wall Street Journal*, *Bloomberg View* (three times), *New York Times* (three times), *Los Angeles Times*, *Miami Herald*, *Pittsburgh Post-Gazette*, and *Boston Globe*, among dozens of other outlets. It provides the clearest path forward for creditors seeking to recoup some of their investment, Puerto Rican institutions looking for a financial path forward, and the people of Puerto Rico people who rightly fear the damage that deep budget cuts would do to their already economically-challenged community.

When asked to defend their opposition to granting Puerto Rico's public corporations access to Chapter 9, some have argued that because the utilities were not able to file for Chapter 9 bankruptcy protection when the investments were made, allowing them to do so now would mean Congress is changing the rules in the middle of the game. This argument ignores the fact that Congress has always had the authority to allow Puerto Rico to restructure its debt – a potential outcome disclosed in bond rating documents. The argument also ignores the fact that the risk of default was a primary reason for the high potential returns on the bonds, which is what induced some hedge funds to buy so many in the first place. Hedge funds knew about the risk of debt restructuring and sought to profit from that risk.

Conclusion

Conversations with some analysts depict an atmosphere in which hedge funds treat efforts to maximize returns as a casual game pitting very sophisticated investors with significant financial, legal and political assets against anyone who threatens the bottom line. It is important to remember that the economic crisis in Puerto Rico is real to those living through it every day. Unemployment is at record levels. Poverty levels are higher than any state in the nation. The economy has been described as having "kind of disappeared from the map."[34] It

[32] Fox, M. (2015, February 10). Tempted by Puerto Rico Bonds? Be Careful, Expert Warns. In CNBC.com. Retrieved August 19, 2015, from http://www.cnbc.com/2015/02/10/tempted-by-puerto-rico-bonds-be-careful-expert-warns.html

[33] Fox, M. (2015, February 10). Tempted by Puerto Rico Bonds? Be Careful, Expert Warns. In CNBC.com. Retrieved August 19, 2015, from http://www.cnbc.com/2015/02/10/tempted-by-puerto-rico-bonds-be-careful-expert-warns.html

[34] Surowiecki, J. (2015, April 6). The Puerto Rican Problem. In The New Yorker. Retrieved August 19, 2015, from http://www.newyorker.com/magazine/2015/04/06/the-puerto-rican-problem

is causing residents of the island of all social classes to pack up and leave. From 2010 to 2013, about 50,000 people – mainly younger workers – left Puerto Rico for the U.S. mainland every year.[35]

The profits that hedge funds are trying to extract are coming out of the pockets of hard-working Puerto Rican families. For institutional investors to demand full repayment on investments they knew to be risky is both unjust and unrealistic, considering the destruction of Puerto Rico's long-term economic viability that would result. Puerto Rico's public corporations need Chapter 9 bankruptcy protection. It is time to stop letting Wall Street investors pad their resumes and line their pockets with money from families stuck in struggling economies. This is true for Puerto Rico and anywhere else a hedge fund tries to squeeze a profit from people who had nothing to do with their investment decisions.

35 Carasik, L. (2015, August 11). Gutting Schools Won't Solve Puerto Rico's Debt Crisis. In Al Jazeera America. Retrieved August 19, 2015, from http://america.aljazeera.com/opinions/2015/8/gutting-schools-wont-solve-puerto-ricos-debt-crisis.html