# ON THE DECISION TO REGULATE HEDGE FUNDS: THE SEC'S REGULATORY PHILOSOPHY, STYLE, AND MISSION

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*In a controversial move in late 2004, the Securities and Exchange Commission (SEC) decided to require hedge fund managers to register with the agency as investment advisers. Until then, the SEC had largely refrained from ramping up hedge fund regulation, even after the collapse of Long-Term Capital Management in 1998.*

*Although this article takes some issue with the SEC's decision to regulate hedge funds, its primary focus is not on the particular costs and benefits of regulating hedge funds. The inquiry is broader: what can we learn generally about SEC decision making and securities regulation from the SEC's decision to regulate hedge funds now by subjecting fund managers to the registration requirements of the Investment Advisers Act? Since the SEC consciously shifted direction in deciding to regulate hedge funds—and in doing so overstepped the traditional boundary of securities regulation by looking past the ability of sophisticated and wealthy hedge fund investors to protect themselves—the hedge fund rule prompts reconsideration of SEC decision making, particularly in the aftermath of Enron and the other recent corporate scandals that marked the early 2000s.*

*Although nobody knows for sure what motivates a regulator, the SEC's decision to adopt its new hedge fund rule is consistent with two views—one political; the other, psychological. First, the SEC did not want to get caught flat-footed and embarrassed again, as it had been*

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*by Enron, WorldCom, the mutual fund abuses, and securities analyst conflicts of interest. Second, after the earlier scandals, the risk of fraud and other hedge fund abuses weighed disproportionately on the agency, prompting it to act when it had not in the past. The particular concern is that such political and psychological influences result in overregulation.*

*This article concludes with a suggestion. To mitigate the risk of overregulation, the SEC should increasingly consider using default rules instead of mandatory rules. Defaults at least give parties a chance to opt out if the SEC goes too far. Indeed, in some cases, perhaps the SEC can exercise an even lighter touch and simply articulate best practices.*

## I. INTRODUCTION

The hedge fund industry is a trillion dollar business.[1] In large part, hedge funds are defined by the extent to which the Securities and Exchange Commission (SEC) does not regulate them. The standard hedge fund structure has ensured that a hedge fund is not subject to the principal regulatory requirements of the federal securities laws.[2] This is not to suggest that hedge funds skirt SEC regulation as a result of shenanigans where hedge fund managers strain to fit their funds within obscure legal loopholes. Rather, the design of federal securities laws itself has caused hedge funds to be lightly regulated.[3] There are well-established exclusions from the key mandates of the Securities Act of 1933 (1933 Act), the Securities Exchange Act of 1934 (1934 Act), the Investment Company Act of 1940 (Investment Company Act), and, until recently, the Investment Advisers Act of 1940 (Advisers Act). Hedge funds have simply been structured in an open and aboveboard fashion to take advantage of the exclusions that Congress has seen fit to build into the securities law regime.

However, at least to a degree, the regulatory landscape has recently changed for hedge funds. In 2004, in a divisive and controversial three-to-two vote by an agency that overwhelmingly acts unanimously, the SEC adopted a new hedge fund rule that requires hedge fund managers to register as investment advisers under the Advisers Act.[4]

Requiring hedge fund managers to register under the Advisers Act is a measured step by the SEC that, while imposing some burdens on

1. HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT: REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 1 (1999), *available at* http://www.treas.gov/press/releases/reports/hedgefund.pdf [hereinafter HEDGE FUNDS].

2. *Id.* at 3.

3. Robert C. Pozen, *Hedge Funds Today: To Regulate or Not?*, WALL ST. J., June 20, 2005, at A14.

4. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 84 SEC Docket 1032 (Dec. 2, 2004) [hereinafter Final Hedge Fund Rule Release].

hedge funds, does not require those funds to register their securities offerings, provide the extensive quarterly or annual disclosures required of public companies, or comply with the panoply of mandates that burden mutual funds. The crux of the SEC's new hedge fund rule, then, is not the rule's substance but the fact that the SEC decided to regulate hedge funds at all.

What can we learn more generally about SEC decision making and securities regulation from the agency's recent decision to regulate hedge funds by subjecting fund managers to the Advisers Act? Because the SEC consciously shifted direction in deciding to regulate hedge funds, the SEC's new hedge fund rule provides an opportunity to revisit the SEC's overall regulatory philosophy and style, particularly in the aftermath of Enron, WorldCom, and other recent scandals.[5] This article anchors in the SEC's new hedge fund rule as an example of SEC decision making that provides a useful lens through which to view the institution of the SEC and how it behaves. Because hedge funds provide a weak case for SEC intervention, something the SEC implicitly conceded until very recently, it is important to consider what influences might have weighed on the SEC this time around.

Although nobody knows for sure what motivates a particular regulator, the SEC's decision to regulate hedge funds is consistent with two views, both of which have broader implications for securities regulation. First, the SEC did not want to get caught flat-footed and embarrassed again, as it had been by the scandals at Enron, WorldCom, numerous mutual funds, and elsewhere, by seeming to take a lax regulatory stance with respect to hedge funds in the post-Enron era. Second, on the heels of the earlier scandals, the risk of fraud and other hedge fund abuses loomed disproportionately large at the SEC, prompting it to act when in the past the agency had abstained from doing so—that is, the SEC irrationally reassessed upward the cost of not regulating hedge funds.

Part II summarizes the hedge fund industry and its regulation. In considering the merits of requiring hedge fund managers to register as investment advisers under the Advisers Act, Part III revisits the fundamental problem that the federal securities laws' mandatory disclosure regime addresses in an effort to crystallize what it means for an investor to be "informed." When is government intervention warranted to protect investors against fraud and information asymmetries? What does it

5. Whether or not the Federal Reserve or the Treasury Department should regulate the hedge fund industry is beyond this article's present scope. Further, this article does not cover the regulation of broker-dealers, including prime-brokers, or other creditors or counterparties of hedge funds. For a comprehensive assessment of theses relationships, see COUNTERPARTY RISK MANAGEMENT GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005), *available at* http://www.crmpolicygroup.org/docs/CRMPG-II.pdf.

For an insightful article that studies what drives and constrains decision making at the SEC, see Donald C. Langevoort, The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty (manuscript on file with author).

mean for investors to be able to fend for themselves in the face of imperfect information, militating against stricter regulation? Part III does not purport to evaluate comprehensively the costs and benefits of hedge fund regulation. Part III's more modest purpose is briefly to assess the merits of the new hedge fund rule, particularly from the vantage point of SEC efforts to protect hedge fund investors, because such an assessment suggests that the SEC overstepped the traditional boundary of securities regulation by looking past the ability of sophisticated and wealthy hedge fund investors to protect themselves. This, then, leads into the subsequent discussion, which tries to explain why the SEC took such steps now.

Part IV examines particular psychological and political factors that seemed to impact SEC regulation in the aftermath of the corporate, accounting, and mutual fund scandals that began to emerge in the fall of 2001. Trying to understand the SEC's decision in 2004 to regulate hedge funds when it had not done so earlier prompts the broader inquiry into SEC decision making. Part IV turns from the merits of the SEC's hedge fund rule to focus on the psychology and politics of investor protection, as well as the potential consequences of an investor protection orientation to regulation, particularly when fueled by market crashes or high-profile scandals. Simply put, the problem is that the SEC will overregulate.[6] Part IV first takes a behavioral perspective, considering securities regulation in terms of the so-called "precautionary principle," which has been most influential in the areas of environmental and health regulation. The behavioral discussion stresses how certain unconscious psychological biases can cause frauds and other instances of corporate malfeasance to weigh disproportionately on securities regulators, skewing their assessment of the costs and benefits of regulating in favor of regulation when a less biased appraisal may caution a less aggressive regulatory stance. An SEC, for example, that places a priority on investor protection may by its own lights crack down too heavily if it irrationally fears corporate malfeasance because of various psychological biases that tilt the agency's cost-benefit analysis. Part IV then considers the political economy of securities regulation. The discussion highlights that regulatory competition, particularly when coupled with the rise of an "investor class" in the United States and the watchful eye of a financial and business media, can spur the SEC to regulate too aggressively.

It is worth noting at the outset that the discussion of overregulation acknowledges that there are no clear markers to guide the SEC or any other administrative agency in ascertaining the line between too much and too little regulation. The regulatory "sweet spot" is hard to identify because of normative disagreements over what risks are tolerable and because information imperfections make it difficult to know the costs

6. This article discusses what it means to "overregulate" *infra* Part IV.E.

and benefits of regulating. Although the discussion in Part IV focuses on the SEC and securities regulation, the analysis informs our understanding of the economics, politics, and psychology of risk regulation in the economy more broadly.[7]

Policymakers often see themselves as having two choices: adopt particular mandates or do nothing. There is, of course, a third option: adopt default rules that govern unless parties opt out of them. Part V explains that the SEC, to mitigate the risk of overregulating securities markets, should rethink its regulatory technique. Instead of imposing mandatory requirements, the SEC might consider adopting default rules that securities market participants can bargain around. In fact, the SEC can exercise an even lighter touch. In some instances, the SEC can simply recommend best practices that the SEC believes *should* be followed but without any legal consequences if they are not. This is to say, the SEC could leverage market discipline and the law's so-called "expressive function" as an alternative to mandatory one-size-fits-all regulations. For example, one can envision a rule that allows hedge fund managers to opt out of a default requirement that they register under the Advisers Act. One can also imagine the SEC articulating hedge fund best practices through a formal commission release or through the drumbeat of speeches by the commissioners and senior staff. Part VI concludes.

## II. A BRIEF SUMMARY OF THE HEDGE FUND INDUSTRY AND ITS REGULATION

Hedge fund critics have characterized hedge funds as "shadowy" investment vehicles that "escape" regulation by "exploiting loopholes" in the federal securities laws in order to freewheel in the equivalent of a "wild west" financial frontier.[8] Although this rhetoric exaggerates the

7. This article's discussions of the psychology and political economy of securities regulation at the SEC implicate the broad literature on democratic (or populist) versus technocratic (or autocratic) approaches to the administrative state, including the literature on the risk perception of experts versus the risk perception of the lay public. It is, however, beyond this article's scope to rehearse the extensive literature on the administrative state. For a small sampling of this work, see STEPHEN BREYER, BREAKING THE VICIOUS CIRCLE: TOWARD EFFECTIVE RISK REGULATION (1993); PAUL SLOVIC, THE PERCEPTION OF RISK (2000); CASS R. SUNSTEIN, LAW OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005); W. KIP VISCUSI, RATIONAL RISK POLICY (1998); Samuel R. Bagenstos, *The Americans with Disabilities Act as Risk Regulation*, 101 COLUM. L. REV. 1479 (2001); Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1 (1995); Jim Rossi, *Participation Run Amok: The Costs of Mass Participation for Deliberative Agency Decisionmaking*, 92 NW. U. L. REV. 173 (1997); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059 (2000); Cass R. Sunstein, *The Laws of Fear*, 115 HARV. L. REV. 1119 (2002) (reviewing PAUL SLOVIC, THE PERCEPTION OF RISK (2000)). For more on the administrative state generally, see articles cited *infra* notes 173 and 187.

8. Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 611 (2001); Gretchen Morgenson, *A Fib Here, A Scandal There*, N.Y. TIMES, Sept. 18, 2005, § 3, at 1; Winston Ray, *Name of the Game Is Boosting Returns and Reducing Risk*, S. CHINA MORNING POST, Dec. 1, 2003, at 6; David Roeder, *Bond Manager Yields to Muni Temptation*, CHI. SUN-TIMES, May 1, 2005, at 42.

point, there is some substance to the bad rap that hedge funds have received. Hedge funds, for example, were implicated in the market timing and late trading scandals that have plagued the mutual fund industry.[9] Regulators have questioned whether Wall Street firms who serve as prime brokers place investors in hedge funds in part because the hedge funds agree to use the firms for other profitable services relating to the funds' trades.[10] The NASD, which regulates broker-dealers, has highlighted instances indicating that brokers sometimes fail to conduct appropriate suitability analyses or fully disclose risks when marketing hedge funds to individual investors.[11] There was also concern that hedge funds might be manipulating takeover outcomes when a hedge fund with shares in a target company was flagged for vote buying when it acquired shares in the bidder and then hedged its long position.[12] In addition to other enforcement actions that the SEC has brought against hedge funds, in an extraordinary move in early 2005, the SEC sought and received emergency relief to stop an alleged $81 million fraud involving a number of related hedge funds run by the KL Group.[13] Later in 2005, the SEC and the marketplace witnessed a major fraud at Bayou Management that brought down the hedge fund.[14]

Aside from concerns over illicit behavior in the hedge fund industry, many people start out skeptical of hedge funds because they do not understand hedge funds' investment strategies, including the complex models that underlie them.[15] Others are troubled because hedge funds often

9. *See* John C. Coffee, Jr., *A Course of Inaction: Where Was the SEC When the Mutual Fund Scandal Happened*, 2004 LEGAL AFF. 46 [hereinafter Coffee, *A Course of Inaction*]; Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 929–33 (2005); Kate Kelly & Ian McDonald, *Invesco, AIM Settle Trading-Abuse Cases*, WALL ST. J., Sept. 8, 2004, at C1; Paul Schott Stevens, *Honest Funds*, WALL ST. J., Sept. 13, 2004, at A20.

10. *See, e.g.*, Jed Horowitz, *Moving the Market: Wall Street Woos Hedge Funds Despite Worries Over Losses*, WALL ST. J., May 16, 2005, at C3; Henny Sender & Gregory Zuckerman, *Are Hedge Funds and Brokers Too Interlocked?—As SEC Opens Talks on Industry, Matchmaking Grabs Attention; Investor Suitability Is an Issue*, WALL ST. J., May 15, 2003, at C1.

11. *See, e.g.*, Susanne Craig, *Hedge Funds Can Be Headache for Broker, as CIBC Case Shows*, WALL ST. J., Feb. 22, 2005, at C1; Gregory Zuckerman, *Hedge-Fund Ads Prompt NASD's First Crackdown*, WALL ST. J., Apr. 23, 2003, at C5.

12. *See* Andrew Ross Sorkin, *Icahn Accuses a Hedge Fund of Stock Manipulation*, N.Y. TIMES, Dec. 13, 2004, at C1.

Hedge funds have generally become more active in how the businesses they invest in are run, as well as in corporate governance. *See infra* note 101.

13. Press Release, SEC Obtains Emergency Relief Against Palm Beach, Florida, Hedge Funds for $81 Million Fraudulent Offerings (Mar. 3, 2005), *available at* http://www.sec.gov/news/press/2005-27.htm; *see also* Julie Creswell, *Paradise and Money Lost*, N.Y. TIMES, Aug. 14, 2005, § 3, at 1.

14. Ian McDonald et al., *Hedge-Fund Havoc: Missing Cash and a Principal's Suicide Note; Letter Admits Years of Fraud at Bayou, the Police Say; Firm Had Tie to Its Auditor; Unaccounted for: $440 Million*, WALL ST. J., Aug. 29, 2005, at A1; Gretchen Morgenson et al., *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1.

15. *See* CFA Institute, *Hedge Funds 101: What Investors Need to Know*, http://www.cfainstitute.org/investors/hedgefunds101.html.

make money by betting against the market[16] or when markets are particularly volatile. As a final salvo, hedge fund critics balk that hedge fund managers charge a rich management fee of one to two percent of the assets under management plus around twenty percent of the fund's profits, if not more.[17] A recent study receiving media attention found that the average compensation of the top 25 managers of hedge funds was around $250 million in 2004.[18] It is not uncommon for hedge fund managers to make tens of millions of dollars a year.

A better understanding of a hedge fund is necessary before proceeding with the discussion.[19] There is no definition of a "hedge fund" under the federal securities laws.[20] Rather, hedge funds typically are described blandly as lightly regulated private investment vehicles that try to

16. *See* Jesse Eisinger, *Hedge Trimmers*, WALL ST. J., Apr. 14, 2004, at C1; Randall Smith et al., *Regulators Review Complaints About Hedge Funds' Research—Companies with Beaten Stocks Tell Eliot Spitzer and the SEC that Negative Research Is to Blame*, WALL ST. J., Jan. 22, 2003, at C1; Kopin Tan, *Options Report: Stock Slip, and Investors Look to Hedges*, WALL ST. J., Feb. 22, 2002, at C10.

17. Riva D. Atlas, *Hedge Funds Are Stumbling but Manager Salaries Aren't*, N.Y. TIMES, May 25, 2005, at C5; Nina Munk, *Gunslingers No More: The Cautious Cash In*, N.Y. TIMES, May 22, 2005, § 3, at 4.

18. *See* Atlas, *supra* note 17. Another survey showed that hedge fund managers earned on average nearly $1.2 million in total compensation in 2004. *See Hedge Fund Manager Salaries Jump*, CNN MONEY, June 28, 2005.

19. For thorough overviews of the hedge fund industry, see LESLIE RAHL, HEDGE FUND RISK TRANSPARENCY: UNRAVELING THE COMPLEX AND CONTROVERSIAL DEBATE (2003); Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189 (1999); William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 309 (1999); Mila Getmansky et al., *Sifting Through the Wreckage: Lessons from Recent Hedge-Fund Liquidations*, 2 J. INVESTMENT MGMT. 6 (2004); HEDGE FUNDS, *supra* note 1; Kyle L. Brandon, *The State of Hedge Funds*, 5 SIA RESEARCH PAPERS, Sept. 20, 2004, *available at* http://www.sia.com/research/pdf/RsrchRprtVol5-10.pdf; Nicholas Chan et al., *Systemic Risk and Hedge Funds* (Feb. 22, 2005), *available at* http://ssrn.com/abstact=671443; DEUTSCHE BANK, FEBRUARY 2004, EQUITY PRIME SERVICES GROUP, 2004 ALTERNATIVE INVESTMENT SURVEY—HEDGE FUNDS: FULL SPEED AHEAD [hereinafter 2004 ALTERNATIVE INVESTMENT SURVEY]; CREDIT SUISSE FIRST BOSTON EQUITY RESEARCH, EUROPEAN WHOLESALE BANKS: HEDGE FUNDS AND INVESTMENT BANKS (2005) [hereinafter EUROPEAN WHOLESALE BANKS]; INVESTOR FORCE, HEDGE FUND SURVEY (Jan. 2003), *available at* http://www.investorforce.com/images/flonetwork/Hedge_Fund_Survey_2003.pdf. For media accounts of the hedge fund industry, see Jenny Anderson & Riva D. Atlas, *Is This the New Emerald City, or the Road to the Next Crash?*, N.Y. TIMES, Mar. 27, 2005, § 3, at 1; Suzanne McGee, *Hedged Bets: Private Bankers Are Guiding the Wealthy to Hedge Funds*, BARRON'S, Oct. 18, 2004, *available at* http://proquest.umi.com/pdlink?did=719728581&Fmt=4&clientld=36305&/RQT=309&VName=PQD; Joseph Nocera, *The Quantitative, Data-Based, Risk-Massaging Road to Riches*, N.Y. TIMES, June 5, 2004, § 6 (Magazine), at 44; Pozen, *supra* note 3; Gregory Zuckerman & Ian McDonald, *Heard on the Street: The Wild West of Hedge Funds Becomes Tamer*, WALL ST. J., Jan. 24, 2005, at C1; David Skeel, *Behind the Hedge*, LEGAL AFF., Dec. 2005, at 28.

For an overview of the hedge fund industry by the SEC staff, see U.S. SECURITIES AND EXCHANGE COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter HEDGE FUND STAFF REPORT]; *see also* Paul S. Atkins, Comm'r, U.S. Securities & Exchange Comm'n, Remarks Before the Managed Funds Association (Sept. 29, 2005), *available at* http://www/sec.gov/news/speech/spch09205psa.htm; Chester S. Spatt, Director, SEC Office of Economic Analysis, Speech by SEC Staff: Economic Aspects of Hedge Funds (July 26, 2005), *available at* http://www.sec.gov/news/speech/spch072605css.htm.

*See also* Tremont Capital Management, http://www.tremont.com (providing one of the most extensive hedge fund databases).

20. *Cf.* M.P. Dunleavy, *Does "Hedge Fund" Mean Anything Anymore?*, N.Y. TIMES, Oct. 9, 2005, § 3, at 26.

maximize risk-adjusted returns for investors as compared to simply beating some index or the market as a whole.[21] To date, hedge funds have regularly been structured as limited partnerships or limited liability companies (LLC), with fund investors being limited partners or LLC members, respectively, who acquire their interests in the fund in private placements that are exempt from the registration requirements of the federal securities laws.[22] Most importantly, perhaps, hedge funds are not mutual funds.[23] Consequently, unlike their mutual fund cousins, hedge funds have wide flexibility in their trading strategies, including shorting securities,[24] and are able to leverage the fund and charge an incentive (or performance) fee tied to the hedge fund's returns. Mutual funds are also subject to strict capital requirements that hedge funds do not have to meet.[25] Without going into detail, typical hedge fund strategies include convertible arbitrage, emerging markets, long/short equity, event-driven, fixed income, global macro, managed futures, market neutral, and short biased.[26] In the past couple of years, hedge funds have increasingly become shareholder activists in a further attempt to generate returns.[27]

If hedge funds occupied only a small corner of the market, there would be no need for government intervention in the industry. In fact, hedge funds are significant players in financial markets. Estimates put the number of hedge funds in 2005 at up to 8000 with total assets around one trillion dollars and growing rapidly.[28] In 1993, by comparison, there

21. HEDGE FUNDS, *supra* note 1, at 10–13.

22. *Id.* at 64–67.

23. Mutual funds are subject to the Investment Company Act of 1940. Hedge funds are structured in such a way as to fall within certain statutory exclusions under the Investment Company Act. In particular, § 3(c)(1) of the Investment Company Act excludes from the definition of an "investment company" subject to the Act any issuer that has outstanding securities beneficially owned by 100 or fewer investors and that has not offered (and does not propose to offer) its securities publicly. Section 3(c)(7) of the Investment Company Act excludes from the definition of "investment company" any issuer whose outstanding securities are owned exclusively by so-called "qualified purchasers." Section 2(a)(51) of the Act defines a "qualified purchaser" to include, among others, (i) any natural person who owns not less than $5 million in investments and (ii) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than $25,000,000 in investments. A fund can have an unlimited number of qualified purchasers and still fall outside the definition of "investment company" and thus not be subject to the Investment Company Act.

24. *Id.* at 56.

25. *Id.* at 55. The Investment Company Act of 1940 operates to limit the extent to which mutual funds can borrow and short securities. Further, mutual funds cannot charge performance fees that only reward the fund manager if the fund performs well without punishing the manager if the fund performs poorly. Mutual Funds must also have enough capital to cover any redemptions.

26. *Id.* at 13–14.

27. *See infra* note 101.

28. Brandon, *supra* note 19, at 6–7; EUROPEAN WHOLESALE BANKS, *supra* note 19; *see Special Report: The New Money Men—Hedge Funds*, ECONOMIST, Feb. 19, 2005, at 73 (discussing the rapid growth of hedge funds and providing an overview of the industry). For an argument that growth in the hedge fund industry is ending, see Edward Chancellor, *Hedge Funds Today: So Much Money So Little Talent*, WALL ST. J., Aug. 24, 2005, at A10.

Traditional Wall Street firms have themselves ventured into the hedge fund business. JP Morgan Chase, for example, acquired Highbridge Capital in 2004. *See* Andy Kessler, Commentary, *JP Hedgie*, WALL ST. J., Sept. 28, 2004, at A22. Other Wall Street firms have established or expanded existing in-

were approximately 1100 hedge funds managing a total of about $50 billion.[29] In 2004 alone, according to some reports, over 1400 new hedge funds were started.[30] Eton Park Capital Management, a hedge fund launched in early 2005, received front-page attention in the financial press. The new fund, run by Eric Mindich, a very successful trader who at one point ran Goldman Sachs' risk-arbitrage trading desk, raised over $3 billion for the fund, which was believed to be the largest amount ever raised by a hedge fund when launched.[31]

The dramatic growth of the hedge fund industry has fueled concerns about so-called "systemic risk," which goes to the safety and soundness of financial markets. Two commentators recently described systemic risk as follows:

> Systemic risk can be defined as the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses. A key feature in the propagation of such a systemic shock is acute uncertainty regarding an institution's ability to satisfy its immediate payment obligations and a simultaneous inability of counterparties to hedge such risk.[32]

Others have described systemic risk more simply as "the possibility of a series of correlated defaults among financial institutions—typically banks—that occurs over a short period of time, often caused by a single major event."[33]

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house hedge funds, in addition to their trading desks. *See* Ann Davis, *Wall Street Builds the "Bionic" Hedge Fund: Securities Firms Construct Them Stronger and Faster, They Hope; Financial Laboratory at Citigroup*, WALL ST. J., Oct. 25, 2004, at C1.

Hedge funds are not only a U.S. phenomenon. *See, e.g.*, Silvia Ascarelli & David Reilly, *Europe is Becoming a Hedge-Fund Heaven; Unlike U.S., Smallfry Can Buy, Despite the High Risks Involved; Investors Bristle at Regulation*, WALL ST. J., Apr. 15, 2005, at C1 (discussing the hedge fund industry in Europe); Geraldo Samor, *Brazil's Hedge Funds Get So Hot, Hot, Hot Nest Eggs Get Fried*, WALL ST. J., June 23, 2004, at C1 (discussing the hedge fund industry in Brazil); Laura Santini, *U.S. Hedge Funds Make a Comeback in Asia; Trading Outposts are Opened in Hong Kong and Singapore, As Firms Recruit Local Talent*, WALL ST. J., Aug. 26, 2004, at C1; Jason Singer, *New Deal: With Rising Clout, Hedge Funds Start to Sway Mergers; Managers in Europe Join Forces to Push Prices Higher; General Dynamics Outbid; Icahn Alleges Vote-Buying*, WALL ST. J., Jan. 25, 2005, at A1 (discussing the role of hedge funds in recent control transactions in the U.K.); *see also* Patrick Jenkins, *The Eclectic Survivor*, FIN. TIMES, May 15, 2005, at 11 (discussing the role of hedge funds in control issues at Deutsche Börse).

29. Brandon, *supra* note 19, at 6–7.

30. *See* Henny Sender, *More Hot Managers Leave Hedge Funds to Start Their Own*, WALL ST. J., Mar. 22, 2005, at C1; *see also* Brandon, *supra* note 19, at 6.

31. *See* Gregory Zuckerman & Henny Sender, *Exclusive Club: Ex-Trader Creates Hot Hedge Fund, and a Traffic Jam; Big Investors Clamor to Join Mr. Mindich's Operation, Despite Stringent Terms; Elsewhere Returns are Down*, WALL ST. J., Jan. 12, 2005, at A1.

32. Paul Kupiec & David Nickerson, *Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation*, 48 J. REAL EST. FIN. & ECON. 123, 123 (2004).

33. Chan et al., *supra* note 19, at 1. For thorough analyses of systemic risk and hedge funds, see *id*. *See also* Timothy F. Geithner, Keynote Address on Hedge Funds and Their Implications for the Financial System (Nov. 17, 2004), *available at* http://www.ny.frb.org/newsevents/speeches/2004/ge:04117.html; HEDGE FUNDS, *supra* note 1; TOWARD GREATER FINANCIAL STABILITY, *supra* note 5. For a concise but useful discussion of systemic risk, see Anna Bernasek, *Could a Few Hedge Funds*

For an example of the sudden destabilizing impact that hedge funds, if large enough, can have on financial markets, people still point to the dramatic 1998 collapse of Long-Term Capital Management (LTCM) and the orchestration by the Federal Reserve Bank of New York of a private bailout of LTCM to arrest the chain reaction of events that threatened global markets if LTCM defaulted on its obligations.[34] The key events leading to LTCM's collapse were as follows. LTCM's primary trading strategy was based on the fund's view that the risk premium on debt would decrease around the globe, in which case the price of more risky debt would increase and the price of less risky debt (for example, government securities) would decrease.[35] Unexpectedly, though, Russia devalued the ruble and declared a debt moratorium in 1998, while, at the same time, the Asian financial crisis persisted.[36] This sparked a "flight to quality," which resulted in the risk premium increasing as investors fled to less risky investments—the exact opposite of what LTCM had bet on.[37] When this flight occurred, LTCM, by some estimates, held more than $125 billion in total assets, had notional derivatives positions exceeding $1.5 trillion, and had an exceptionally high balance-sheet leverage ratio of 25 to 1. The worry was that shockwaves would ripple through global financial markets if LTCM defaulted on its obligations to its creditors and counterparties. This systemic concern prompted the Federal Reserve Bank of New York to act.[38]

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*Spoil the Party?*, N.Y. TIMES, July 3, 2005, § 3, at 4; Henny Sender, *Changing Face of Market Risk; Report Looks at New Complexity of Derivatives, Other Products; Making Sure the "Plumbing" Works*, WALL ST. J., July 27, 2005, at C1.

34. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000); *see also* HEDGE FUNDS, *supra* note 1; Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189 (1999).

For typical commentary following the collapse of LTCM, including calls by some for more regulation, see Susan C. Ervin, *Long Term Impacts of LTCM: Trimming Hedge Funds?*, SE25 A.L.I.-A.B.A. 31 (1999); Mark Gerson & Thomas Lehrman, *Most Hedge Funds Play It Safe*, WALL ST. J., Oct. 1, 1998, at A4; Burton G. Malkiel & J.P. Mei, *Hedge Funds: The New Barbarians at the Gate*, WALL ST. J. Sept. 29, 1998, at A22; Floyd Norris, Editorial Observer, *Risking Everything on One Big Gambler*, N.Y. TIMES, Oct. 1, 1998, at A30; Gerald F. Seib, *Insider Bailouts: Can They Feed Populist Politics?*, WALL ST. J., Sept. 30, 1998, at A20; Leslie Wayne, *Congress to Debate Greater Oversight of Hedge Funds*, N.Y. TIMES, Oct. 1, 1998, at C1.

35. For an accessible discussion of the investment strategy and types of trades that had earlier made LTCM so successful, see LOWENSTEIN, *supra* note 34, at 23–80, 96–120.

36. *Id.* at 123–60.

37. *Id.* at 163.

38. William McDonough, President of the Federal Reserve Bank of New York at the time of LTCM's collapse, put it this way:

> There are several ways that the problems of Long-Term Capital could have been transmitted to cause more widespread financial troubles. Had Long-Term Capital been suddenly put into default, its counterparties would have immediately "closed-out" their positions. If counterparties would have been able to close-out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms had rushed to close-out hundreds of billions of dollars in transactions simultaneously, they would have been unable to liquidate collateral or establish offsetting positions at the previously existing prices. Markets would have moved sharply and losses would have been exaggerated. Several billion dollars of losses might have been experienced by some of Long-Term Capital's more than 75 counterparties.

In 2003, the *Wall Street Journal* featured a story on the demise of Eifuku Master Trust, a Japanese hedge fund with over $300 million under management that collapsed in only seven trading days.[39] Although not posing the same systemic risk as the fall of LTCM, Eifuku's fall underscores, as the *Wall Street Journal* noted, "just how quickly [hedge funds] can implode."[40] In May, 2005, the hedge fund industry was rattled, and many worried about widespread losses throughout financial markets, when Kirk Kerkorian announced an expected offer to buy additional shares of General Motors' outstanding stock, which was followed by Standard & Poor's cutting GM's credit rating to junk status.[41] This one-two punch led to significant losses for hedge funds that had bet that GM's bonds would outperform its stock because the facts went against the hedge funds' models and trading strategies.[42] The stock prices of a number of prominent Wall Street firms, such as J.P. Morgan Chase, Morgan Stanley, and Goldman Sachs, fell as investors sold off their shares amid worries about these firms' exposure to hedge funds.[43]

On the other hand, too much should not be made of systemic risk. The risk associated with a hedge fund's dramatic collapse is relatively remote. LTCM was extremely leveraged and there has been no subsequent systemic threat of LTCM's magnitude. Additionally, the recent $500 million fraud that brought down Bayou posed no systemic risk, although the fund's investors were wiped out. That said, hedge fund activities do impact markets routinely. For example, a recent Credit Suisse

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> These direct effects on Long-Term Capital's counterparties were not our principal concern. While these losses would have been considerable, and would certainly have adversely affected the firms experiencing them, this was not, in itself, a sufficient reason for us to become involved.
>
> Two factors influenced our involvement. First, in the rush of Long-Term Capital's counterparties to close-out their positions, other market participants—investors who had no dealings with Long-Term Capital—would have been affected as well. Second, as losses spread to other market participants and Long-Term Capital's counterparties, this would lead to tremendous uncertainty about how far prices would move. Under these circumstances, 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: a loss of investor confidence, leading to a rush out of private credits, leading to a further widening of credit spreads, leading to further liquidations of positions, and so on. Most importantly, this would have led to further increases in the cost of capital to American businesses.

*Risks of Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Serv.*, 105th Cong. (1998) (statement of William J. McDonough, President, Fed. Reserve Bank of New York), *available at* http://www.newyorkfed.org/newsevents/speeches/1998/med981001.html.

For an extended account of the collapse of LTCM, see LOWENSTEIN, *supra* note 34, at 123–218.

39. *See* Henny Sender & Jason Singer, *Hedge Funds: Reward & Risk: A Betting Man and His Fund's Hard Fall—Collapse of Eifuku Master Trust Happened in Seven Trading Days, Under Calm Market Conditions*, WALL ST. J., Apr. 10, 2003, at C1. For another example of the dramatic losses that can result from leverage, even if the fund survives, see David Reilly, *How to Make $600 Million? Get $1.3 Billion; A Hedge Fund, Bailey Coates, Sees its Assets Shaved in Half, Feeling the Downside of Leverage*, WALL ST. J., May 23, 2005, at C1. On the upside for fund investors, leverage magnifies returns. *Id.*

40. Sender & Singer, *supra* note 39.

41. Riva D. Atlas, *Hedge Fund Rumors Rattle Markets*, N.Y. TIMES, May 11, 2005, at C1.

42. *Id.*; *see also* John Plender, *Hedge Funds—The Flawed Product of a Freakish Cycle*, FIN. TIMES, May 15, 2005, at 11.

43. Atlas, *supra* note 41.

First Boston report cites a number of studies indicating that hedge funds account for between 40 to 50% of trading activity in major stock markets, such as the New York Stock Exchange and the London Stock Exchange, and account for over 70% of daily activity in the convertibles market, the U.S. distressed debt market, and the U.S. exchange-traded fund market.[44]

It is also important to keep concerns about hedge fund malfeasance in proper perspective. The abuses and illegal activities that have punctuated the hedge fund industry are not representative of hedge fund behavior generally. The reality is that the vast majority of hedge funds are not engaged in any fraudulent or otherwise illegal behavior, and the vast majority of hedge fund managers are not rogue traders rolling the dice in undisciplined ways while betting other people's money. Whether it is because we are still in a post-Enron climate with heightened sensitivity to financial corruption, or because attention rarely focuses on the banks that were not robbed, the reality that hedge funds provide investors with legitimate opportunities to earn superior returns is downplayed. Additionally, whatever systemic risk is posed by the trading activities of highly leveraged hedge funds, hedge fund trading spins off important systemic benefits by leading to more efficient and more liquid capital markets that are better able to withstand unanticipated shocks to financial markets.[45] More recently, some hedge funds have come out of the shadows to assume the role of shareholder activist, particularly in proxy contests and takeover battles.[46]

Without question, hedge funds are secretive. The very nature of hedge funds requires that they operate in secrecy because hedge funds make money by exploiting market inefficiencies and by taking positions

44. EUROPEAN WHOLESALE BANKS, *supra* note 19, at 4–5.

45. Timothy F. Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, put it this way in a 2004 speech:

> Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an important source of risk transfer and diversification.
>
> They don't perform these functions out of a sense of noble purpose, of course, but they are a critical part of what makes the U.S. financial markets work relatively well in absorbing shocks and in allocating savings to their highest return. These benefits are less conspicuous than the trauma that has been associated with hedge funds in periods of financial turmoil, but they are substantial.

Timothy F. Geithner, President and Chief Executive Officer, Fed. Reserve Bank of New York, Hedge Funds and Their Implications for the Financial System (Nov. 17, 2004), http://www.ny.frb.org/newsevents/speeches/2004/ge1041114.html. For the SEC's take on the benefits of hedge funds, see HEDGE FUND STAFF REPORT, *supra* note 19, at 4–5.

For more technical discussions of the role of hedge funds in financial markets, see Suleyman Basak & Benjamin Croitoru, *On the Role of Arbitrageurs in Rational Markets*, J. FIN. ECON. (forthcoming 2006), *available at* http://ssrn.com/abstract=475483.

The finance literature on hedge funds ultimately ties into the general literatures on the limits on arbitrage, the efficient capital market hypothesis, behavioral finance, and heterogeneous investor expectations. For an excellent, nontechnical overview of these literatures, see Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003).

46. *See infra* note 101.

based on anticipated market moves. The opportunity to make money quickly vanishes when trading strategies or particular positions and trades are disclosed and others start to make the same investments. There is a big difference, however, between secrecy and illicit behavior. To say that hedge funds escape regulation by exploiting loopholes leaves the misimpression that hedge funds are somehow evading the law's reach in unintended ways. Hedge funds have been lightly regulated, but that is a result of the design of the federal securities laws.[47] There are well-established exclusions from the key mandates of the 1933 Act,[48] the 1934 Act,[49] the Investment Company Act,[50] and (until recently) the Advisers Act.[51] Hedge funds have simply been structured in an open and above-board fashion to take advantage of the exclusions that Congress has seen fit to build into the securities law regime.[52] That having been said, the cumulative effect of a regulatory scheme that left hedge funds outside the scope of the registration and disclosure mandates of the 1933 Act, the 1934 Act, the Investment Company Act, and the Advisers Act has troubled regulators, as well as some investors.

It is against this backdrop—as viewed through the lens of the still-fresh scandals involving Enron, WorldCom, and numerous Wall Street firms—that in late 2004 the SEC reversed its approach to hedge fund regulation.[53] Still reacting to the wave of corporate and accounting scan-

47. For an overview of the overall regulatory regime that covers the hedge fund industry, see generally Jeffrey C. Blockinger & Rebecca M. Palmer, *Hedge Fund Managers in the Era of Heightened Regulatory Scrutiny*, 37 REV. SEC. & COMMODITIES REG. 159 (2004); Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591 (2001); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681 (2000); Managed Funds Ass'n, Information Available Directly from Hedge Funds: U.S. Regulatory Filings by Hedge Fund Managers, http://www.mfainfo.org/images/PDF/MFA_Hedge_Fund_InfoSourceList.pdf (last visited Apr. 9, 2006).

48. 15 U.S.C. § 77a (2000).

49. *Id.* at § 78a.

50. *Id.* at § 80a-1.

51. *Id.* at § 80b-1.

52. For example, a hedge fund (1) is not subject to the Investment Company Act if the fund has a hundred or fewer investors or if all of its investors are so-called "qualified purchasers"; (2) does not have to register its securities offering under the 1933 Act if it only allows so-called "accredited investors" to invest; and (3) does not have to register under the 1934 Act if it has only engaged in private offerings and has fewer than five hundred investors in the fund. *See id.* § 78*l*(g)(1); *id.* § 80a-3(c); 17 C.F.R. § 230.506 (2004); 17 C.F.R. § 240.12g-1 (2004).

53. *See* Final Hedge Fund Rule Release, *supra* note 4; Registration Under the Advisers Act of Certain Hedge Fund Advisers, Exchange Act Release No. IA-2266, 83 SEC Docket 1124 (proposed July 20, 2004) [hereinafter Hedge Fund Rule Proposal]; HEDGE FUND STAFF REPORT, *supra* note 19. For a number of questions raised by the American Bar Association following adoption of the hedge fund rule, see Letter from the ABA Section on Business Law to the SEC Division of Investment Management (June 23, 2005), *available at* http://www.abanet/org/buslaw/committees/CL410000pub/comments/20050705000000.pdf.

Notably, after the collapse of Long-Term Capital Management, the President's Working Group on Financial Markets, which comprises (with the individual office holders at the time in parentheses) the Secretary of the Treasury (Robert Rubin), the Chairman of the Board of Governors of the Federal Reserve (Alan Greenspan), the Chairman of the SEC (Arthur Levitt), and the Chairman of the Commodity Futures Trading Commission (Brooksley Born), recommended against greater SEC regulation of the hedge fund industry. *See* HEDGE FUNDS, *supra* note 1.

dals that began with Enron in 2001,[54] the SEC evidently would no longer tolerate a largely unregulated $1 trillion (and growing) hedge fund industry about which it knew very little. The following briefly summarizes the change in regulation.

Under Section 203(b)(3) of the Advisers Act, an investment adviser[55] who is otherwise subject to the registration requirements of the Advisers Act does not have to register with the SEC if it: (1) has had fewer than fifteen clients in the prior twelve-month period; (2) does not hold itself out to the public as an investment adviser; and (3) does not advise a registered investment company. Rule 203(b)(3)-1 of the Advisers Act had allowed an investment adviser to count an investment fund, such as a hedge fund, as a single client for purposes of Section 203(b)(3). In other words, a hedge fund with, say, 100 investors counted as a single client of an adviser for the fifteen-client threshold under Section 203(b)(3). Consequently, a hedge fund manager could manage up to fourteen hedge funds, regardless of the number of hedge fund investors, without triggering the obligation to register with the SEC as an investment adviser under the Advisers Act.

In late 2004, the SEC, by a divisive and controversial three-to-two vote, adopted new Rule 203(b)(3)-2 of the Advisers Act. Rule 203(b)(3)-2 requires an investment adviser of a "private fund" to look through the fund to count each investor in the fund as a single client for purposes of the registration requirement under the Advisers Act. Accordingly, assuming the other requirements for registration are met, an adviser of one or more private funds must register with the SEC if, in the aggregate, there are fifteen or more investors in the fund or funds. A "private fund" includes any company that (1) qualifies as an investment company, except for the exclusions from registration under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; (2) permits its owners to redeem their ownership interests in the company within two years of purchase (the "two-year lockup" provision); and (3) is offered based on the investment advisory skills, ability, or expertise of the investment adviser. In short, as a result of new Rule 203(b)(3)-2, hedge fund managers had to start registering with the SEC as investment advisers under the Advisers Act beginning February 1, 2006. This means, among other things, that a hedge fund manager must (1) file a Form ADV with the SEC, which requires disclosures regarding the fund's business practices and the manager's background, although the manager does not have to disclose details of the fund's investment strategies or trades; (2) deliver basic information to clients about the fund's business

54. *See generally* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

55. An "investment adviser" is generally defined as any natural person or company who, for compensation, engages in the business of providing investment advice. 15 U.S.C. § 80b-2a(11).

practices and the fund manager's background; (3) adopt procedures governing proxy voting by the hedge fund; (4) adopt a code of ethics; (5) develop a system of internal controls and compliance procedures to prevent violation of the Advisers Act; and (6) appoint a chief compliance officer.[56] Most importantly, registered investment advisers must maintain specified books and records and make them available to the SEC for examination and inspection.[57]

In addition, as a registered investment adviser, a hedge fund manager is subject to section 205(a)(1) and Rule 205-3 under the Advisers Act. Section 205(a)(1) and Rule 205-3 generally prohibit an adviser from charging a performance fee to any investor who is not a "qualified client" (i.e., an investor whose net worth does not exceed $1.5 million or who does not have assets worth at least $750,000 under management with the fund's adviser). A registered adviser to a fund must look through the fund to determine whether the fund's investors are qualified clients who can be charged a performance fee. Consequently, many "accredited investors" under Regulation D of the 1933 Act who are not "qualified clients" under the Advisers Act will be kept from investing in hedge funds because hedge fund managers will not choose to forego the 20% carry they typically charge.[58]

Both registered and unregistered investment advisers, including hedge fund managers, also owe fiduciary obligations to their funds and are subject to prohibitions against fraud. These fiduciary and antifraud provisions predate the SEC's new hedge fund regulation.

A number of criticisms have been aimed at the new hedge fund regulation, including claims that (1) it will drive hedge funds offshore; (2) its cost of compliance will erect entry barriers that keep new funds from launching; and (3) it will chill hedge fund managers from undertaking at least some new and innovative investment strategies, leading to less efficient, less liquid, and less stable financial markets. Others have worried that hedge fund regulation will divert valuable financial and human resources of the SEC from focusing on regulating the larger mutual fund industry. Uncertainty over how the SEC might ultimately use its exami-

56. For a thorough discussion of the consequences of investment adviser registration under the Advisers Act, see Final Hedge Fund Rule Release, *supra* note 4. *See also* 15 U.S.C. §§ 80b-3, 80b-4, 80b-4a, 80b-5, 80b-6 (2005); 17 C.F.R. §§ 275.204-2, 275.204-3, 275.204A-1, 275.206(4)-2, 275.206(4)-3, 275.206(4)-4, 275.206(4)-6, 275.206(4)-7 (2005).

57. Section 204 of the Advisers Act, 15 U.S.C. § 80b-4 (2000).

58. To the extent that a hedge fund only opens itself to "qualified purchasers" under section 3(c)(7) of the Investment Company Act, many accredited investors are already kept out of certain hedge funds.

As this article went to print, the D.C. Circuit Court of Appeals vacated and remanded the SEC's hedge fund rule, calling it "arbitrary." *See* Goldstein v. SEC, No. 04-1434 (June 23, 2006). Given this development, the future shape of hedge fund regulation is uncertain. However, the thrust of this article—namely, an inquiry into the SEC's decision making when adopting the new hedge fund rule—remains important.

nation and inspection authority over hedge funds has been a chief concern among critics of the SEC's rule change.

Even opponents of more hedge fund regulation generally concede that the SEC's adopted rule change is a measured step, although it remains to be seen whether this is just the first of many steps toward more regulation of the industry.

## III. INVESTOR PROTECTION VS. SYSTEM PROTECTION

The need to get accurate information into investors' hands and to protect them from hedge fund abuses could be argued to justify the hedge fund rule, as could the need to protect the financial system from the risk that it will destabilize if losses ripple across financial institutions when hedge funds suffer major losses. Neither rationale, however, has enough purchase to justify the SEC's new rule. First, the SEC traditionally has not stepped in to protect the kinds of wealthy investors and institutions who typically invest in hedge funds. Instead, the SEC has deferred to such well-heeled investors to protect themselves through market discipline. Second, the SEC has never principally been concerned with the kinds of systemic risks that hedge fund collapses pose. Systemic risk is a matter for other regulators such as the Federal Reserve and the Treasury Department. Long-time Federal Reserve Board Chairman Greenspan, for one, has been an outspoken critic of the SEC's hedge fund rule.[59] That said, the SEC is charged with ensuring that investors are sufficiently confident in the integrity of securities markets so that they do not withdraw from the market. Yet one would have to stretch to argue that recent hedge fund activities have undermined investor confidence in hedge funds or securities markets generally.

### *A. Protecting Investors*

Although some evidence shows a modest "retailization" of the hedge fund industry, the vast bulk of hedge fund investors can protect themselves, at least insofar as the federal securities laws understand investor self-protection.[60] In particular, wealthy individuals and institu-

59. *See Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2004) (statement of Alan Greenspan, Chairman, Fed. Reserve Bd. of Governors).

60. "Retailization" refers to the development finding nonaccredited investors increasingly exposed to hedge funds, such as through investments in so-called "funds of funds" or through pension funds that invest in hedge funds. *See, e.g.*, Final Hedge Fund Rule Release, *supra* note 4; *see also* Jane J. Kim, *Hedge Funds Target Smaller Investors*, WALL ST. J., Apr. 27, 2005, at D1; Aaron Lucchetti, *Hedge Funds: Profits and Perils*, WALL ST. J., Sept. 15, 2004, at C1; Jeff D. Opdyke, *As Scrutiny Grows, New Breed of Fund Lowers Ante for Individuals; The Schwab Option*, WALL ST. J., Jan. 23, 2003, at D1; *cf.* Karen Damato, *Hedge-Fund Action for the Mutual-Fund Set*, WALL ST. J., Aug. 30, 2004, at C1 (describing mutual funds that adopt hedge-fund-like investment strategies).

One particular concern of funds of funds, as well as funds of funds of funds, is the layering of fees that reduces investor returns. *See, e.g.*, Stephen J. Brown et al., *Fees on Fees in Funds of Funds*, 2 J. INVESTMENT MGMT. 39 (2004).

tions—for example, investors that qualify as "accredited investors" under Regulation D of the 1933 Act—are far and away the predominant investors in hedge funds.[61] Such investors are considered able to "fend for themselves" when investing, militating against the need for the SEC to step in to protect them.[62] To put it in statutory terms, securities offerings limited to accredited investors are exempt, under the private offering exemption of Section 4(2), from the registration requirements of Section 5 of the 1933 Act.[63] Nor do such private offerings trigger the ongoing disclosure obligations of the 1934 Act.[64]

It is noted that the question of investment adviser registration arises under the Advisers Act and not the 1933 Act. Nonetheless, the notion that investors who can "fend for themselves" do not need SEC protection is an animating principle of securities regulation that helps demarcate the appropriate boundary of SEC regulation across the federal securities laws.[65]

This article will not reopen the entire debate over whether accredited investors can, in practice, protect their own interests; instead, it will go along with the federal securities laws and assume that they can.[66] Rather, because the SEC has decided to regulate an industry dominated by presumptively sophisticated investors, this article will reexamine a more targeted question: what does it mean for investors to be able to fend for themselves when they have limited information? Put differently, when information asymmetries persist, should not the SEC step in to ensure that even sophisticated investors have better information?[67] After

61. *See* Rule 501(a) of the 1933 Act, 17 C.F.R. § 230.501(a) (2005) (defining "accredited investor").

62. The "fend for themselves" reference comes from the seminal 1953 case, *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953), in which the Supreme Court found that the touchstone of a private offering exempt under § 4(2) of the 1933 Act from the registration requirements of § 5 of the 1933 Act is that the offerees "are able to fend for themselves." *Id.* at 125. The animating philosophy of the private offering exemption is that offerees able to fend for themselves do not need the protection of the federal securities laws. *See generally* 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1361–98 (3d ed., rev. 1999).

As a matter of practice, hedge funds do not rely on the case law under § 4(2) and *Ralston Purina* to ensure that the offering of fund securities qualifies as a private placement exempt from 1933 Act registration. Rather, hedge funds offer their securities only to accredited investors under Regulation D.

63. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 402–11 (5th ed. 2004). Similarly, the financial thresholds required to qualify as a "qualified purchaser" under Section 3(c)(7) of the Investment Company Act, 15 U.S.C. § 80a-2, exceed the financial thresholds required to qualify as an accredited investor. If all of a fund's investors are qualified purchasers, the fund does not have to register as an investment company under the Investment Company Act, largely on the grounds that such investors do not need the Act's protection.

64. Only when there are 500 or more investors is registration under the 1934 Act required. Securities Exchange Act of 1934, 15 U.S.C. § 781(g) (2000). Hedge funds, then, ensure that they do not cross this 500-investor threshold.

65. This animating principle reflects an implicit cost-benefit analysis that the costs of SEC intervention in such instances exceed the benefits.

66. For more on investor sophistication, see generally LOSS & SELIGMAN, *supra* note 62, at 1361–1454.

67. For an overview of the mandatory disclosure system and much of the related literature, see Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities*

all, even sophisticated investors may not be able to protect their own interests if they do not have the information they need or want about the issuer or cannot feasibly understand it.

Without question, hedge fund investors have limited information, particularly when it comes to a hedge fund's positions.[68] However, it does not follow that more regulation is warranted.[69] First, hedge fund investors have more information than regulators seem to admit. Investors, particularly institutional investors, engage in active due diligence before investing, routinely retain advisory firms to evaluate options for them, and negotiate for more disclosure from hedge funds.[70] Before investing, investors not only consider a fund's investment strategy and prior performance, but also the fund's ongoing transparency, valuation procedures, organizational structure, internal controls, back office operations, legal compliance procedures, and risk profile and risk monitoring, among other things.[71] Investors and their advisers are not above hiring private investigators to research managers' backgrounds.[72] A 2004 study by

*Regulation*, 81 WASH. U. L.Q. 417, 420–30 (2003). *Cf.* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1 (providing an interesting analysis suggesting that even sophisticated investors may not be able to fend for themselves in understanding and evaluating usually complex transactions).

68. Even if investors had detailed information about a fund's trading, it is doubtful how useful the information would be to investors given its typical complexity. *See* Schwarcz, *supra* note 67.

69. For more on the economics of information and its implications for consumer protection, including in securities markets, see, for example, Howard Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491 (1981); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Frank H. Esterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Robert H. Gertner, *Disclosure and Unraveling*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 605 (Peter Newman ed., 1998); Iain Ramsay, *Consumer Protection*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 410 (Peter Newman ed., 1998); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979); Joseph E. Stiglitz, Information and the Change in the Paradigm in Economics, Nobel Prize Lecture (Dec. 8, 2001), http://nobelprize.org/economics/laureates/2001/stiglitz-lecture.pdf.

70. *See, e.g.*, *Hedge Funds: Hearing Before H. Comm. on H. Financial Servs. and the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, 108th Cong. (2003) (statement of John F. Maudlin, President, Millennium Wave Investments) ("The simple fact is that most institutional funds hire outside analysts to evaluate and recommend hedge funds."); Jane J. Kim, *Digging for Hedge-Fund Dirt*, WALL ST. J., Aug. 8, 2005, at C1.

71. *See, e.g.*, INT'L ASS'N OF FIN. ENGINEERS, INVESTOR RISK COMM., VALUATION CONCEPTS FOR INVESTMENT COMPANIES AND FINANCIAL INSTITUTIONS AND THEIR STAKEHOLDERS (2004), *available at* http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf; MANAGED FUNDS ASS'N, 2003 SOUND PRACTICES FOR HEDGE FUND MANAGERS, *available at* http://www.mfainfo.org/images/PDF/2003SoundPractices_ForHedgeFundManagers.pdf; Best Practices in Hedge Fund Investing; Due Diligence for Global Macro and Managed Futures Strategies, Education Committee of the Greenwich Roundtable (on file with author).

72. Jane J. Kim, *supra* note 70; Suzanne McGee, *supra* note 19, at 28, 36 (explaining common due diligence practices, including the hiring of private investigators to research managers' backgrounds). Some commentators point to the collapse of Bayou Management LLC, a hedge fund in which investors lost nearly $500 million, as an example of the shortcomings of due diligence efforts. *See* Riva D. Atlas & Jenny Anderson, *Did Fees at Bayou Overwhelm Diligence?*, N.Y. TIMES, Aug. 30, 2005, at C1; Ian McDonald et al., *Going Short: Hedge-Fund Havoc: Missing Cash and a Principal's Suicide Note*, WALL ST. J., Aug. 29, 2005, at A1; *see also* Ianthe Jeanne Dugan, *Scandal Puts Spotlight*

Deutsche Bank found that nearly 40% of the hedge fund investors surveyed spend an average of three to six months doing diligence before investing, with 20% of those surveyed spending an average of six months or more on diligence.[73] Merely 3% of investors surveyed said they spend less than one month doing diligence. Only 21% of Deutsche Bank's respondents said that they normally invest in a fund at its inception, with the remaining 79% presumably waiting for the fund to develop a track record to gauge performance. Pension plans reported, on average, that they annually meet with about forty hedge fund managers in making only one to three allocations, and the average for endowments was to interview about ninety hedge fund managers a year to make just four to six allocations. Managers of so-called "funds of hedge funds" reported that they sometimes interview over 400 hedge fund managers to make just fifteen or so allocations. A separate recent survey of hedge fund managers by the Hennessee Group LLC, a self-described "global advisor to hedge fund investors," showed that 33% of the managers surveyed said that they allow investors to view the fund's entire portfolio, and 60% of the managers said that they disclose their largest long positions, and 34% said that they disclose their largest short positions.[74]

Not only do investors perform due diligence, but many hedge fund managers—up to 40 to 50% by some estimates, including the SEC's—voluntarily registered as investment advisers in order to signal their willingness and ability to comply with the Advisers Act and to encourage investors to invest in the fund.[75] Given that complying with the Advisers Act is costly, such voluntary registration can contribute to a so-called "separating equilibrium" that allows "honest" advisers, who are willing

*on Hennessee Group*, WALL ST. J., Sept. 2, 2005, at C1 (suggesting potential conflicts of interest at hedge fund advisory firms, such as the Hennessee Group, which had steered investors to Bayou); Gregory Zuckerman & Ian McDonald, *At Wood River, Tide of Red Flags Went Unnoticed*, WALL ST. J., Oct. 12, 2005, at C1 (asking how sophisticated investors missed "red flags" at Wood River Partners LP, a struggling hedge fund).

Complementing the diligence that investors and their advisers do, Morningstar has announced that it will start ranking hedge funds, just as it does mutual funds; others already aggregate and sell research on hedge funds. *See* Erin E. Arvedlund, *Wealth Manager: Morningstar Is Expanding Hedge-Fund Database*, WALL ST. J., June 22, 2005, at D3; *see also* Scott Patterson, *Tracking the Numbers/Street Sleuth: Race to Rate Hedge Funds Begins in Heavy Fog*, WALL ST. J., Sept. 28, 2005, at C1 (describing the challenges the secret nature of hedge funds presents for ratings).

73. This study and the following Deutsche Bank data are from 2004 ALTERNATIVE INVESTMENT SURVEY, *supra* note 19. *See also* Allison Bisbey Colter, *Investors Seek Hedge-Fund Data*, WALL ST. J., Apr. 1, 2003, at D2 (reporting on an earlier Deutsche Bank study).

74. 2004 Annual Hedge Fund Manager Survey, Hennessee Group LLC.

75. *See* Brandon, *supra* note 19, at 11–12; *see also* Hedge Fund Rule Proposal, *supra* note 53, § 5; Hedge Fund Staff Report, *supra* note 19, at 20–22 (discussing hedge fund manager registration under the Advisers Act prior to the new rule). Fifteen percent of the respondents in the 2004 ALTERNATIVE INVESTMENT SURVEY by Deutsch Bank, *supra* note 19, said that they invest only in funds with managers who register under the Advisers Act.

The *Wall Street Journal* reported in 2005 that some hedge funds have approached rating agencies voluntarily to ask for creditworthiness ratings so that the funds could distinguish themselves from their competitors. Scott Patterson, *Race to Rate Hedge Funds Begins in Heavy Fog*, WALL ST. J., Sept. 28, 2005, at C1.

to subject themselves to the Advisers Act, to distinguish themselves from unregistered managers who choose not to be bound by the Advisers Act.[76] Put simply, some hedge funds have used voluntary registration as a marketing tool. In making their allocations, investors can evaluate for themselves the value of investment adviser registration. For example, many institutional investors, most notably pension plans, have only invested in hedge funds where the manager has registered. Testifying before Congress about the hedge fund rule, then-SEC Chairman Donaldson responded to critics by saying that investment adviser registration must not be "burdensome, inflexible or costly" because that would deter a manager from opting in.[77] Chairman Donaldson had it backwards. The type of market sorting that has taken place in the hedge fund industry, whereby funds can opt in to the Advisers Act, does not work if the regulatory regime opted in to is not, in fact, burdensome and costly.[78] Otherwise, opting in sends no positive signal to investors about the quality of the fund and its manager.

Even if no disclosures are forthcoming and no hedge fund managers opt in to the Advisers Act, hedge fund investors are still protected. So long as investors know what they know, and are in a position to know what they do not know, investors can fend for themselves.[79] Investors can price the risk of having imperfect information, as well as the risk as-

76. For classic work on signaling, see MICHAEL SPENCE, MARKET SIGNALING: INFORMATION TRANSFER IN HIRING AND RELATED PROCESSES (1974); Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973) [hereinafter Spence, *Job Market Signaling*]; Michael Spence, *Competitive and Optimal Responses to Signals: An Analysis of Efficiency and Distribution*, 7 J. ECON. THEORY 296 (1973). *See also* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 122–58 (1994); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 280–85 (1991); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1786–91 (2000).

77. *Investor Protection and the Regulation of Hedge Fund Advisers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2004) (statement of William H. Donaldson, Chairman, U.S. Securities & Exchange Commission), *available at* http://www.sec.gov.newstestimony/ts071504whd.

78. *Cf.* Spence, *Job Market Signaling*, *supra* note 76, at 358 (explaining in the employment context that "a signal will not effectively distinguish one applicant from another, unless the costs of signaling are negatively correlated with productive capability").

79. *See* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1425–46 (discussing people's estimation of the "odds" of some risk) (1983); *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1441–42 (1989) (discussing the pricing of risk in corporate contracts). For cognate issues in the context of the early days of derivatives regulation, see, for example, Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993) (analyzing how informational problems could persist among bankers evaluating derivatives); *see also* Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69 (1995).

Notably, some hedge fund investors did express a desire for more regulation. *See, e.g.*, Allison Bisbey Colter, *Some Investors in Hedge Funds Seek More Regulatory Oversight*, WALL ST. J., Feb. 5, 2003, at B7D. Notwithstanding the expressed desire for more regulation, investors have continued to plow money into hedge funds.

For a brief account of some recent effects of market discipline in the hedge fund industry, see Gregory Zuckerman & Ian McDonald, *The Wild West of Hedge Funds Becomes Tamer*, WALL ST. J., Jan. 24, 2005, at C1.

sociated with other monitoring challenges that make it difficult for investors to oversee and discipline hedge fund managers. Investors can, for example, simply refuse to invest. Investors are mobile and have many choices among hedge funds and between hedge funds as an asset class and other investments.[80] Additional government intervention is not justified because sophisticated investors choose to invest in a hedge fund that provides them with what some might view as too little information. Given the overall philosophy and structure of the federal securities laws, insofar as sophisticated investors are concerned, more than persistent information asymmetries are needed to justify regulation. It has not been the SEC's job, in other words, to protect sophisticated investors from themselves if they choose to invest with limited disclosures in hand.[81]

Investors strike whatever bargains they can with the hedge fund in deciding to invest; the test for whether the SEC should intervene to protect sophisticated investors is not whether the investors received everything in the negotiation that they requested or that the SEC thinks they should have received.[82] Moreover, it is not irrational for an investor to prefer secrecy when it comes to the hedge fund's trading strategies and to rely on the reputation of the fund manager as a substitute for better information and more investor control.[83] It is also reasonable for investors to depend on the manager's performance fee to help align the manager's incentives with the best interests of the fund's investors.[84] Plus, managers

80. It is worth allowing, however, the possibility that some hedge funds, whose successful managers have a "pedigree" that investors want to invest in, may have market power giving them leverage to provide less disclosure without losing investors and the bargaining power to charge higher fees.

81. The above discussion focuses on disclosure, but sophisticated investors can also judge the value of other requirements that flow from investment adviser registration. Before the SEC adopted the new hedge fund rule, nothing blocked a hedge fund from appointing a chief compliance officer, adopting a code of ethics, or implementing strict internal controls if that is what investors demanded. Investor due diligence has routinely focused on these and other operational and back office considerations.

82. For that matter, people have limited information when deciding to invest in stocks and bonds. The mandatory disclosure system at the core of the federal securities laws might ameliorate the information asymmetry problem it addresses, but mandatory disclosure does not solve the problem. The federal securities laws, for example, (1) only provide for periodic disclosure, although it is made more continuous with the filing of current reports on Form 8-K; (2) only prohibit "material" misstatements or omissions; and (3) encourage, but do not mandate, the disclosure of most forward-looking information.

83. For more on the benefits of keeping a hedge fund's investments secret, see Tanya Styblo Beder, *Hedge Funds: Improving Disclosure*, RISK, Dec. 2002, *available at* http://www.financewise.com/public/edit/riskm/rmforinvestors/rmforinvestors-hedgefunds.htm (summarizing the views of the Investor Risk Committee of the International Association of Financial Engineers).

84. This is not to say that performance fees are structured optimally from the investors' perspective. For example, the typical performance fee incentivizes a hedge fund manager to take on greater risk and leverage since the manager does not bear the full downside risk of his investment decisions but is rewarded handsomely if the fund performs well. The incentive to take on risk and leverage increases when the manager has to exceed some prior "high-water mark" to earn his performance fee. Simply put, the value of a manager's effective call option increases with volatility, although the 1–2% of assets under management the manager earns may offset his incentive to take risks. *See, e.g.*, William N. Goetzmann et al., *High-Water Marks and Hedge Fund Management Contracts*, 58 J. FIN. 1685 (2003); Skeel, *supra* note 19; Stavros Panageas & Mark M. Westerfeld, *High Water Marks: High Risk Appetites? Hedge Fund Compensation and Portfolio Choice* (Nov. 2004), http://ssrn.com/abstract=

typically put their money where their mouth is by co-investing in the hedge fund. Such "bonding" is a basic technique that principals rely on to reduce agency costs when it is difficult to monitor their agents.[85] Further, even before the SEC adopted its new hedge fund rule, hedge fund managers were subject to antifraud provisions and fiduciary obligations under the federal securities laws.[86] Of course, this discussion presupposes that investors have an incentive to fend for themselves. And they do. The risk of loss motivates investors to do diligence and evaluate hedge fund controls, procedures, operations, and ongoing disclosure practices.

This analysis does not make the strong claim that sophisticated investors always accurately price the risk of having imperfect information and little control by perfectly adjusting the terms of their investment to account for the risk of investing in a hedge fund about which they know comparatively little and over which they do not have direct influence.[87] Because of bounded rationality and various cognitive biases, for example, investors and their advisers often make mistakes in evaluating investment opportunities, even with good information.[88] For instance, an investor who is overoptimistic may underestimate the risk that the hedge fund will flop or that the manager will engage in some sort of dishonest behavior. Setting aside the psychology of decision making, investors may at times simply be wrong in their assessments. Additionally, when it comes to individual investors, investing in hedge funds has become fashionable; some have even referred to it as being "cool."[89] Likewise, institutions, such as endowment funds and pension plans, in recent years have rushed to invest in hedge funds to earn higher returns. The concern is that if investors develop a "taste" for hedge funds and get caught up in the fad of investing in them or otherwise clamor for higher returns, they may not give due attention to the terms and conditions of their invest-

616962; *see also* John Plender, *Hedge Funds—The Flawed Product of a Freakish Cycle*, FIN. TIMES, May 15, 2005, at 11. On the other hand, these incentives are not hidden from view, but are known to investors, who can then price the risk of the manager's compensation structure.

85. *E.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

86. *See* Investment Advisers Act § 206, 15 U.S.C. § 80b-6. Even without the new rule, broker-dealers are subject to so-called suitability obligations that require them to determine the suitability of products they recommend to or invest in for their customers. *See* HEDGE FUND STAFF REPORT, *supra* note 19, at 25–27. Hedge funds are, in many instances, regulated by the Commodities Futures Trading Commission under the Commodity Exchange Act. *See id.* at 23–25.

87. Indeed, it is never certain what the "right" adjustment is that an investor should make to the limited information hedge fund managers often provide.

88. For an excellent overview of behavioral finance, see Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003). *See also* Paredes, *supra* note 67, at 444 n.126 (collecting citations).

89. *See, e.g.*, LOWENSTEIN, *supra* note 34, at 25–26; Jenny Anderson & Riva D. Atlas, *supra* note 19; Justin Lahart, *Ahead of the Tape*, WALL ST. J., Oct. 25, 2004, at C1 ("Five years ago, members of the country-club set were bragging about the hot stock they had bought. Nowadays, it is all about having money with a hot manager."); McGee, *supra* note 19, at 28; Deborah Solomon, *Deals & Deal Makers: Former SEC Chief Levitt Urges Tough Hedge-Fund Regulation*, WALL ST. J., May 7, 2003, at C5 (reporting Arthur Levitt as saying, "My experience in the market tells me that when you develop an investment flavor of the day, it's time to be careful.").

ments or may get comfortable investing in a hedge fund that is not appropriate for them.[90]

Admittedly, market imperfections such as those described above can compromise the ability of sophisticated investors to protect themselves by negotiating for disclosures and evaluating the risk of remaining information asymmetries and agency problems. To date, however, the SEC has eschewed a more textured analysis of what it means for investors to be able to fend for themselves by delving investor-by-investor into the details of investor behavior. Instead, the SEC has relied on proxies, such as an investor's wealth or the fact that the investor is an institution, in articulating the regulatory line separating when SEC intervention is warranted to protect investors and when it is not.[91]

90. For data on hedge-fund liquidations, see, for example, Getmansky, *supra* note 19 (explaining the "attrition rate" (i.e., failure rate) of hedge funds in terms of past performance, volatility, and investment styles and summarizing studies on hedge fund failure).

These potential market failures are not unique to hedge fund investing. Psychological influences, as well as time pressures and transaction costs, affect investing behavior generally. Just as it may be presently fashionable to invest in hedge funds, similar herd behavior or bandwagon effects have contributed to stock market bubbles and will do so again in the future. Many have suggested, for example, that investors, including the so-called "smart money," irrationally threw money at tech companies, especially "dot-com" companies, in the mid- to late-1990s when a more rational analysis of company fundamentals did not come close to sustaining valuations. *See, e.g.*, Eli Ofek & Matthew Richardson, *DotCom Mania: The Rise and Fall of Internet Stock Prices*, 58 J. FIN. 1113 (2003). *See generally* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2001).

91. *But see* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002) (suggesting possibility that securities regulation take investor psychology into account); Paredes, *supra* note 67 (same).

Nor has the SEC dug into the merits of particular offerings in deciding whether to regulate. In other words, it should be of no consequence to the SEC that investors choose to invest in hedge funds that levy large fees and that might underperform other investment opportunities. The SEC is no better equipped to evaluate a hedge fund investment opportunity than it is at evaluating whether an investor should buy shares of Google, General Motors, General Electric, or Tyco.

Without question, some hold fast to the idea that even accredited investors are not, in fact, able to protect themselves and thus need SEC protection when investing in hedge funds. A full-blown response to this argument is beyond this article's scope, although a few brief responses are in order. First, this criticism is not limited to hedge funds, but would challenge the wisdom of the private offering exemption across the board. I am not aware of any serious argument to gut § 4(2) in this way. Indeed, the effect of Regulation D was to bring certainty to private offerings such that issuers could engage in private offerings with confidence that the planned offering would not run afoul of the 1933 Act's registration requirements under § 5. Private placements are an important and efficient manner for raising capital.

Second, a hard look by the SEC at investor ability risks morphing into a version of merit review, which was expressly rejected when the federal securities laws were adopted.

Third, before advocating that the SEC should delve into the details of investor behavior in crafting regulation, one would have to consider the various informational problems, behavioral factors, and organizational challenges that affect regulators and their agencies. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); *see also* Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165 (2003) [hereinafter Rachlinski, *The Uncertain Case*].

Fourth, more paternalistic regulation may be counterproductive by giving rise to moral hazard problems as investors come to rely increasingly on the SEC to protect them.

In short, when propounding government regulation over market discipline (or vice versa, for that matter) one has to avoid the so-called "nirvana fallacy" that Demsetz explained. Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 1 (1969) ("The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm

An important allowance is in order. A potential benefit of the hedge fund rule, at least insofar as the mandated disclosure on Form ADV is concerned, is that it may reduce duplicative investor due diligence. The new hedge fund rule may be warranted to reduce transaction costs by mandating disclosures that mimic the typical result when hedge fund managers and investors negotiate what information the fund will provide. Indeed, this transaction-cost reducing rationale may justify even more mandatory disclosures than Form ADV presently provides.[92] Further, the standardization of disclosure may facilitate investor comparisons across funds.[93] Comparability across funds could be particularly important to hedge fund valuation, an issue that the SEC did not address in its hedge fund rulemaking. Notably, the SEC did not offer any such transaction-cost reducing rationale for the new rule. Nor does such rationale justify many of the other consequences of requiring hedge fund managers to register under the Advisers Act.[94]

### *B. Protecting the System*

The growing hedge fund industry can have significant adverse impacts on financial markets. Although protecting hedge fund investors

and an existing 'imperfect' institutional arrangement . . . . In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.").

92. *Cf.* Getmansky et al., *supra* note 19, at 30–31 (arguing that the hedge fund rule does not require disclosure of the right information and that the SEC should have access to information regarding monthly returns, leverage, assets under management, fees, instruments traded, and the brokerage, financing, and credit relationships of hedge funds).

93. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 76, at 303–04.

94. For more on the transaction-cost reducing rationale of mandatory disclosure, see, for example, Coffee, *supra* note 69, at 733–34.

The above assessment of the SEC's new hedge fund rule is from the particular perspective of whether hedge fund investors can adequately protect their own interests. Hedge funds have been flagged in recent years for activities that, although benefiting the hedge fund's investors, may harm investors in other enterprises and other market participants. One should not read this article's critique of the SEC's hedge fund rule as arguing that hedge funds should have a free pass across the board. Hedge funds are, and should be, subject to federal and state law regulating activities such as market timing, late trading, vote buying, insider trading, and market manipulation. This article takes no position on whether laws, regulations, and judicial doctrines governing such behavior should be revised in light of the hedge fund industry's recent growth.

A cognate point is that the rest of the market would like more information about hedge funds. In other words, there are third-party effects when the SEC requires hedge fund managers to make public disclosures; and so in this view, disclosure should be mandated, aside from whether hedge fund investors themselves are able to get the information they demand before investing. *See generally* EASTERBROOK & FISCHEL, *supra* note 76, at 290–92; Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1342–69 (1999). There is some traction to this argument, although it has its limits. First, a good deal of hedge fund information is already publicly available without additional SEC disclosure requirements. Second, the most salient information concerns a hedge fund's strategies and positions, and yet the disclosure of this information undercuts the basic hedge fund business model. And third, the logic of this positive externalities argument favoring hedge fund disclosure would justify requiring disclosures by private equity funds, venture capital funds, and all private companies. That disclosure, however, would run afoul of the basic structure of the federal securities laws.

from losses does not warrant greater hedge fund regulation, the risk to the financial system posed by hedge fund activities might. Externalities—such as the systemic risk that arises when leading financial institutions are exposed to highly leveraged hedge funds—might justify some sort of government intervention.[95] When hedge fund managers leverage the fund and undertake their investment strategies, and when banks and other financial institutions extend credit to hedge funds or otherwise take the other side of hedge fund transactions, the hedge fund managers and the bankers and counterparties on the other side understandably focus on the private benefits and costs of the transactions, not the social cost of greater leverage or speculation in the financial system as a whole.[96] Similarly, hedge fund investors focus on the private benefits of hedge fund behavior, such as magnified returns from leverage, and not systemic risk. Having said this, managing systemic risk in financial markets is a role that has fallen principally to the Treasury Department and the Fed, not the SEC. The SEC is not charged with managing systemic risk in financial markets by, say, trying to constrain leverage or certain speculative activities and complex derivatives transactions.[97] Indeed, the SEC's expertise does not extend to managing systemic risk.

It is, however, the SEC's charge to ensure investor confidence. A hit to investor confidence does not pose a "systemic risk" as such. Yet, it is generally assumed that the United States' thick and broad securities markets depend on investor confidence in the integrity and fairness of securities markets. The Supreme Court has recognized that an "animating purpose" of the federal securities laws is "to insure honest securities markets and thereby promote investor confidence."[98] The logic of federal securities regulation, as suggested earlier, is that the mandatory disclosure regime of the federal securities laws shores up investor confidence and the integrity of securities markets by redressing information asymmetries and targeting fraud. Mandatory disclosure and federal antifraud provisions, in the conventional view, encourage investors to invest, leading to more efficient and more highly valued securities markets. Put

95. For a recent paper suggesting a heightened concern regarding systemic risk, see Chan et al., *supra* note 19.

96. Notably, there is a social benefit of leverage and speculation—i.e., greater liquidity and more efficient securities markets.

97. If the SEC is to assert itself when it comes to questions of systemic risk, it should do so through its membership in the President's Working Group on Financial Markets. However, the SEC does have a more direct role in regulating broker-dealers. Further, hedge fund investors may welcome their fund's being highly leveraged because it can magnify investor returns. Thus, any SEC steps to constrain leverage would not necessarily benefit hedge fund investors.

Whether the SEC should enhance the disclosures required of banks and other hedge fund counterparties so that those investing in such financial institutions can better evaluate their exposure to leveraged hedge funds is a different question. Indeed, it would be part and parcel of the mandatory disclosure regime that the SEC administers to require such enhanced disclosures by financial institutions in their quarterly and annual reports.

98. United States v. O'Hagan, 521 U.S. 642, 658 (1997); *see also* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 216–19 (3d ed., rev. 1998); Paredes, *supra* note 67, at 467–69.

differently, one can think of federal securities regulation as addressing a "lemons problem" that can arise in securities markets when investors are unable to protect themselves from having imperfect information.[99]

Yet, even in the name of promoting investor confidence, the SEC's regulatory reach is limited and does not encompass regulatory steps designed to reduce leverage or otherwise manage systemic risk in financial markets.[100] It should not be enough to trigger SEC intervention in the hedge fund industry when accredited investors choose to invest in highly leveraged hedge funds that engage in speculative and risky trades, or when financial institutions continue to extend credit to and execute deals with such funds, regardless of the potential investor and counterparty losses.

More importantly, if anything, the explosion of the hedge fund industry to a trillion dollar business, while sharpening concerns over systemic risk, belies the need for SEC intervention. Money continues to flood into hedge funds. There is no lemons problem leading investors to flee hedge funds, and the hedge fund industry does not suffer from a lack of investor confidence. To the contrary, investors might be too confident investing in hedge funds. The most serious concern for hedge fund investors is not imperfect information or fraud, but the increasing difficultly managers have generating risk-adjusted above-market returns—so-called

99. For the classic work on the lemons problem, see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). For an application of the lemons problem to securities regulation, see, for example, Paredes, *supra* note 67, at 470–72; Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002).

100. Nor, for that matter, should the SEC be in the business of regulating to prevent bubbles in any particular type of asset class or investment vehicle or to discourage speculation (in any case, how does one decide when a bubble exists or that there is excessive speculation?). Whether other authorities, such as the Federal Reserve or the Treasury Department, should play such a role is beyond the scope of this article. Notably, though, the Federal Reserve has been blamed before for fueling bubbles, such as the inflated stock market in the 1990s. Recently, then-Federal Reserve Board Chairman Greenspan has recognized that the U.S. housing market has "a lot of local bubbles" that have been fueled by the Fed's easy-money policy of keeping interest rates low. *See* Edmund L. Andrews, *Greenspan Is Concerned About "Froth" in Housing*, N.Y. TIMES, May 21, 2005, at C1; *cf.* Jeannine Aversa, *Greenspan Builds Case for Limiting Fannie, Freddie Holdings*, ASSOCIATED PRESS, May 19, 2005 (reporting that Greenspan has urged limits on the holdings of Fannie Mae and Freddie Mac to deleverage these entities' balance sheets, a type of substantive intervention that Greenspan has argued against when it comes to hedge funds). For an interesting analysis of the potential role of law in preventing market crashes generally, see Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741 (2000). *See also* Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777 (2000) (analyzing what, if anything, government should do to address the prospect of bubbles in U.S. stocks, focusing on the SEC and the Fed, and criticizing the "stock-based investor religion" that has been fostered and that "has distorted market demand for stocks"); Karmel, *supra* note 9 (suggesting a role for the SEC in curbing speculation).

The Supreme Court has itself limited the reach of the federal securities laws by circumscribing the SEC's regulatory purview to disclosure-related matters, unless the relevant statute provides (or at least contemplates) otherwise. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); *see also* Paredes, *supra* note 67, at 423 n.17. *But see* Chamber of Commerce of U.S. v. SEC, 412 F.3d 133, 138–40 (D.C. Cir. 2005) (presenting an arguably more expansive reading of SEC authority under the Investment Company Act).

"alpha"—as more and more money chases market inefficiencies.[101] More to the point, active hedge funds actually promote the integrity of securities markets by engaging in the types of arbitrage that makes securities markets at least semi-strong efficient. The teaching of behavioral finance notwithstanding, the reasonable expectations investors have that they can rely on securities prices as approximating fundamental value is a cornerstone of securities market integrity. Indeed, I am not aware of any indication that hedge fund activities have in any meaningful way undercut investor confidence in securities markets more generally. This is unlike what happened as money flowed out of the market or stayed on the sidelines following the revelations of the scandals at Enron, WorldCom, and elsewhere.

101. *See* Amanda Cantrell, *Hedge Funds: A Wild Quarter*, CNN MONEY, June 1, 2005, *available at* http://money.cnn.com/2005/07/01/markets/hedgefunds.index.htm; Jane J. Kim, *Concerns Grow About Prospects of Hedge Funds*, WALL ST. J., Dec. 15, 2004, at D1; Gregory Zuckerman & Henny Sender, *Hedge Funds Hit Rocky Stretch as Field Becomes More Crowded*, WALL ST. J., May 10, 2005, at A1.

For a summary of the ongoing debate over whether hedge funds generate superior returns, see Edward Chancellor, *Hedge Funds Today: So Much Money So Little Talent*, WALL ST. J., Aug. 24, 2005, at A10; Kim, *supra*; Burton G. Malkiel & Atanu Saha, *Hedge Funds Today: Caveat Emptor*, WALL ST. J., July 26, 2005, at A24; Roger G. Ibbotson & Peng Chen, *Sources of Hedge Fund Returns: Alphas, Betas, and Costs* (Yale ICF, Working Paper No. 05-17, 2005), *available at* http://ssrn.com/abstract=733264. For additional data on hedge fund returns, see Brandon, *supra* note 19, at 9–10. *Cf.* Ianthe Jeanne Dugan, *Sharpe Point: Risk Gauge Is Misused*, WALL ST. J., Aug. 31, 2005, at C1 (explaining the shortcomings of focusing on the so-called "Sharpe Ratio," a measure of a fund's returns to variability, in evaluating hedge fund performance); Jesse Eisinger, *Lifting the Curtain on Hedge-Fund Window Dressing*, WALL ST. J., Sept. 7, 2005, at C1 (discussing the practice whereby, at the end of the month or quarter, some hedge funds are alleged to buy additional shares of stocks the funds own to push up the price, enabling the funds to report better performance to their investors). The issue of how to calculate returns for the hedge fund industry has long been a matter of dispute.

Recently, hedge funds have become more involved in the corporate governance and strategy of the companies they invest in as hedge fund managers have tried new approaches to generate profits. *See, e.g.*, Jesse Eisinger, *Hedge-Fund Activism Wins Plaudits, but the Focus Is Really on Firms' Cash*, WALL ST. J., Oct. 12, 2005, at C1; Jesse Eisinger, *Subplot in Contest for MCI: Fast Money vs. the Long Term*, WALL ST. J., Mar. 9, 2005, at C1; Mike Esterl & Henny Sender, *Highbridge Fund Sent Default Note to Retailer Saks*, WALL ST. J., June 20, 2005, at C5; Gary McWilliams & Gregory Zuckerman, *Circuit City Draws $3.25 Billion Bid; Highfields' Offer Signals New Shareholder Influence by Hedge Fund Managers*, WALL ST. J., Feb. 16, 2005, at A3; Susan Pulliam & Martin Peers, *Once a Loan Wolf, Carl Icahn Goes Hedge-Fund Route*, WALL ST. J., Aug. 12, 2005, at A1; Henny Sender, *Hedge Funds: The New Corporate Activists*, WALL ST. J., May 13, 2005, at C1; Jason Singer, *New Deal: With Rising Clout, Hedge Funds Start to Sway Mergers; Managers in Europe Join Forces to Push Prices Higher; General Dynamics Outbid; Icahn Alleges Vote-Buying*, WALL ST. J., Jan 25, 2005, at A1; Stephen Taub, *Hedge Fund Activism Gains Momentum*, CFO.COM, May 26, 2005, *available at* http://www.cfo.com/article.cfm/4027893?f=related+origin=archive.

To find returns, some hedge funds have also begun to compete with more traditional lenders to make loans, especially to distressed companies. *See* Nicole Bullock, *Hedge Funds Fill the Capital Gap as Banks Cut Power-Sector Loans*, WALL ST. J., Apr. 30, 2003, at B6B; Henny Sender, *Hedge Funds Nip at Wall Street; Financing Role in Recent Deals Challenges the Core Business of Investment-Banking Firms*, WALL ST. J., May 26, 2005, at C1; Henny Sender, *Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play*, WALL ST. J., July 18, 2005, at C1; *see also* Shefali Anand, *Looking Afield, Hedge Funds Launch Reinsurance Firms*, WALL ST. J., July 27, 2005, at C1. Interestingly, hedge funds may hedge their exposure by, for example, shorting their borrower's stock. Even if its borrower suffers financially, the hedge fund can gain from its short. According to some, this gives the hedge fund an incentive to put the borrower in bankruptcy sooner than a traditional lender might.

That said, a caveat is in order. Hedge funds now control $1 trillion and are not simply a small part of the market. Further, discomforting hedge fund conduct, such as alleged vote buying, fraud, and market manipulation, has reached the headlines and come under scrutiny.[102] Thus, investor confidence might take a future hit, even if it has not yet, as the hedge fund industry continues to grow and impact the market. Retail investors in particular might come to believe that the market is rigged against them as they continue to read about hedge fund antics. In fact, investors may lose faith in the SEC if the SEC allows an increasingly influential hedge fund industry to go unregulated. And if investors lose faith in the SEC, they may lose further faith in the integrity of securities markets. Accordingly, perhaps the SEC needed to "do something" given the hedge fund industry's size, secrecy, and market impact.[103] Requiring hedge fund managers to register under the Advisers Act does not meaningfully respond to alleged hedge fund misconduct, although it does give the SEC examination and inspection authority and undeniably is a step in the direction of holding hedge funds accountable.

It is also worth noting that in addressing systemic risk, the Treasury Department and the Federal Reserve have relied on hedge fund creditors and counterparties to discipline hedge fund trading and leverage, even in the aftermath of LTCM's collapse.[104] The regulatory strategy has not been to regulate hedge funds directly. Indeed, then-Federal Reserve Board Chairman Alan Greenspan counseled against the new SEC hedge fund rule because of the risk that hedge fund regulation will compromise the essential efficiency, liquidity, and shock-absorbing role hedge funds play in financial markets. Greenspan testified before the Senate Committee on Banking, Housing, and Urban Affairs:

> If you start to inhibit the number of types of unregulated participants in the financial market from taking the types of risks and supplying the liquidity, I'm fearful that we will remove some of the flexibility that we have in our overall [financial] system. And while

102. *See generally* Henry T.C. Hu & Bernard S. Black, *Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms* (Feb. 2006) (Univ. of Texas Law, Law and Econ Research Paper No. 70), *available at* http://ssrn.com/abstract=887183; Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control (Sept. 28, 2005) (manuscript on file with author). *Cf.* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

103. *Cf.* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 572–73 (2001) (explaining the "suspicion of secret power").

104. In fact, to a considerable degree, the Treasury Department and the Federal Reserve advanced market-based approaches to encourage creditor and counterparty monitoring of hedge funds. See *infra* note 209 for more on market discipline.

A Credit Suisse First Boston study recently put 2004 investment banking revenue from hedge-fund-related activity at about $25 billion. EUROPEAN WHOLESALE BANKS, *supra* note 19, at 10–11. For more on the amount of business that Wall Street does with hedge funds, see, for example, Jed Horowitz, *Wall Street Woos Hedge Funds Despite Worries over Losses*, WALL ST. J., May 16, 2005, at C3. The concern is that with so much business coming from hedge funds, Wall Street firms may be overly eager to do business with hedge funds, compromising the market discipline relied on to keep hedge fund leverage and trading practices in check.

> I'm certainly of the opinion that should hedge funds accept capital from retail investors they should be under the same regulations as mutual funds, but so long as their source of funds, equity funds, are professional or large investors with net worths, say, exceeding a million dollars or more, I see no purpose in regulation and I see very significant potential loss in doing so.[105]

This reintroduces an important point noted earlier. Before one worries too much about systemic risk, one must recognize that hedge funds are important to ensuring the smooth operation of financial markets and the accuracy of securities prices, upon which investor confidence and the integrity of securities markets depend.

Responding to notes of caution such as Greenspan's, in the SEC release adopting the new hedge fund rule, a majority of the commissioners confidently expressed the view that requiring hedge fund managers to register under the Advisers Act will not impede the systemic benefits of hedge funds.[106] The SEC, or at least the three commissioners voting for the rule, might have been overconfident in the agency's ability to administer judiciously the new rule to avoid imposing too heavy of a burden on hedge funds. It is notable that, on the one hand, supporters of the new hedge fund rule reasoned that it would allow the Commission to learn about an industry that had operated outside its scrutiny; on the other hand, the rule's supporters were confident that they knew enough about the industry to assert that the rule would not be too costly. Further, the SEC's own views on the cost-benefit analysis of the hedge fund rule are in tension. The SEC has aptly explained that the new hedge fund rule is a measured reform that does not substantively regulate hedge funds.[107] Yet, the SEC majority voting for the rule also touted the deterrent effects of the new regulation and stated that the specter of an SEC examination "should alter hedge fund advisers' behavior."[108] Whatever its virtues, deterrence has a downside: overdeterrence. Hedge fund manager

105. *Renomination of Alan Greenspan: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. (2004) (statement of Alan Greenspan, Chairman, Fed. Reserve Bd. of Governors).

106. *See* Final Hedge Fund Rule Release, *supra* note 4, at 21–25, 93 (explaining that "registration of hedge fund advisers under the Advisers Act would not impede hedge funds' operations"); Hedge Fund Rule Proposal, *supra* note 53, at 23 ("Registration of hedge fund advisers . . . would not impede hedge funds' operations. The [Advisers] Act does not prohibit any particular investment strategies, nor does it require or prohibit specific investments.").

More to the point, SEC Chairman Donaldson suggested that only bad actors would oppose the rule. He testified before the Senate Banking Committee: "I don't get much push back from people [who] are operating good funds. I don't get much push back from people who have nothing to hide." Stephen Labaton, *Hedge Fund Plan Fractures Civility of Republicans*, N.Y. TIMES, July 16, 2004, at C1. Of course, one reason at least some "good funds" may not have pushed back is because these funds' managers recognized that the new rule could create an entry barrier that gives them a competitive advantage over start-up and smaller funds.

107. Final Hedge Fund Rule Release, *supra* note 4, at 22–25.

108. *Id.* at 28. The SEC continued: "Hedge fund advisers each day make decisions based on risk analysis of alternative investments, and should be particularly sensitive to the consequences of getting caught if their conduct is unlawful." *Id.* at 29.

registration may deter not only bad conduct, but also good conduct. Although investment adviser registration is a measured regulatory step, with it comes SEC examinations and inspections. These examinations and inspections, especially when conducted by a staff that is inexperienced in hedge fund matters and investment strategies, run some risk of regulatory second guessing of legitimate behavior and trading.[109] It is inappropriate, then, to look only to the four corners of the hedge fund rule in evaluating its potential impact on the hedge fund industry. One has to allow for the risk that the rule will crimp certain investment strategies and financial innovations or will keep some reputable managers out of the hedge fund business altogether. In either case, the efficiency, stability, and smooth functioning of financial markets is potentially jeopardized, particularly if there is a significant shock to financial markets that hedge funds are not as ready to absorb.

But judgment on this point should not be passed too quickly. SEC examinations and inspections actually have a bright side. The need for more aggressive SEC regulation may be defused if the SEC uncovers misconduct early before it metastasizes. Would we have the Sarbanes-Oxley Act, for example, if the SEC had uncovered the frauds at Enron and WorldCom years earlier? Some hedge fund regulation today, particularly in the relatively mild form of investment adviser registration, may be worth the cost, including the overdeterrence of beneficial hedge fund behavior, if such regulation reduces the likelihood of a future SEC crackdown.[110]

For reasons such as those highlighted in Part IV below, it seems that the SEC was too ready to regulate hedge funds.[111] Of course, if the SEC does not end up with adequate funding or staffing to carry out its initiatives actively,[112] or if hedge funds end up a low priority at the SEC, the fact that the SEC reversed course to regulate hedge fund managers will be less consequential in practice. The SEC's interest in regulating hedge funds will undoubtedly ease, at least in the near term, with Christopher Cox replacing William Donaldson as SEC chairman.[113]

109. *See, e.g.*, Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Remarks Before the Managed Funds Association (Sept. 29, 2005) (discussing the lack of staff expertise regarding hedge funds).

110. *See* Coates, *supra* note 103, at 567–79 (discussing SEC "re-regulation" after a scandal or economic downturn and how early regulatory efforts may defuse the demand for more aggressive future regulation).

111. For a concise summary of the issues and a conclusion that hedge fund regulation was appropriate "as long as the oversight isn't overzealous," see Frank Partnoy, *Road Rules for Hedge Funds*, N.Y. TIMES, Dec. 15, 2004, at A2.

112. In the past, the SEC, by many accounts, often has been understaffed and underfunded. *See, e.g.*, Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 236–50 (2004).

113. A Cox-led SEC should result in a deregulatory shift at the agency. *See, e.g.*, Stephen Labaton, *Acting Quickly, Bush Nominates Congressman to Lead S.E.C.*, N.Y. TIMES, June 2, 2005, at A1; Deborah Solomon et al., *Cox's Nomination to Run SEC Signals a Regulatory Shift*, WALL ST. J., June

## IV. THE SEC'S MISSION

The SEC's decision to regulate hedge funds by mandating that fund managers register under the Advisers Act reflects a fundamental feature of federal securities regulation—namely, federal securities regulation is primarily oriented toward investor protection in the sense of remedying information asymmetries and rooting out fraud.[114] The SEC, at both the commissioner and staff levels, has long characterized itself as the investors' protector, a framing of the agency's mission that may impact its regulatory approach.[115] Indeed, the agency's mantra, plastered on its Web site and recited time and again by the commissioners and the staff, is that "we are the investor's advocate," a phrase going back to William O. Douglas, who served as an early SEC chairman before becoming a Supreme Court Justice.[116]

Government intervention in securities markets to put information in investors' hands and to protect investors against corporate abuses serves a distributional goal by protecting investors against losses. Such government intervention also serves the larger goal of promoting capital formation and more efficient and liquid securities markets in that investor protection regulation can shore up investor confidence in the integrity of securities markets. Sometimes, though, increased investor protection, such as through more mandatory disclosure and more aggressive SEC oversight and enforcement, can impede market participation and thus undercut the capital formation process and the efficiency and liquidity of securities markets.[117]

This tension drives the cost-benefit analysis of regulating securities markets. Regulatory systems that allow for flexible, dynamic financial markets inevitably come at the risk of investor loss, fraud, and corruption. Regulators have to exercise restraint and allow for misconduct and abuse of investors because, at some point, investor protection overburdens financial markets. The question of when it becomes too costly for the government to protect investors is a fundamental challenge of securities regulation. Expressing a similar sentiment when testifying before Congress after LTCM's demise, then-Federal Reserve Chairman Green-

3, 2005, at A1; Deborah Solomon & John D. McKinnon, *Donaldson Ends an SEC Tenure Marked by Active Regulation*, WALL ST. J., June 2, 2005, at A1.

114. In his remarks at the meeting where the Commission adopted the hedge fund rule, Chairman Donaldson put the new rule in the context of the SEC's "central mission" of "investor protection and enforcement of our securities laws, and most particularly the prevention and prohibition of fraud." William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman, SEC Open Meeting: Registration of Hedge Fund Advisers (Oct. 26, 2004).

115. *See* Choi & Pritchard, *supra* note 91, at 33–36; *see also* A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1083–86 (2005).

116. Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, Greater Boston Chamber of Commerce: The SEC Today (Nov. 6, 1995), *available at* http://www.sec.gov/news/speech/speecharchive/1995/spch065.txt.

117. This is the very concern to which then-Federal Reserve Board Chairman Greenspan directed his comments quoted above.

span explained: "Our current economy, with its wide financial safety net, fiat money, and highly leveraged financial institutions, has been a conscious choice of the American people since the 1930s. We do not have the choice of accepting the benefits of the current system without its costs."[118]

Although it is impossible to quantify precisely, and although one's assessment of the SEC may vary with the context, in the post-Enron era, the SEC generally has emphasized protecting investors against losses despite complaints that doing so will compromise the broader goals of promoting capital formation and ensuring that markets are highly flexible. In adopting its new approach to hedge funds, for example, the SEC stressed recent hedge fund frauds, as well as the role of hedge funds in the market timing and late trading scandals plaguing mutual funds.[119] The SEC paid relatively short shrift to the cost of regulating hedge funds.

In this Part, attention turns away from tallying the costs and benefits of securities regulation generally, or hedge fund regulation in particular, to address two general influences that can predispose the SEC toward regulating in an effort to minimize fraud and related abuse of investors. The first influence is psychological; the second, political. And both breed an investor protection orientation to securities regulation.

Psychology and politics will not affect agency decision making to the same extent, or in the same direction, all the time. A strong case can be made, though, that since Enron's collapse, psychological and political influences have affected the SEC to a noticeable degree and that the effect has been to tilt the SEC toward more aggressive regulation. The SEC's decision to regulate hedge funds falls into this pattern.

### *A. Behavioralism and the "Precautionary Principle"*

The SEC's investor protection approach to securities regulation, especially as it has played out in the post-Enron environment, is consistent with a more general philosophy of risk regulation known as the "precautionary principle."[120] The precautionary principle is most closely linked

118. *Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management, Before the H. Comm. on Banking & Financial Services*, 105th Cong. (1998).

119. *See* Final Hedge Fund Rule Release, *supra* note 4.

120. For extensive discussions of the precautionary principle, see CASS R. SUNSTEIN, LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005); THE PRECAUTIONARY PRINCIPLE IN THE 20TH CENTURY: LATE LESSONS FROM EARLY WARNINGS (Poul Harremoës et al. eds., 2002); RETHINKING RISK AND THE PRECAUTIONARY PRINCIPLE (Julian Morris ed., 2000); Frank B. Cross, *Paradoxical Perils of the Precautionary Principle*, 53 WASH. & LEE L. REV. 851 (1996); David A. Dana, *A Behavioral Economic Defense of the Precautionary Principle*, 97 NW. U. L. REV. 1315 (2003); Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003 (2003) [hereinafter Sunstein, *Beyond the Precautionary Principle*]; Cass R. Sunstein, *Irreversible and Catastrophic* (John M. Olin Law & Econ. Working Paper No. 242; Pub. Law & Legal Theory Working Paper No. 88, 2005), *available at* http://ssrn.com/abstract_id=705328; Cass R. Sunstein, *Precautions Against What? The Availability Heuristic and Cross-Cultural Risk Perceptions*, U. CHI. L. & ECON. (Olin Working Paper No. 220; AEI-Brookings Joint Center, Working Paper No. 04-22, Aug. 2004), *available at* http://ssrn.com/

with environmental and health-related regulation. Simply put, the precautionary principle provides that it is better to be safe than sorry—an aggressive regulatory policy of anticipation and preemption intended to avoid certain harms.[121] The benefit of a precautionary regulatory strategy is that it can lead regulators to take prophylactic steps instead of simply reacting after problems materialize. Regulators are often criticized for being at least one step behind, chasing yesterday's problems instead of anticipating those of tomorrow.[122] However, therein lies the risk of a precautionary regulatory approach—namely, the risk of overregulation as regulators aggressively try to avoid some identified harm. Plus, prophylactic steps often are not informed by the insight and information that comes with the experience that is needed to craft a nuanced response because prophylactic steps, by their nature, presuppose problems that may not in fact exist. Further, with time, it may become clear that today's fix is inappropriate. Without question, delay can be problematic, but so can acting too soon. Additionally, in reality, the precautionary principle is misleading as a regulatory guide. As Cass Sunstein has stressed, precautionary steps with respect to one risk necessarily lead to other risks.[123] Sunstein refers to the "opportunity benefits" that inevitably are lost when some conduct is regulated and the "substitute risks" that can arise when some other risk is regulated.[124]

The real question, then, is what risks do regulators regulate to avoid and what risks do regulators tolerate? Put differently, what risks do we want to be safe from and at what cost? The answer depends in considerable part on value judgments—the normative weight placed on various outcomes. However, it also depends on various psychological biases that affect human judgment and decision making by making certain risks more fearful, even if they are less threatening in fact.

Concerning securities regulation, not only does the SEC perceive itself as the investor's protector, but investor losses, hedge fund collapses,

abstract=578303 [hereinafter Sunstein, *Precautions Against What?*]; Robert W. Hahn & Cass R. Sunstein, *The Precautionary Principle as a Basis for Decision Making*, 2 ECONOMISTS' VOICE, Issue 2 (2005). *Cf.* Adrian Vermeule, *Libertarian Panics*, 36 RUTGERS L.J. 871 (2005) (discussing government responses to "panics").

For a more general argument favoring a "strong" SEC, such as one that presumably undertakes a proactive, aggressive regulatory stance consistent with the precautionary principle, see Robert A. Prentice, *The Inevitability of a Strong SEC*, CORNELL L. REV. (forthcoming).

121. Sunstein, *Beyond the Precautionary Principle*, *supra* note 120, at 1003–04.

122. Indeed, the Sarbanes-Oxley Act was largely reactionary, responding to a myriad of perceived problems, such as analyst conflicts of interests and a lack of auditor independence, that were by no means new concerns.

123. *See, e.g.*, Sunstein, *Beyond the Precautionary Principle*, *supra* note 120, at 1020–29; Sunstein, *Precautions Against What?*, *supra* note 120, at 8–11.

124. *See, e.g.*, Sunstein, *Beyond the Precautionary Principle*, *supra* note 120, at 1008–09, 1023, 1036–38; Sunstein, *Precautions Against What?*, *supra* note 120, at 8–11; *see also* Cross, *supra* note 120, at 882–88.

A related concern is that a "better-safe-than-sorry" approach to one risk can deprive other regulatory efforts of resources. Cross, *supra* note 120, at 908–14. Regulating hedge funds, for example, may divert resources that could be better spent on, for example, mutual fund regulation.

and jarring frauds are salient events that are readily recalled when crafting regulation, particularly in light of the drumbeat of the media and politicians who play up the losses and abuses, magnifying their salience.[125] As such, these events will likely more prominently feature in the decision making of regulators than the events' actual magnitude warrant. This disproportionate impact of especially salient events on decision making is often associated with the so-called "availability heuristic," whereby salient risks are more available to one's mind and thus receive more attention, as well as the "representativeness heuristic" and "probability neglect," according to which people tend to overstate the probability of some bad recent event occurring again in the future.[126] In addition, regulators, by virtue of their positions, may be inclined to respond aggressively to a perceived risk because, after all, regulators are there to regulate.[127] The costs of greater securities regulation—such as the risk of less flexible, less efficient, and less liquid financial markets—are not nearly as stirring or tangible as the perceived costs of not regulating. Perhaps such biases would be countered, and the regulatory calculus dif-

125. *See, e.g.*, Sunstein, *Precautions Against What?*, *supra* note 120, at 21–27 (discussing "cascade" effects).

More generally, it has been shown that market crashes are often met with a strong regulatory response. *See* STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860 (1998); Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997); *see also* Paul G. Mahoney, *The Pernicious Art of Securities Regulation*, 66 U. CHI. L. REV. 1373 (1999); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003); *cf.* Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1 (2002).

126. *See, e.g.*, DANIEL KAHNEMAN & SHANE FREDERICK, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment*, *in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 49, 60–73 (Thomas Gilovich et al. eds., 2002); AMOS TVERSKY & DANIEL KAHNEMAN, *Availability: A Heuristic for Judging Frequency and Probability*, *in* HEURISTICS & BIASES 163, 175–78 (Daniel Kahneman et al. eds., 1982); *see also* Dana, *supra* note 120, at 1321–36; Sunstein, *Beyond the Precautionary Principle*, *supra* note 120, at 1035–54; Sunstein, *Precautions Against What?*, *supra* note 120, at 13–21; *cf.* Gregory Mitchell, *Case Studies, Counterfactuals, and Causal Explanations*, 152 U. PA. L. REV 1517, 1538–39 (2004) (describing how single events, particularly vivid events such as Enron's collapse, affect policy debates as a person "transforms her specific explanation for the isolated event into a general explanation for a class of potential events, and it becomes a prediction for future problems"). For a more critical analysis that questions such biases, see Charles Yablon, *The Meaning of Probability Judgments: An Essay on the Use and Misuse of Behavioral Economics*, 2004 U. ILL. L. REV. 899.

For important work explaining the role of psychology in SEC decision making, see Choi & Pritchard, *supra* note 91 (cataloging behavioral biases at the SEC, including bounded search; bounded rationality; availability, hindsight, and fundamental attribution biases; framing effects; overconfidence; confirmation bias; and groupthink); *see also* Pritchard, *supra* note 115, at 1078–87.

Emotion may also play a role in regulatory decision making. One could imagine regulators, as well as the public, being "disgusted" with and "angry" at senior executives, attorneys, investment bankers, money managers, auditors, and the like after Enron and the other scandals. For a useful overview of law and emotion, see Eric A. Posner, *Law and the Emotions*, 89 GEO. L.J. 1977 (2001).

127. Langevoort has characterized this in terms of the psychology of commitment—that is, regulators are committed to regulating. Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1144 n.16 (2003). Milton Friedman has made a similar point, but contended that regulators regulate to serve their self-interest. Milton Friedman, *Why Government is the Problem*, *in* ESSAYS ON PUBLIC POLICY 1, 7–9 (1993).

ferent, if the risk of overregulation was concretely defined in terms of fewer jobs, the lack of health care, a lower return for investors, and a lower standard of living, or even simply in terms of fewer investment opportunities as opposed to sterile and impersonal concepts like "market efficiency," "capital formation," "capital allocation," and "liquidity."[128]

The bottom line is that securities regulators, as well as the public and the media, often have an exaggerated concern over fraud and investor losses and, at least by comparison, a dulled sensitivity to the costs of greater investor protection.[129] This is not to say that the costs of regulation are unaccounted for, but rather that they frequently do not receive appropriate consideration in the assessment of whether to regulate. The regulatory analysis is especially tilted toward regulating during times of perceived crisis.

The behavioral view of the precautionary principle thus explains the investor protection orientation of securities regulation in terms of psychological influences that cause certain harms to stand out in a person's thinking. Such behavioral influences can result in overregulation even as regulators act in what they honestly believe is the public's best interest but unknowingly go too far. In some instances, regulators are rational and undertake a better-safe-than-sorry approach to mitigate whatever risk they are most worried about, having objectively considered the costs and benefits of regulation—a variant of a "maximin" approach to risk regulation that minimizes worst-case scenarios or other particularly bad outcomes.[130] Under the behavioral characterization of the precautionary principle, however, regulators' cost-benefit analysis is skewed. Because of unconscious biases, regulators' good-faith assessments of the costs and benefits of regulating are skewed toward avoiding a particularly salient harm.[131] Stated differently, the hypothesis is that if such biases were not at work, regulators sometimes would not regulate where they currently do; and where such biases are at work, regulators probably do not even see themselves as being particularly precautionary in how they regulate. The concern that cognitive bias leads to overregulation is exacerbated when regulators overestimate their ability to exercise oversight and en-

128. *Cf.* George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) ("So far as the efficiency and growth of the American economy are concerned, efficient capital markets are even more important than the protection of investors—in fact efficient capital markets *are* the major protection of investors.").

129. It is difficult to ascertain the magnitude of the impact of cognitive biases on regulatory decision making. *See* Yablon, *supra* note 126, at 936–37. Who knows for sure what the SEC or any other administrative agency would do if it assessed risk in a more probabilistic fashion?

130. *See generally* Cass R. Sunstein, *Irreversible and Catastrophic*, CORNELL L. REV. (forthcoming), *available at* http://ssrn.com/abstract=705323.

131. Regulators, then, are imperfectly rational just like the rest of us. Thus, one has to consider the irrationality of individuals at the SEC before arguing for more securities regulation in response to investor irrationality and the mounting studies behind behavioral finance. *See* Choi & Pritchard, *supra* note 91.

force the law with a nuanced touch that minimizes the costs of regulation.[132]

Both hedge fund regulation and the broad "proactive" approach to securities regulation that SEC Chairman Donaldson articulated during his tenure from 2003–05 indicate how the precautionary principle operates.[133] As Donaldson put it, "I want us to become better equipped to see over the hills and around the corners for problems that may be looming in the distance."[134] In short, the SEC under Donaldson reacted to Enron and other scandals with an aggressive and preemptive regulatory agenda to protect investors.

The particular post-Enron worry is that securities regulators overestimated the benefits of regulating to protect investors against fraud and other corporate abuses and underestimated the costs of doing so, leading to too much regulation that overburdened securities markets. Even those who initially favored the Sarbanes-Oxley Act and related reforms initiated by the SEC, the New York Stock Exchange, and NASDAQ have begun to wonder whether, at least in some respects, the reaction to Enron and WorldCom was too aggressive—overly precautionary, that is—in attempting to stem potential abuses. More to the point, in Enron's wake, the SEC decided to regulate hedge funds largely on the basis that it had become a one trillion dollar industry and that future widespread abuses may occur, seeming to set aside the cautions of Greenspan and others regarding the costs of regulating the industry and to disregard the animating structure of the federal securities laws that has allowed wealthy investors and institutions to protect themselves without SEC intervention.

### *B. Politics and the "Democratization" of Securities Regulation*

Alternatively, there is a political economy account of the SEC's emphasis on preventing investor losses and attention-grabbing abuses. This account explains regulation as a function of the private benefits

132. Like the rest of us, regulators are subject to being overconfident. *See, e.g.*, *id.* at 28–29. Thus, regulators may overestimate their ability to regulate effectively without overreacting.

133. For example, Chairman Donaldson created a new "Office of Risk Assessment" so the SEC could "anticipate potential problem areas [in] the securities industry, and [] focus on early identification of new or resurgent forms of fraud and illegal or questionable activities." Press Release, Sec. & Exch. Comm'n, Charles Fishkin Named Director of SEC's New Office of Risk Assessment: Director to Coordinate Initiatives Launched by Chairman in 2003 (2004), *available at* http://www.sec.gov/news/press/2004-92.htm. The office is said to operate under the "Doctrine of No Surprises." Joshua Chaffin & Adrian Michaels, *Investor Protection to Be SEC Priority*, FIN. TIMES, Nov. 18, 2003, at 17. For more information, see U.S. Securities & Exchange Commission, 2004–2009 Strategic Plan, http://www.sec.gov/about/secstratplan0409; Lori A. Richards, Director of the Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, The Need for More Proactive Risk Assessment, Remarks at NRS Annual Spring Compliance Conference (Apr. 14, 2004), *available at* http://www.sec.gov/news/speech/spch041404lar.htm.

134. William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Remarks to the Practicing Law Institute (Mar. 5, 2004), *available at* http://www.sec.gov/news/speech/spch030504whd.htm.

regulators might get from regulating or, to express it in somewhat softer terms, regulators' responsiveness to the political agenda of the day. More active regulation and enforcement of the federal securities laws in recent years might have been warranted on the merits as a range of abuses came to light with the scandals at Enron and elsewhere.[135] Still, the political economy take on securities regulation has particular resonance in the post-Enron era. The SEC was criticized in a way that it rarely is for not doing more to prevent the wave of corporate scandals led by the collapses of Enron and WorldCom. In addition, the agency was widely rebuked for not catching the market timing, late trading, and other abuses that plagued the mutual fund industry. At the same time, New York Attorney General Eliot Spitzer aggressively attacked corporate corruption, displacing (or at least challenging) the SEC in the arena of securities regulation, and he was lauded for uncovering some of the scandals that occurred on the SEC's watch.

Over the past few years—including when the SEC adopted the new hedge fund rule—the SEC has responded to this embarrassing criticism with aggressive regulation and enforcement.[136] The Commission acceded to mounting political pressure to "do something" to be proactive going forward in the aftermath of Enron, WorldCom, and the mutual fund scandals. There was, in short, a widespread demand for securities regulation from politicians as well as the public. The fashion turned in favor of stiffer securities regulation and enforcement, with the presumption falling in favor of regulation and the burden resting on those who opposed more government intervention into securities markets to prove their position.

One might expect SEC activism in response to competition from Spitzer, as well as to the possibility that Congress could step in to fill a

135. For arguments that the Sarbanes-Oxley Act might have gone too far, see, for example, Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495 (Nancy Rapoport & Bala Dharan eds., 2004); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002).

136. *See, e.g.*, Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 967–68 (2005) [hereinafter Macey, *Positive Political Theory*]; Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117 (2004) [hereinafter Macey, *Wall Street in Turmoil*]; John C. Coffee, Jr., *Competitive Federalism: The Rise of the State Attorneys General*, N.Y. LAW J., Sept. 18, 2004, at 5; *see also* Choi & Pritchard, *supra* note 91, at 26–27 (discussing the "political imperative [of the SEC] to respond to the latest headlines"); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 921–49 (1994) [hereinafter Macey, *Administrative Agency Obsolescence*] (arguing that the SEC aggressively asserted itself to grab regulatory "turf" in response to what Macey characterized as the agency's "obsolescence" in the early 1990s); Pritchard, *supra* note 115, at 1078–83 (arguing that there has been "regulatory overreaction" at the SEC since Enron's demise). *See generally*, BREYER, *supra* note 7, at 33–51 (discussing the role of politics and public perceptions of risk and harms in risk regulation and the incentive of regulators to "err on the safe side").

perceived regulatory void.[137] Plus, the SEC faces a new kind of pressure to regulate as securities markets have become more democratized in recent years with a growing number of investors, including individual investors, paying attention to the SEC.[138] The existence of a burgeoning "investor class" in the United States, where nearly half of all U.S. households were invested in one or more mutual funds in 2003, is bound to influence securities regulation, even at an independent administrative agency such as the SEC.[139] Even though commissioners and staff at the SEC are not as brazenly political as elected officials might be in trying to please voters, individuals within the agency, to one degree or another, are presumably interested in shoring up their own reputations and promoting their own personal opportunities. Any such concerns play out against a background sensibility that regulators do "good" by acting, which itself points toward more regulation. Further, the SEC has an institutional interest in assuring its predominance in regulating securities markets and staking out its jurisdiction against potential or actual incursions by Congress or the states. It should be noted, though, that not everybody at the SEC has towed the more-aggressive regulatory line of recent years. Although making the case against more regulation on the heels of Enron was an uphill challenge given the political climate, SEC Commissioners Atkins and Glassman repeatedly dissented in a series of important three-to-two votes.[140]

The bright side of regulatory competition, coupled with increased public scrutiny of the agency, is that it might have spurred a lax SEC into action.[141] The concern, of course, is that the SEC became too active in trying to protect investors.[142]

137. A more sinister take, and one that has been offered regarding the SEC's hedge fund regulation, is that the SEC has acted opportunistically to build a regulatory empire when given the chance to do so in the wake of Enron and the other scandals. *See SEC Crime Spree*, WALL ST. J., Sept. 27, 2004, at A18 (describing the new hedge fund rule as SEC "empire-building"); *see also* Macey, *Positive Political Theory*, *supra* note 136 (arguing that the scandals at Enron and elsewhere created a "policy window" that allowed the SEC to expand its reach).

138. *See, e.g.*, Donaldson, *supra* note 134 ("More recent disclosures that a number of mutual funds engaged in late trading, market timing, and selective disclosure have led individual investors to be outraged, and to demand a swift response.").

139. INVESTMENT COMPANY INSTITUTE, 2004 MUTUAL FUND FACT BOOK 79–80.

140. Commissioners Atkins and Glassman dissented, for example, when it came to adopting the new hedge fund rules, Regulation NMS, and new board independence requirements for mutual fund boards. For more on the political climate post-Enron favoring aggressive regulation of corporations and securities markets, see generally Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

141. *See, e.g.*, Coffee, *A Course of Inaction*, *supra* note 9, at 46; Dale A. Oesterle, *Early Observations on the Prosecutions of the Business Scandals of 2002–03: On Sideshow Prosecutions, Spitzer's Clash with Donaldson over Turf, the Choice of Civil or Criminal Actions, and the Tough Tactic of Coerced Cooperation*, 1 OHIO ST. J. CRIM. L. 443, 467–71 (2004).

142. Most of the critiques have focused on the SEC's response to Spitzer. Many have argued that the SEC ramped up its regulatory and enforcement efforts, at least in part, to show it was acting and to stay a step ahead of Spitzer. *See* Coffee, *A Course of Inaction*, *supra* note 9, at 49 (explaining that "Spitzer's tougher approach has clearly had an impact on the SEC"); Macey, *Wall Street in Turmoil*, *supra* note 136, at 120; Oesterle, *supra* note 141, at 458–71; Charles Gasparino, *Regulators Muscle Up*,

More generally, an administrative agency has a comparative advantage over other lawmakers in crafting regulatory regimes because of the agency's subject matter expertise and its ability to remain relatively insulated from politics and public clamoring, as least as compared to elected officials.[143] An expert agency's comparative advantage is compromised, however, when its members respond to political pressures and headlines in determining how to regulate.[144] The independence and impartiality of an administrative agency are eroded when politics rival the underlying merits of regulatory proposals when an agency sets its agenda. Accordingly, an administrative agency, such as the SEC, should avoid being influenced by the kind of political and reputational pressures that can influence elected officials who have to politick. As others before me have stressed, politics and headlines are not the proper gauge of what makes for a prudent regulatory regime. In short, the SEC should not cave to pressure from business interests *not* to regulate, but nor should it be

NEWSWEEK, Apr. 16, 2005, at 48 (discussing the "Spitzer Effect" in explaining the SEC's aggressive regulatory stance and stating that the "SEC seems determined to show it's not the 90-pound weakling of the regulatory world"); Deborah Solomon, *Hot Issues Await Donaldson in First Days at SEC's Helm*, WALL ST. J., Feb. 18, 2003, at A4 (explaining that "[t]o get state attorneys general . . . to back down, Mr. Donaldson will need to convince them that he is ready to hold Wall Street's feet to the fire" and that by regulating hedge funds, Donaldson "can quickly strike a populist tone with investors" and reporting Senator Schumer as saying that "[Donaldson's] got to act pretty boldly and decisively early on"); *cf.* Harry DeAngelo et al., *Perceptions and the Politics of Finance: Junk Bonds and the Regulatory Seizure of First Capital Life*, 41 J. FIN. ECON. 475, 478 (1996) (arguing that plans to run for governor influenced then-California Insurance Commissioner John Garamendi's decision to seize two insurance companies that were heavily invested in junk bonds at a time when junk bonds were out of favor). *See generally* Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APP. CORP. FIN. 13 (1991) (discussing the politics of finance and takeovers).

Congress' quick and heavy-handed response to Enron and WorldCom with the Sarbanes-Oxley Act illustrates the possibilities. For a thorough account of events leading up to the adoption of Sarbanes-Oxley, see generally Romano, *supra* note 140; Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

Hedge fund legislation has been proposed in Congress before. *See* Stephen M. Schultz & Steven B. Nadel, *Handling Hedge Funds: Navigating the Regulatory Maze*, 5-JUN BUS. L. TODAY 54, 56 (1996); Leslie Wayne, *Congress to Debate Greater Oversight of Hedge Funds*, N.Y. TIMES, Oct. 1, 1998, at C1.

143. *See, e.g.*, BREYER, *supra* note 7, at 60–63, 78 (noting the importance of "political insulation" for those charged with risk regulation). For a classic treatment of the regulatory benefits of independent agencies that have expertise in the area in which they regulate, see, for example, JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS (1938). *See also* Michael J. Breger & Gary J. Edles, *Established by Practice: The Theory and Operations of Independent Federal Agencies*, 52 ADMIN. L. REV. 1111, 1135 (2002); Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 234–36, 250–53 (2004); *cf.* Jim Rossi, *Participation Run Amok: The Costs of Mass Participation for Deliberative Agency Decisionmaking*, 92 NW. U. L. REV. 173 (1997). *But cf.* PAUL SLOVIC, THE PERCEPTION OF RISK (2002) (extolling the virtues of the "rival rationality" of lay persons).

Whether an administrative agency can be *too* independent is beyond this article's scope, although it is doubtful that this is a concern for the SEC. A number of influences constrain the agency's behavior. For example, the SEC is subject to congressional oversight and is funded by Congress. SEC administrative proceedings, rulemaking, and enforcement actions are subject to judicial review. Commissioners serve limited five-year terms and the commissioners are politically divided with no more than three of the five commissioners coming from the same political party. The sophisticated staff at the agency can moderate what the SEC does. Finally, the corporate and securities bar, as well as investors and other securities market participants, keep tabs on the agency and monitor its activities.

144. *Cf.* Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059, 1064–73 (2000) (assessing various problems when regulators respond to a public demand for regulation).

swayed by pressure from the public or media scrutiny *to* regulate. Even if individuals at the SEC do not push regulation to score points with the public, the effect is comparable if the SEC tries to outflank elected officials to protect its turf.[145]

The same point can be made another way by more explicitly considering the SEC's payoffs when deciding whether or not to regulate. If the SEC fails to regulate, particularly on the heels of a period of scandals, and there are subsequent instances or episodes of attention-grabbing corporate malfeasance, the SEC will likely be scorned for being lax. Yet if the SEC regulates aggressively, the SEC may face some mild criticism, but it will not be lambasted for going too far. This itself could bias the agency in favor of regulating when in doubt.

To be clear, this is not to say that the SEC should not take the public's views and concerns into account; it should. For that matter, the SEC should also take the views and concerns of corporate America into account. Further, the SEC should be flexible enough to adjust its regulatory agenda and proposals as it gains a richer and more textured understanding of issues.[146] However, there is a difference between regulators who consider the perspectives of the public in trying to craft the optimal regulatory regime that accommodates all interests and regulators who regulate, if only in part, to appease an agitated public, avoid the risk of further criticism, or career build.[147]

The SEC is always subject to political influence because of congressional oversight and funding decisions, as well as the possibility that Congress will legislate or simply subject the SEC to hearings on the Hill to explain itself.[148] The White House also can always publicly or pri-

145. The phrase "regulatory competition" really is a misnomer in this context. Regulatory competition typically contemplates that regulated parties have a choice of which regulatory regime governs their activities. For example, a company can choose to incorporate in Delaware, California, Nevada, Ohio, or any other state. The reality, though, is that parties are subject to both the SEC and to Spitzer (or any other state authority with jurisdiction). Instead of referring to regulatory competition between the SEC and Spitzer, perhaps we should talk in terms of "regulatory piling on." Beyond that, when Spitzer or others in effect regulate through law enforcement, the de facto regulatory regime that such authorities impose is not subject to any of the procedures spelled out in the Administrative Procedure Act. The decision-making process can take place behind closed doors, whereas at least the meetings of administrative agencies, such as the SEC, generally must be open. (The best such example being the global settlement addressing securities analyst conflicts of interest, which, it should be noted, the SEC signed on to. *See, e.g.*, Stephen Labaton, *10 Wall Street Firms Reach Settlement in Analyst Inquiry*, N.Y. TIMES, Apr. 29, 2003, at A1; Randall Smith et al., *Wall Street Firms to Pay $1.4 Billion to End Inquiry, Record Payment Settles Conflict-of-Interest Charges*, WALL ST. J., Apr. 29, 2003, at A1.) Ironically, the D.C. Circuit Court of Appeals recently found that the SEC itself violated the requirements of the Administrative Procedure Act in adopting certain mutual fund rules in 2004. See *infra* note 187.

146. *See infra* note 184 and accompanying text.

147. As one of the SEC Canons of Ethics puts it, a Commission member "should not be swayed by partisan demands, public clamor or considerations of personal popularity or notoriety; so also he should be above fear of unjust criticism by anyone." 17 C.F.R. § 200.58 (2005).

148. For an overview of the independence of the SEC and its funding, see Seligman, *supra* note 143.

vately weigh in with the agency.[149] The politics of securities regulation, however, seemed to weigh more heavily on the SEC in Enron's wake, as the SEC tried to make up for prior periods of laxity.[150] The "democratization" of securities regulation—that is, the impact on securities regulation of a growing investor class and more intense media attention—lays the foundation for excessive investor protections that overly burden business, the capital formation process, and securities market operations.

Competition from Spitzer has already subsided and the public scrutiny directed toward the SEC has begun to fade as the most egregious corporate abuses are behind us; stocks have rebounded from the clouds of scandal; and a new set of issues, other than going after corporate crime, have become better political fodder for elected officials. This is, however, only mildly comforting to those who believe that securities regulation went too far in recent years because the effects of the recent crackdown on corporate abuses will continue to be felt, especially insofar as the SEC enacted new mandates that remain on the books, such as the new hedge fund rule.

### *C. When First Steps Are Not Last Steps*

Unlike many of the reforms enacted post-Enron, the SEC's new hedge fund rule is relatively modest. Accordingly, concerns that the SEC went too far in adopting the rule change are eased somewhat. Even so, there is reason to worry that the SEC's first step in regulating hedge funds will not be its last.[151]

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149. Much has been written on the relationship between administrative agencies, on the one hand, and Congress and the President, on the other. *See, e.g.*, Lisa Schultz Bressman, *Beyond Accountability: Arbitrariness and Legitimacy in the Administrative State*, 78 N.Y.U. L. REV. 461, 487–515 (2003); Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137 (2001); *see also* WILLIAM L. CARY, POLITICS AND THE REGULATORY AGENCIES (1967); ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE (1992); Harvey J. Goldschmid, *The SEC at 70: Let's Celebrate Its Reinvigorated Golden Years*, 80 NOTRE DAME L. REV. 825 (2005); Macey, *Positive Political Theory*, *supra* note 136, at 952–56; Pritchard, *supra* note 115; Seligman, *supra* note 143, at 250–53; J. Sinclair Armstrong, *Congress and the Securities and Exchange Commission*, 45 VA. L. REV. 795 (1959); Symposium, *The Independence of Independent Agencies*, 1988 DUKE L.J. 215; *cf.* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005) (studying the circumstances under which Congress will step in to make corporate law and displace Delaware).

150. *See supra* note 142.

151. For careful analysis of slippery slopes and how they actually come about, see Frederick Schauer, *Slippery Slopes*, 99 HARV. L. REV. 361 (1985); Eugene Volokh, *The Mechanisms of the Slippery Slope*, 116 HARV. L. REV. 1026 (2003). *See also* Eric Lode, *Slippery Slope Arguments and Legal Reasoning*, 87 CAL. L. REV. 1469 (1999); Mario J. Rizzo & Douglas Glen Whitman, *The Camel's Nose Is in the Tent: Rules, Theories, and Slippery Slopes*, 51 UCLA L. REV. 539 (2003); Ruth E. Sternglantz, *Raining on the Parade of Horribles: Of Slippery Slopes, Faux Slopes, and Justice Scalia's Dissent in* Lawrence v. Texas, 153 U. PA. L. REV. 1097 (2005).

Commissioner Atkins recently said in a speech that, having realized that Form ADV disclosures required of registered investment advisers are of little use, the SEC staff is

> mulling over ways to get more data from the [hedge fund] industry such as requiring that information be filed periodically with the SEC. Although proponents of registration insisted that they

When a scandal concerning hedge funds breaks, or when hedge funds become, say, a $3 trillion industry, the SEC may feel compelled to regulate more, perhaps moving beyond hedge fund advisers to the actual funds. Some, including the SEC, may see another scandal or an implosion of some large funds as proof that the SEC did not go far enough in requiring investment adviser registration and that more regulation is needed.[152] Having regulated hedge funds once, it will be easier for the SEC to regulate again because the agency will have already crossed the line into hedge fund regulation with the recently adopted rule.[153] Indeed, having entered the hedge fund fray with its new rule, the SEC may have set itself up for criticism if a widespread scandal emerges or hedge fund valuations collapse for some other reason. Even if the commissioners voting in favor of the hedge fund rule genuinely had no expectation of further regulation—and in fact would not further regulate if faced with another LTCM or a succession of Canary Capitals[154] and Bayous—future commissioners may have a different take. The Donaldson Commission, in adopting the hedge fund rule, did not (and perhaps could not) bind future commissioners not to regulate more. The SEC offered numerous rationales for regulating hedge funds, any one of which could provide the basis for more intrusive regulation in the future.[155]

One concrete concern is that the SEC will at some point regulate venture capital and private equity funds, which are increasingly hard to distinguish from hedge funds. Presently, the two-year lock-up period included in the new hedge fund rule is intended to save the managers of venture capital and private equity funds from having to register as investment advisers. Because venture capital and private equity funds have typically had longer lock-up periods than hedge funds, the two-year lock-up provision operates to remove venture capital and private equity funds from the definition of a "private fund" whose manager must register under the Advisers Act. There otherwise is no principled basis articulated in the hedge fund report prepared by the SEC staff as a prelude to the new rule, or in the SEC's proposing or final rule releases, for treating the managers of venture capital and private equity funds differently from hedge fund managers.[156]

> were not interested in hedge fund advisers' investment strategies, might not the staff conclude that strategies are a relevant factor in assessing risk?

Paul S. Atkins, Commissioner, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Remarks Before the Managed Funds Association (Sept. 29, 2005), *available at* http://www.sec.gov/news/speech/spch092905psa.htm.

152. *Cf.* Gregory Mitchell, *supra* note 126 (describing how generalizations and "causal stories" are extrapolated from single events).

153. *See* Volokh, *supra* note 151, at 1077–82 (cataloging the mechanisms of the slippery slope).

154. Canary Capital Partners LLC, a hedge fund, was implicated in the market timing and late trading mutual fund scandals around 2002–03. *See* Coffee, *A Course of Inaction*, *supra* note 9, at 49; Karmel, *supra* note 9, at 929–33.

155. *See* Final Hedge Fund Rule Release, *supra* note 4.

156. For additional commentary on the two-year lock-up, see John Berlau, *Who Is Watching the Watchdog?*, WALL ST. J., Dec. 9, 2005, at A14 (noting that the two-year lock-up is the only regulatory

The two-year lock-up period may have already had a distorting effect on the hedge fund industry. Hedge funds are starting to adopt longer lock-up periods to avoid the investment adviser registration requirement.[157] Yet, it may be difficult for newer hedge funds whose managers are less well-known and who do not have a track record of success to convince investors to lock up their money for longer periods. And the costs and burdens of compliance with the Advisers Act may be too great for smaller funds to bear. Thus, the new hedge fund rule may have erected an entry barrier that undercuts competition in the hedge fund industry by giving established firms an advantage over upstarts.[158] Indeed, established funds might have welcomed the SEC's venture into hedge fund regulation. Not only may the regulation undercut competition for capital, but a two-year lock-up compromises the disciplining effect of threatened capital withdrawals. The SEC may respond to longer lock-up periods, having invited them, with more regulation.

In brief, even if requiring hedge fund managers to register as investment advisers makes sense, perhaps the SEC should have abstained from taking this first step because of the risk that it will lead to overly burdensome regulation down the road—that is, that the SEC's mission will creep so that private equity and venture capital funds get swept up in the SEC's targeting of hedge funds and that hedge fund activities themselves will eventually be regulated more aggressively. It might have been appropriate for the SEC to sit on its hands today to avoid going too far in the future.

On the other hand, the slippery slope risk can prove too much. There is always the risk that prudent regulation today will lead to excessive regulation tomorrow. Legislators and regulators, as well as courts, are in the business of having to draw these regulatory lines. As Justice Holmes put it, "[W]here to draw the line . . . is the question in pretty much everything worth arguing in the law."[159] It is possible that the SEC will limit itself to investment adviser registration for hedge fund managers, as presently defined under the Advisers Act. Further, changed circumstances may warrant tougher regulation, and appropriate reforms may be easier to implement in the future if initial steps are taken earlier. By taking moderate steps to regulate hedge funds today, the SEC may be seen as having "purchased an option" to regulate further.[160] Addition-

distinction between hedge funds on the one hand and private equity and venture capital funds on the other).

157. Gregory Zuckerman, *Hedge Funds Brace for Regulation*, WALL ST. J., June 8, 2005, at C1; *see also* Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule: Some Big Firms Change Lockups, Stop Accepting New Investments to Take Advantage of Loopholes*, WALL ST. J., Nov. 10, 2005, at C1.

158. *See* Zuckerman, *supra* note 157; Allison Bisbey Colter, *Some Hedge Fund Managers Welcome More Regulation*, WALL ST. J., Feb. 5, 2003, at B7D.

159. Schauer, *supra* note 151, at 380 n.52 (quoting Irwin v. Gavit, 268 U.S. 161, 168 (1925)).

160. *See* Sunstein, *Irreversible and Catastrophic*, *supra* note 120; *see also* RICHARD POSNER, CATASTROPHE: RISK AND RESPONSE 161–62 (2004).

ally, although there is merit to the slippery slope argument, within it lies the danger that regulators will be overly conservative and inflexible. Excessive adherence to the status quo entrenches prior decisions at the expense of useful reform. And those who oppose regulation should be cautious before staking too much on the slippery slope argument because the same argument can be employed to argue against deregulation.

### *D. The Bright Side of SEC Precautions*

It is important not to be too critical of the SEC's emphasis on investor protection. Circumstances sometimes warrant a tough regulatory stance and, just because a series of high-profile scandals spawns regulation, it does not inevitably follow that such regulation does more harm than good.[161] At least to a degree, ramped-up SEC efforts to boost disclosures, root out fraud, and aggressively enforce the federal securities laws might have been justified. Additionally, although political pressures and saving face might have spurred the SEC to crack down in recent years, business interests in other instances might effectively block worthwhile regulatory initiatives needed to protect investors.[162] There are certain periods, such as during bull markets or when the SEC is under budget pressures, when SEC oversight might be too passive.[163] More generally, just as there are periods of active regulation that can be excessive, there are also periods of active deregulation. In the past decade or so, there were a number of deregulatory developments, some of which were blamed for helping set the stage for the Enron wave of scandals by contributing to a more permissive regulatory and enforcement environment.[164] In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court held that there was no private cause of action under § 10(b) and Rule 10b-5 of the 1934 Act for aiding and abetting securities fraud.[165] The Private Securities Litigation Reform Act of 1995

161. *Cf.* Vermeule, *supra* note 120, at 871 (making the point that panics might be justified and that "fear can motivate beneficial action as well as detrimental action"). For an argument in a different context that scandal-driven legislation can be beneficial, see DAVID A. SKEEL, JR., ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM (2005).

162. For more on public choice and the SEC, see Coates, *supra* note 103; Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527 (1990); Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315; Jonathan R. Macey, *Administrative Agency Obsolescence*, *supra* note 136. *See generally* Paul G. Mahoney, *The Political Economy of the Securities Act of 1993*, 30 J. LEGAL STUD. 1 (2001).

163. For a history of SEC budget pressures, see Seligman, *supra* note 143, at 236–49.

164. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 318–24 (2004); Troy A. Paredes, *After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*, 81 WASH. U. L.Q. 229, 234–36 (2003).

165. 511 U.S. 164 (1994); *cf.* E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571, 1578–1603 (2004) (explaining the judicial expansion and contraction of the federal securities laws). More re-

(PSLRA) (1) heightened pleading requirements, making it more difficult for private plaintiffs to survive a motion to dismiss a securities fraud claim under the federal securities laws;[166] (2) stayed discovery while a motion to dismiss is pending[167] and shifted away from joint and several liability toward proportional liability for securities fraud claims;[168] and (3) created safe harbors for certain misleading forward-looking statements.[169] The Securities Litigation Uniform Standards Act of 1998 also restricted state securities class actions.[170] Some may argue, then, that it is appropriate for securities regulation to overshoot in some instances to compensate for times when securities regulation might be too permissive. A basic problem with this pendulum argument, however, is that an instance of overregulation rarely, if ever, matches up neatly with an earlier instance of underregulation in striking the optimal regulatory balance. Further, instances of overregulation are infrequently unwound, although regulators can moderate the impact of overregulation by scaling back enforcement efforts. Still, any evaluation of a regulatory regime must consider the flow of regulation and enforcement over time to see trends and to gain a better appreciation for the long-run net effect. An analysis that focuses on a snapshot of a particular set of reforms in isolation can be misleading. It is also important to consider any SEC regulation, or any failure to regulate, in the context of the entire system of securities regulation. The focus should be on not only the federal securities laws as enforced by the SEC, but also criminal prosecutions brought by the federal government, private lawsuits, norms, best practices, state securities law enforcement, and market pressures.[171]

Another set of arguments, rooted in the need to protect the SEC as an institution, might also cut in favor of the SEC's heavy regulatory hand in recent years. First, if the public demands regulation, perhaps the SEC should supply it.[172] This suggestion is at odds with the article's earlier criticism of the SEC for having responded to political pressure and headlines by aggressively regulating post-Enron. However, the practical reality is that if the public demands SEC action, the agency may have to act aggressively to preserve its own legitimacy and authority as the country's

cently, in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), the Supreme Court stiffened the requirements for private plaintiffs to establish loss causation in a securities fraud action.

166. *See* LOSS & SELIGMAN, *supra* note 63, at 1389.

167. *Id.* at 1387.

168. *Id.* at 1391.

169. *Id.* at 1390.

170. *Id.* at 1189.

171. For more on a systems analysis that views the system of securities regulation as compromising complementary parts that fit together to create a whole that is greater than the sum of its parts, see Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055 (2004); Paredes, *supra* note 164. For a thorough explication of such an approach to law, see Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479 (1997).

172. *Cf.* Pildes & Sunstein, *supra* note 7, at 40–43 (discussing the need for the public to "trust" regulators).

chief securities regulator as well as to settle the markets and boost investor confidence. At a minimum, the SEC may have to regulate *enough* to avoid provoking public outrage for seemingly taking a permissive stance. This is true even if the prudent policy, when it comes to the narrower substantive question of how best to regulate the securities markets, would be to take a more moderate approach. The institutional legitimacy of the SEC is a worthy consideration, and how the SEC measures up to the public's perception of a proper regulatory response matters.[173]

Second, not only may the public demand SEC action, but the SEC staff might too. This is not to suggest that an administrative agency should regulate to please the staff. It is to say, though, that staff morale matters. A demoralized staff can undercut an agency's effectiveness and, in some instances, talented individuals will simply leave. It is reasonable to think that the SEC staff would have been demoralized if the agency had not cracked down in response to the abuses at Enron, WorldCom, and elsewhere. One can easily imagine the staff questioning what the SEC's purpose is if it is not to respond with a heavy hand to such a wave of scandal.

Third, if the SEC had not stepped up its regulatory efforts by adopting a host of new regulations, bringing a record number of enforcement actions, and imposing historic civil fines, some other lawmaker probably would have taken such steps. In particular, the SEC's aggressive stance to occupy the field of securities regulation, including the SEC's decision to extend the Advisers Act to cover hedge fund managers, might have kept Eliot Spitzer from asserting the New York Attorney General's Office further into securities markets, and the SEC's active agenda might have kept Congress from enacting more legislation if it perceived the SEC as being too passive. Even those who have been critical of the SEC for overregulating might have been stuck with a "pick your poison" problem in which the active SEC of the past few years was the best available option when compared to the risk of an even more active Spitzer or Congress had the SEC been less aggressive. In short, SEC activism might have arrested a more burdensome crackdown by others.

173. For more on administrative agency legitimacy generally, see, for example, Bressman, *supra* note 149. *See also* Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667 (1975). For relevant discussions of Stewart, see Matthew D. Adler, *Justification, Legitimacy, and Administrative Governance*, ISSUES IN LEGAL SCHOLARSHIP (2005), *available at* http://www.bepress.com/ils/iss6/art3/; Jerry L. Mashaw, *Structuring a "Dense Complexity": Accountability and the Project of Administrative Law*, ISSUES IN LEGAL SCHOLARSHIP (2005), *available at* http://www.bepress.com/ils/iss6/art4/. To many individuals, the mere existence of malfeasance proves that federal securities regulation was not stringent enough. There is, of course, a different way of looking at it. It might be conclusive proof that the regulatory regime is overly burdensome if there were no frauds. This is not to say that a major fraud, particularly when it leads to a company's collapse, is good in and of itself. It is to say, though, that an optimal regulatory regime will be flexible enough to allow not only for mistakes, but also for some corruption and abuse.

Taking such institutional considerations into account expands the potential grounds for regulation beyond the narrow costs and benefits of a particular proposal.

### *E. Some General Lessons for Risk Regulation in Financial Markets and Otherwise*

Three key points that matter not only in crafting securities regulation, but that bear on the design of risk regulation in any part of an economy, should be culled from the prior discussion and stressed.

First, without really defining the term, this article has discussed the "overregulation" of securities markets. Yet, this term is not self-defining; it must be given meaning. When has regulation gone too far or not gone far enough? As others have explained, this question is, in part, a value judgment.[174] There are costs and benefits of regulating more or less. Depending on one's values or preferences, one places different normative weights on these costs and benefits. Simply put, value judgments drive a person's priorities and, thus, the tradeoffs a person is willing to make when choosing among regulatory options. Some people are willing to regulate more to avoid an Enron, WorldCom, LTCM, or Canary Capital scandal even if the additional burdens on issuers and other securities market participants make it more difficult for companies to raise capital and make securities markets less efficient and less liquid.[175] On the other hand, others are willing to tolerate the risk of corporate abuses and fraud as the price that must be paid for a dynamic economy that ultimately benefits both investors and employees.[176] As George Stigler expressed it:

> To be sure, a list of good things will seldom create controversy if each person is allowed his own priorities, or, differently put, if the price tags are not attached. In fact, there is no substantive difference between hating a thing and professing love for it if only the price were not undeniably exorbitant.[177]

One could recast the point in different terms: should the goal of federal securities regulation be to promote efficient markets and capital formation subject to the constraint that investor losses caused by fraud and other abuses do not exceed some threshold? Or, should the goal of federal securities regulation be conceived of as protecting investors from abuses so long as the efficient and smooth operation of securities mar-

174. *See* Pildes & Sunstein, *supra* note 7, at 55–64; BREYER, *supra* note 7, at 16; *see also* Bagenstos, *supra* note 7, at 1484–87, 1496. For more on the related concept of the "rival rationality" of lay people as compared to experts, see sources cited *infra* note 184.

175. Such value judgments are inescapable when setting regulatory priorities.

176. In making these tradeoffs, cognitive bias might again come into play—in the form of loss aversion—as the SEC focuses on preventing losses caused by fraud at the expense of yet-to-be-realized benefits. *See* Choi & Pritchard, *supra* note 91, at 27–28. Loss aversion reflects the idea that people disfavor a loss more than they value a similar gain.

177. GEORGE J. STIGLER, THE CITIZEN AND THE STATE: ESSAYS ON REGULATION 168 (1975).

kets and capital formation are not compromised too much? In short, what is the optimization problem that federal securities regulation addresses?[178]

However one thinks about it, these tradeoffs are particularly difficult because more than dollars are at stake; the monetary damages from fraud do not capture the entirety of the individual harm.[179] For example, should the psychological and emotional harm to individuals when their retirement is wiped out be taken into account? If so, how?[180]

To be sure, empirical disputes over the actual effect of more or less regulation often lead to disagreements over regulatory policy and tactics.[181] Again, taking the SEC as an example, there are factual disputes over the likely consequences of the SEC's new hedge fund rule.[182] Even without such factual disputes, regulators' underlying value judgments will still often differ and, therefore, so will their perceptions of the proper regulatory response. In fact, a person's values likely affect how she understands and interprets information before her and how she fills the gaps in painting a more complete picture, suggesting an important interconnection between value judgments and factual disagreements.[183] Recognizing that values are at play in defining the line between overregula-

178. When the Securities Act was adopted, President Roosevelt stated, "The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business." H.R. REP. NO. 73–85, at 2 (1933). A different stated purpose, presumably with different regulatory consequences, would have been, "to promote capital formation and honest business with the least possible harm to investors."

179. This point relates to the incommensurability of various benefits and costs. For more on incommensurability, see, for example, Pildes & Sunstein, *supra* note 7, at 64–72 (explaining that "political" and "moral" choices must be made when regulating). *See generally* Symposium, *Law and Incommensurability*, 146 U. PA. L. REV. 1169 (1998).

180. For example, without question, employees at Enron who had both their incomes and their wealth tied to the company should have been more diversified and so bear at least some responsibility for the harms they suffered when the company collapsed. But what many Enron employees *should* have done is different from what they in fact did. The unfortunate fact of the matter is that many Enron employees were not adequately diversified. How should this weigh in the regulatory balance?

181. *See generally* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 4–14 (Harvard Law Sch. Discussion Paper No. 521, 2005), *available at* http://ssrn.com/abstract=839250 (discussing the difficulties of measuring the costs and benefits of financial regulation).

182. A separate particularly noteworthy factual dispute has centered on the costs of new SEC regulations that require greater mutual fund board independence. For the crux of the dispute, see the SEC's release adopting these mutual fund rules and the dissent of Commissioners Atkins and Glassman. Investment Company Governance, Investment Company Act Release No. IC-26520 (Sept. 7, 2004); *see also* U.S. Sec. & Exch. Comm'n, Exemptive Rule Amendments of 2004: The Independent Chair Condition, A Report in Accordance with the Consolidated Appropriations Act of 2005, Staff Report to the U.S. Securities & Exchange Commission (Apr. 2005).

183. Along these lines, for an interesting article that explains factual disputes in terms of "cultural cognition," see Dan M. Kahan & Donald Braman, *Cultural Cognition and Public Policy* 3 (Yale Law Sch., Working Paper No. 87, 2005), *available at* http://ssrn.com/abstract=746508 (developing the claim that "culture is prior to facts in the cognitive sense that what citizens believe about the empirical consequences of [policies] *derives* from their cultural worldviews"). *See also* Dan M. Kahan et al., *Fear and Democracy or Fear of Democracy?: A Cultural Evaluation of Sunstein on Risk*, HARV. L. REV. (forthcoming). If this is so, factual disputes, no matter how sophisticated the empirical analyses, may be intractable.

tion and underregulation is important. It helps ensure that regulators and stakeholders do not talk past each other in urging or opposing regulatory proposals but engage in a more transparent discussion where asserted facts, values, and policy rationales are identified, on the table, and contestable.

Second, for any regulatory goal, crafting a regulatory regime that effectively achieves that goal is a stiff challenge. Even under the best circumstances, designing a "goldilocks" regulatory regime that does not go too far or do too little is difficult. To craft an effective regulatory regime, regulators must be able to appraise, objectively and rationally, the costs and benefits of regulating; regulators' judgment cannot be obscured by cognitive biases. An unbiased, more probabilistic assessment of the consequences of risk regulation should result in more effective regulation that better achieves the defined regulatory purpose. An SEC, for example, that places a priority on protecting investors against fraud may by its own lights crack down too heavily if it irrationally fears another series of scandals because of various cognitive biases that skew its assessment of the costs and benefits of regulating. Even without a regulatory approach intentionally oriented toward protecting investors, the availability bias and other unconscious biases can lead to one. Put differently, the Donaldson SEC might have decided to regulate less aggressively if it had more rationally evaluated the pros and cons of various proposals that it enacted post-Enron. However, concern that the wrong regulatory balance will be struck cuts both ways. In a sustained bull market, such as the 1990s saw, the risk of fraud and corruption or a sharp market decline may be perceived as much more remote than it actually is because individuals do not readily recall any recent scandal or dramatic market selloff. As a result, both regulators and investors may be irrationally lax and complacent.

The takeaway is that whatever value judgments motivate regulators and, as a result, whatever normative weights regulators place on various outcomes, unconscious biases that affect regulators' judgment and decision making can frustrate regulatory efforts, even when regulators are acting in what they honestly believe is the best interest of the public.

Third, as explained above, in weighing the costs and benefits of regulating, it may be appropriate for an administrative agency to consider the impact on the agency if it fails to regulate in response to some perceived crisis. Further, the agency may learn something by considering the public's views, as well as the views of various interest groups. The experts at an agency do not have a monopoly on information, effective analysis, or insight.[184] That said, effective regulation is again foiled when

184. Paul Slovic has been an outspoken proponent of the need for risk regulation to take account of lay individuals' perceptions of risk on the grounds that lay people's risk assessments reflect important value judgments that might differ from experts' judgments. *See, e.g.*, PAUL SLOVIC, THE PERCEPTION OF RISK (2000); *see also* Bagenstos, *supra* note 7, at 1484–87 (summarizing this view).

lawmakers are motivated, even if only to a modest degree, to craft a regulatory regime to appease the general public or a particular constituency. Lawmakers' consideration of the potential private benefits of regulating (or of not regulating) skews their judgment away from acting in the public interest, a basic point that is at the core of the public choice literature.[185] In fact, regulators may actually rationalize their behavior as the "right" thing to do in the best interest of the public to avoid the cognitive dissonance that may be associated with compromising the public interest to further personal interest.[186] Anytime the SEC or other agency is influenced to regulate in response to public pressures to do something, or to scale back regulation in response to pressures from business groups to ease up, it is troubling.

It is not easy to improve the soundness of regulatory decision making. Others have offered a number of possibilities for improving administrative agency decision making, including more rigorous cost-benefit analyses, "harder-look" judicial review of administrative agency decisions, and further use of prediction markets.[187] Additionally, administra-

For a review of Slovic, see Cass R. Sunstein, *The Laws of Fear*, 115 HARV. L. REV. 1119 (2002). *See also* Sunstein, *Cognition and Cost-Benefit Analysis*, *supra* note 7, at 1077–88 (discussing the concept of "rival rationalities").

For an interesting article on the participation of the public in the regulatory state through the notice and comment process, see Mariano-Florentino Cuéllar, *Rethinking Regulatory Democracy*, 57 ADMIN. L. REV. 411 (2005) (also providing an excellent overview of "regulatory democracy"). *See also* Pildes & Sunstein, *supra* note 7, at 8 (suggesting possibilities "to incorporate public judgments about risk so long as they are appropriately informed and reasonable" into regulation).

185. For foundational work on public choice, see, for example, JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

186. *See* Emily Pronin et al., *Understanding Misunderstanding: Social Psychological Perspectives*, *in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT, *supra* note 126, at 637–38 (summarizing cognitive dissonance); Nancy B. Rapoport, *Enron, Titanic, and the Perfect Storm*, 71 FORDHAM L. REV. 1373, 1385–91 (2003) (same).

187. Illustrating the possibilities, the D.C. Circuit Court of Appeals recently found that the SEC violated the Administrative Procedure Act in adopting mutual fund rules in 2004 that provided for more independent mutual fund boards of directors. Chamber of Commerce v. SEC, 412 F.3d 133, 140–45 (D.C. Cir. 2005). The SEC, according to the court, failed to consider adequately the costs of certain reforms and alternatives to the independent chair rule offered by the two dissenting commissioners. *Id.* About a week after the decision, the SEC readopted the rules by a 3-2 vote (Commissioners Atkins and Glassman dissenting, as they did when the SEC adopted the rules originally). Investment Company Governance, Investment Company Act Release No. 26985 (July 7, 2005).

For analyses of these and other proposals, see, for example, Breyer, *supra* note 7; Thomas O. McGarity, REINVENTING RATIONALITY: THE ROLE OF REGULATORY ANALYSIS IN THE FEDERAL BUREAUCRACY (1991); Cass R. Sunstein, LAW OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005); Michael Abramowicz, *Information Markets, Administrative Decisionmaking, and Predictive Cost-Benefit Analysis*, 71 U. CHI. L. REV. 933 (2004); William N. Eskridge, Jr. & John Ferejohn, Comment, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical View*, 87 CORNELL L. REV. 616 (2002); Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489 (2002); Robert W. Hawn & Mary Beth Muething, *The Grand Experiment in Regulatory Reporting*, 55 ADMIN. L. REV. 607 (2003); Thomas O. McGarity, *A Cost-Benefit State*, 50 ADMIN. L. REV. 7 (1998); Pildes & Sunstein, *supra* note 7; Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137 (2001); Eric A. Posner, *Cost-Benefit Analysis as a Solution to a Prin-*

tive agencies could implement various structural reforms, along with stricter internal controls and formal decision-making procedures, to counter cognitive biases and the influence of politics.[188] A number of options could be mined from the experiences of companies and the extensive literatures on organizational behavior, the firm, and management.

Even without rigorous cost-benefit analyses, stricter judicial scrutiny, or revamped organizational structures, risk regulation may still be improved, at least insofar as the risk of overregulation is concerned, if regulators meaningfully were to add default rules to their regulatory menu.

## V. THE SEC'S REGULATORY STYLE

Because securities regulators have imperfect information and thus regulate under uncertainty, the SEC cannot escape the risk that it will get it "wrong." Politics and psychology, especially after periods of scandal, worsen the risk that the SEC will get it wrong by overregulating. If overregulation is a risk—because of imperfect information, politics, psychology, or some combination thereof—what might be done about it?

This article concludes by rethinking the SEC's regulatory style. The following analysis only sketches an approach to securities regulation; it is not a full-blown theory of securities regulation or an exhaustive consideration of the three types of regulatory techniques that it covers: mandatory rules, default rules, and voluntary best practices.

Policymakers often see themselves as having two choices: either adopt mandates or do nothing.[189] Put differently, the choice is often seen as choosing between regulation, on the one hand, and market discipline, on the other. There is, of course, a third option. There is a middle ground that allows regulators to leverage (or encourage) market discipline and thus to influence outcomes but without mandating results.

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*cipal-Agent Problem*, 53 ADMIN. L. REV. 289 (2001); Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549 (2002); Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486 (2002); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059 (2000); Cass R. Sunstein, *Group Judgments: Deliberation, Statistical Means, and Information Markets*, 80 N.Y.U. L. REV. 962 (2005). These works also provide an excellent overview of the administrative state generally. For more on the administrative state, see, for example, Breyer, *supra* note 7; Bressman, *supra* note 149; Cuéllar, *supra* note 184; Pildes & Sunstein, *supra* note 7; Richard B. Stewart, *Administrative Law in the Twenty-First Century*, 78 N.Y.U. L. REV. 437 (2003); Symposium, *Getting Beyond Cynicism: New Theories of the Regulatory State*, 87 CORNELL L. REV. 267 (2002); Symposium, *The Reformation of American Administrative Law*, *available at* www.bepress.com (2005).

Choi and Pritchard have offered a number of suggestions for dealing with behavioral biases at the SEC particularly. *See* Choi & Pritchard, *supra* note 91, at 36–71.

188. *See, e.g.*, Choi & Pritchard, *supra* note 91, at 36–39; Rachlinski, *The Uncertain Case*, *supra* note 91, at 1214–19.

189. *See generally* Steven M.H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 BUS. LAW. 341 (1998) (former SEC Commissioner discussing the "command and control" nature of SEC regulation).

Regulators, for example, can adopt default rules that give the parties an option to opt out.[190] When the SEC chooses to regulate, instead of imposing mandatory one-size-fits-all requirements as it almost always does, the Commission should increasingly consider default rules. The virtue of default rules is that they allow parties to contract around the law to order their affairs to fit their particular needs and preferences. The ability to opt out also provides an important safety valve against the risk of overregulation.[191] This sort of Coasian approach to regulation—whereby regulators allocate rights to certain parties through default rules but allow transacting parties the flexibility to reallocate their rights through contract—would have been particularly appropriate for regulating the hedge fund industry because hedge fund managers and hedge fund investors are sophisticated parties who do, in fact, negotiate. Instead of mandating that a hedge fund manager register as an investment adviser, the SEC could have required a hedge fund manager to register under the Advisers Act or disclose to the fund's investors why the manager has chosen not to register. Investors could then evaluate for themselves the importance of investment adviser registration against the backdrop that managers must register as a default.

It is important to acknowledge that the two-year lockup provision the SEC included in the hedge fund rule turns investment adviser registration into a sort of default. If investors must commit their capital to the hedge fund for at least two years, the fund's manager does not have to register under the Advisers Act. The hedge fund rule, however, does not allow a manager to opt out of investment adviser registration if the fund does not include a two-year lockup. To the extent capital redemptions discipline hedge fund managers, let alone allow investors to cash out and reallocate their capital if they are displeased with a fund's performance, it is easy to imagine that some investors might approve of a manager's opting out of investment adviser registration only if the investors could redeem their capital at any time. The new hedge fund rule cuts off this option, although a true default would permit it.

190. For arguments that the Sarbanes-Oxley Act itself should have made more use of defaults, see Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495 (Nancy Rapoport & Bala Dharan eds. 2004); Larry E. Ribstein, *Sarbanes-Oxley after Three Years* (U. Ill. Law & Econ. Research, Working Paper No. LE05-016, 2005), *available at* http://law.bepress.com/uiuc/wps/papers/act30; Romano, *supra* note 140.

The literature on mandatory versus default rules is vast. For a small sampling, see EASTERBROOK & FISCHEL, *supra* note 76; Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992); Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002); Symposium, *Default Rules and Contractual Consent*, 3 S. CAL. INTERDISC. L.J. 1 (1993); Symposium, *Default Rules in Private and Public Law*, FLA. ST. U. L. REV. (forthcoming 2006). *See also infra* note 198.

191. *See* Choi & Pritchard, *supra* note 91, at 6–7, 44–46 (explaining that securities regulations, once enacted, "often take on a life of their own" whereas competitive pressures allow markets to correct mistakes better). Further, market discipline can fill gaps when there is underregulation.

Precedent exists for a default-rule-based approach to securities regulation. Two notable examples of such an approach under the Sarbanes-Oxley Act of 2002 include the requirement that public companies adopt a code of ethics for senior financial officers or explain why no code was adopted and the requirement that public companies have a financial expert on the audit committee or explain why they do not.[192] In early 2005, the SEC demonstrated the use of defaults when it enacted a new rule under the Investment Company Act that authorizes, but does not require, mutual funds to impose a two percent mandatory redemption fee on short-term trading.[193] On the other hand, in adopting Regulation NMS in 2005, the SEC ultimately rejected the idea of a proposal that would have allowed market participants to opt out of the SEC's new trade-through rule, which, in essence, requires trading centers to get the best price for investors, even at the expense of speed of execution.[194] The SEC also recently rejected the suggestion of Commissioners Atkins and Glassman to require mutual funds to disclose whether they have an independent chairman of the board and whether at least 75% of their board is comprised of independent directors; the SEC instead adopted rules mandating the same.[195]

Those concerned that there will be too much opting out may take comfort in the fact that defaults are sticky, although not legally mandatory.[196] (On the other hand, such stickiness undercuts the point of defaults in the first place.) Assume investment adviser registration for hedge fund managers was a default rule that gave managers an option to opt out. First, as Coase most famously illustrated, the initial legal allocation of entitlements—which would include the "right" to have your hedge fund manager register as an investment adviser under the Advisers Act—is often sticky because of transaction costs.[197] Second, the fact that a hedge fund manager has opted out of the registration requirement would itself be revealing and probably raise suspicions among investors.[198] Investors may rationally interpret the decision to opt out of the

192. *See* Sarbanes-Oxley Act, Pub. L. No. 107-204, §§ 406, 407 (2002).

193. 17 C.F.R. § 270.22c-2(a)(1)(i) (2005).

194. Regulation NMS, Securities Exchange Act Release No. 34-51808 (June 9, 2005).

195. Investment Company Governance, Investment Company Act Release No. IC-26520 (Sept 7, 2004).

196. Accordingly, there is a difference between, say, not opting into registration under the Advisers Act and looking to opt out.

197. *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

198. *See generally* Barry E. Adler, *The Questionable Ascent of* Hadley v. Baxendale, 51 STAN. L. REV. 1547 (1999); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (advancing "penalty defaults" on the grounds that they encourage parties to reveal information in trying to bargain out of the unwanted default); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992) (further advancing information-forcing defaults) [hereinafter Ayres & Gertner, *Strategic Contractual Inefficiency*]; Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591 (1999) (advancing penalty defaults still further). As Ayres and Gertner put it,

default of investment adviser registration as signaling that the manager is somehow dishonest and thus not able (or at least not willing) to comply with the Advisers Act. The decision to opt out of the Advisers Act may be read to reveal more about the manager than the decision not to opt in. Third, the psychological phenomenon known as the "endowment effect" (or alternatively, the "status quo bias") predicts that investors will place higher value on investment adviser registration simply because it is established as a default, meaning that investors will be less likely to negotiate their entitlement away.[199] Fourth, default rules can create a new set of expectations for transactions and in effect shift leverage from one party to another in a negotiation.[200] Not only may investors feel regret if they bargain away their "right," but they may feel emboldened, and thus may dig in, in demanding that the hedge fund manager register once an authority such as the SEC has blessed investment adviser registration and signaled to investors its importance.[201] In part for reasons suggested by item two above, it may be more difficult for a manager to ask to opt out after the SEC expressed its approval for registration. Finally, the default rule itself may serve as an anchor that unconsciously biases the parties' toward keeping with the default.[202]

The SEC can consider an even less intrusive regulatory technique that is more deferential to market outcomes than default rules. The SEC can take advantage of its influence as the dominant regulator of U.S. securities markets and its long-standing reputation as a highly respected

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> In a variety of contexts, promisees may be reluctant to raise issues that indicate that the promisor will have higher costs of performance. . . . [Individual contractors] may be reluctant to suggest alternative provisions . . . because to do so might indicate that the individual is more litigious or more rigidly deontological, and thus more costly to deal with. . . . An aversion to making a counteroffer to a standard form contract may also exhibit a party's strategic reluctance to reveal private information.

Ayres & Gertner, *Strategic Contractual Inefficiency*, *supra*, at 764. For a good summary of this quality of defaults, see Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 617–21 (1998) [hereinafter Korobkin, *The Status Quo*].

199. In other words, the setting of defaults can itself change individual preferences. Professor Korobkin has done some of the leading work on the endowment effect (and inertia more generally) and bargaining. *See, e.g.*, Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998) [hereinafter Korobkin, *Inertia and Preference*]; Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227 (2003) [hereinafter Korobkin, *The Endowment Effect*]; Korobkin, *The Status Quo*, *supra* note 198. For more on the psychology of bargaining, see Russell Korobkin & Chris Guthrie, *Heuristics and Biases at the Bargaining Table*, 87 MARQ. L. REV. 795 (2004) [hereinafter Korobkin & Guthrie, *Heuristics and Biases*].

200. Compare the focal point explanation of the law's expressive function that Professor McAdams has advanced. Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000); *see also* Robert B. Ahdieh, *Law's Signal: A Cueing Theory of Law in Market Transition*, 77 S. CAL. L. REV. 215 (2004).

201. *See* Korobkin, *The Status Quo*, *supra* note 198, at 624 n.47 (citing, among others, David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1879 (1991)).

202. *See, e.g.*, McAdams, *supra* note 200, at 1686–88 (explaining that the "behavior the law 'proposes' can create a focal effect" and that the "psychological literature on 'anchoring' suggests that the first proposed split strongly affects bargaining"); *see also* Korobkin & Guthrie, *Heuristics and Biases*, *supra* note 199, at 799–800.

administrative agency.[203] The SEC can adopt a best-practices mode of regulation—which is to say that the SEC can articulate best practices to guide various securities market participants, in effect leveraging the possibilities of market discipline as a substitute for formal rulemaking. The SEC can formally express its view of best practices through its releases or informally express them through the speeches and writings of individual commissioners and directors of the SEC's various divisions. For example, instead of adopting the new hedge fund rule, the SEC could have emphasized particular best practices for the hedge fund industry, such as the appointment of a chief compliance officer, that hedge fund managers and investors would have been encouraged, but not required, to follow. Imagine the possible market impact if the SEC Chairman and at least one other commissioner, along with the directors of the Divisions of Investment Management and Corporation Finance, had touted a consistent set of hedge fund best practices in a series of speeches; let alone if the SEC had adopted a policy statement on hedge fund best practices. Indeed, the SEC can still go the best-practices route when it comes to such matters as hedge fund valuation[204] or additional disclosures that the SEC believes hedge funds should make and that investors should demand. Experience with the 1933 Act already reflects the influence of a strong statement by the SEC. Even when no disclosures are required in a private offering to accredited investors, issuers typically prepare a private placement memorandum that looks very similar to a registration statement required for public offerings.

A best-practices approach to securities regulation allows for an analogy to Delaware corporate law. To a significant degree, the Delaware courts enforce an enabling corporation code by articulating best practices and aspirations—referred to by Edward Rock as "corporate law sermons"—without imposing any legal liability when directors and officers fail to satisfy these judicially endorsed norms of good corporate governance.[205] The Delaware judiciary's relatively hands-off approach,

203. Studies show that people tend to follow the recommendations and suggestions of authority figures, such as judges and lawmakers, even when it is not required. *See, e.g.*, Lynn A. Stout, *Other-Regarding Preferences and Social Norms* 6, 23 (Georgetown Law & Econ., Working Paper No. 265902, 2001), *available at* http://ssrn.com/abstract=265902.

204. A number of issues swirl around hedge-fund valuation. *See, e.g.*, Henny Sender & Gregory Zuckerman, *Depends on the Math: Valuations May Mask Hedge-Fund Returns*, WALL ST. J., Mar. 25, 2003, at C1; *see also supra* note 101.

205. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1017 (1997); *see also* E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 686–92 (1998); Robert Cooter, *Do Good Laws Make Good Citizens? An Economics Analysis of Internalizing Legal Values* (UC Berkeley Law & Econ., Working Paper No. 2000-8, 2000), *available at* http://ssrn.com/abstract=229950; Lynn A. Stout, *Other-Regarding Preferences and Social Norms* (Georgetown Law & Econ., Working Paper No. 265902, 2001), *available at* http://ssrn.com/abstract=265902.

I have addressed Delaware's approach in more detail in another article. *See* Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1087–96 (2004); *cf.* Wallman, *supra* note 189, at 345 (advocating a securities law regime that is more akin to corporate law in "providing concepts and legal goals that

whereby the judiciary refrains from imposing mandates on companies in favor of private ordering, reflects the judges' recognition that one size of corporate governance does not fit all companies.[206] In short, Delaware's enabling approach to corporate law reflects the view that investors are better judges of a company's corporate governance structure than the judiciary.

By articulating best practices and encouraging directors and officers to "do the right thing"—whether it is through their opinions or through the judges' individual articles and speeches—the Delaware judges shape corporate conduct. The Delaware judiciary's exhortations seem to have the effect predicted by various theories of the "expressive function of law"—the idea that lawmakers and judges can affect how people *do* behave simply by articulating how they *should* behave, even when there is no risk of legal sanction.[207] Perhaps board members and senior executives internalize and follow the judiciary's aspirations because they perceive such conduct to be the right thing to do.[208] An alternative explanation is that these judicial pronouncements serve as a useful checklist that the market can use to monitor and hold management and the board accountable. Investors can measure the governance of companies against the concrete practices the Delaware judges endorse. It can be difficult for directors and officers to reject the market's demands for corporate governance reforms in the face of what at least some influential judges—indeed, those who are likely to preside over any disputes and cases involving alleged fiduciary duty breaches—have set forth as the proper standard of behavior. Relatedly, the judicial articulation of best practices creates a mechanism by which directors and officers can signal that they are good, honest, and loyal managers—that is, they can voluntarily opt in to the judicial suggestions, in effect going above and beyond what the law mandates. Whatever the reason, directors and officers routinely comport with higher standards of corporate conduct than corporate law requires.

must be satisfied to ensure compliance, without the specific detailed regulation we have come to expect and admire in the federal securities area").

Chancellor Chandler's recent opinion in the Disney litigation removes any doubt that the Delaware judiciary has adopted such a best-practices or aspirational approach to corporate law, with the judiciary taking a back seat in key respects to the discipline of markets. *In re* Walt Disney Co. Derivative Litigation, No. Civ. A 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005) (emphasizing the distinction between aspirations for corporate conduct, on the one hand, and legal obligations, on the other).

206. The Delaware approach also reflects the judges' recognition that they have limited information and competency when it comes to evaluating how each company should be run. *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 98–100, 117–24 (2004).

207. For different views of the expressive function of law, see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000); Ahdieh, *supra* note 200; Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000); Robert Cooter, *Expressive Law and Economics*, 27 J. LEG. STUD. 585 (1998); Alex Geisinger, *A Belief Change Theory of Expressive Law*, 88 IOWA L. REV. 35 (2002); McAdams, *supra* note 200; Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

208. *See, e.g.*, Stout, *supra* note 203.

The point is not to equate federal securities regulation with Delaware corporate law or to equate the SEC with the Delaware judiciary. The point, rather, is to illustrate that just as the law serves an expressive function in corporate law, it might serve a similar expressive function in securities regulation.[209] However, the law's potential expressive role in the hedge fund industry in particular should not be strained. Whereas in an effort "to do the right thing" directors and officers might internalize the norms of good governance that the Delaware judges urge, it is doubtful that hedge fund managers will internalize SEC-articulated best practices because of some other-regarding tendency they have to "do right" by their investors or the marketplace generally. There is simply too much money on the line. That said, there is real promise that by emphasizing particular best practices, the SEC can provide investors concrete guidance that facilitates market discipline. Such guidance provides a yardstick against which investors can evaluate directors, officers, mutual funds, hedge funds, and other securities market participants to see how they measure up. Further, if a hedge fund manager on his own initiative decides to follow various best practices, or decides to stick with SEC defaults, such manager might distinguish himself and his fund as "cooperators," so long as opting in (in the case of best practices) and not opting out (in the case of defaults) is costly. No such signal is sent when a hedge

209. If one prefers, one can instead analogize to the banking industry, where regulators have relied, to an important degree, on market discipline and best practices to improve creditor and counterparty risk management when transacting with hedge funds. *See, e.g.*, Basle Committee on Banking Supervision, *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* 1 (1999), *available at* http://www.bis.org/publ/bcbs46.pdf; Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices* (1999), *available at* http://www.mfainfo.org/Washington/derivatives/impairing%20counterparty%20risk.pdf; Counterparty Risk Management Group II, *Toward Greater Financial Stability: A Private Sector Perspective* (2005), *available at* http://www.crmpolicygroup.org/docs/CRMPG-11.pdf; Multidisciplinary Working Group on Enhanced Disclosure, Final Report (2001); The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lesson of Long-Term Capital Management* (1999), *available at* http://www.treas.gov/press/releases/reports/hedgefund.pdf; Timothy F. Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, Hedge Funds and Their Implications for the Financial System, Nov. 17, 2004, *available at* http://www.ny.frb.org/newsevents/speeches/2004/gei04117.html. For more on market discipline in financial markets, see generally David T. Llewellyn, *Inside the "Black Box" of Market Discipline*, INST. ECO. AFF. 41 (2005). *See also* Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Supervisory Guidance on Equity Investment and Merchant Banking Activities, June 22, 2000, *available at* http://www.fsround.org/SR00-9.htm; Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Supervisory Guidance Regarding Counterparty Credit Risk Management, Feb. 1, 1999, *available at* http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9903.htm (examples of so-called "supervisory guidance" provided to the banking industry by the Board of Governance of the Federal Reserve System); *Hearing on H.R. 106-9 Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Banking and Financial Services*, 106th Cong. 106–21 (1999) (statement of Gov. Laurence H. Meyer) (discussing supervisory guidance as an effort to "enhance and support market discipline by strengthening the risk management processes of major creditors and counterparties").

fund and its manager comply with mandatory requirements.[210] Investors can then allocate their capital in response to their findings as they see fit.

Without question, a best-practices regulatory technique would present challenges. One central challenge, of course, is identifying best practices. Consensus may be hard to find among the five SEC commissioners, let alone among the staff or between the commissioners and the staff, as to what the best practices should be in securities markets.[211] A best-practices approach at the SEC would require coordination at the agency, and the SEC chairman might have to rein in the staff occasionally if the staff becomes too independent in articulating best practices without commissioner approval. In some instances, the SEC (admittedly, mostly at the staff level) already gives guidance and warns investors to be wary of certain practices without imposing mandates, so there is some precedent for a best-practices-type approach. For example, in the 2005 *Staff Report Concerning Examinations of Select Pension Consultants*, the SEC's Office of Compliance Inspections and Examinations outlined a number of policies and procedures that pension consultants could adopt under the Advisers Act to address potential conflicts of interest.[212] The

210. *Cf.* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000) (developing a signaling theory of law compliance).

211. There is consensus in the Delaware judiciary, including both the Chancery Court and the Supreme Court, regarding what the aspirations are for director and officer conduct. *See generally* David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127 (1997).

212. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, STAFF REPORT CONCERNING EXAMINATIONS OF SELECT PENSION CONSULTANTS 1–8 (2005), *available at* http://www.sec.gov/news/studies/pensionexamstudy.pdf; *see also* Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, Release No. 34-49695 (May 13, 2004), *available at* http://www.sec.gov/rules/policy/34-49695.htm (describing the internal controls and risk management procedures that the relevant agencies, including the SEC, view as "particularly effective in assisting financial institutions to identify and address the reputational, legal, and other risks associated with complex structured finance transactions"); Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities & Exchange Commission, Remarks before the 2004 Investment Company Institute Securities Law Developments Conference, Dec. 6, 2004, *available at* http://www/sec.gov/news/speech/spch120604smc.htm (urging mutual funds to do a "top-to-bottom review of [their] business operations, with the aim of identifying and addressing any compliance gaps or conflicts of interest" and providing guidance regarding how such review should be performed); *cf.* Press Release, NASD Offers Firms Best Practices for Reviewing New Investment Products, *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGES&SSOocName=NASDLO-013757 (Apr. 6, 2005) (describing NASD Notice to Members 05-26, which, according to the press release, "outlin[es] best practices for developing and vetting new products" and "urges [brokerage] firms to improve their procedures for determining what constitutes a new product and for ensuring that the right questions are asked and answered before a new product is offered for sale"). Similarly, Ethiopis Tafora, the Director of the SEC's Office of International Affairs, recently praised the best-practices code of conduct adopted by the International Organization of Securities Commissions (IOSCO) for credit rating agencies. *See* Ethiopis Tafora, Remarks for the International Organization of Securities Commissions Annual Conference Panel on the Regulation of Credit Rating Agencies (Apr. 6, 2005), *available at* http://www.sec.gov/news/speech/spch040605et.htm (favorably citing the "market 'oversight' mechanism" approach of the IOSCO code of conduct).

In a 2005 speech before the Financial Services Roundtable, Chairman Donaldson admitted that SEC "rules and enforcement actions cannot alone ensure that our markets and our corporations will be clean and ethical." William H. Donaldson, Remarks Before the Financial Services Roundtable (Apr. 1, 2005), *available at* http://www.sec.gov/news/speech/spch040105whd.htm. He continued:

SEC has also posted on its Web site a number of "Investor Alerts" under the attention-getting heading, "Protect Your Money, Avoid Trouble."[213] In addition, more authoritative than the best-practices approach envisioned here, but nonetheless related, is the SEC practice of issuing "interpretive guidance" and "staff legal bulletins."[214]

Perhaps most importantly, for such a restrained best-practices technique to serve its purpose, it is imperative that the failure of securities market participants to comport with the SEC's recommendations would not in and of itself constitute a violation of the federal securities laws. Otherwise, best practices back door into new mandates. Even if the commissioners and the SEC staff accede to this caution, it is not clear that the courts would do the same. One could easily imagine best practices providing a roadmap for the plaintiffs securities bar.

The SEC is not alone in its ability to articulate best practices. The hedge fund industry has itself put forth a number of best practices and general guidelines covering, among other things, hedge fund disclosures, valuation techniques, and due diligence practices. For example, in 2004, the Investor Risk Committee of the International Association of Financial Engineers released its widely cited white paper on *Valuation Concepts for Investment Companies and Financial Institutions and Their Stakeholders*.[215] Also, in 2003, the Managed Funds Association, a trade

> There should be an industrywide culture that fosters ethical behavior in decision-making. . . . The industry needs to look beyond simple compliance with the letter of the law in a check-the-box manner. The industry also needs to search for a new way to instill ethics, integrity, honesty and transparency into its way of doing business. Pie in the sky? Perhaps. But if the industry is really interested in making our work unnecessary, then the ball is in your court.

*Id.* Another option for making the work of the SEC unnecessary (or at least less necessary) is the sort of best-practices approach described here. The SEC can encourage ethical, transparent behavior simply by taking a stance on how securities market participants should behave. *Cf.* Henny Sender, *Credit Derivatives and Their Risks Are on the Table*, WALL ST. J., Sept. 15, 2005, at C1 (discussing a meeting between the New York Federal Reserve Bank and Wall Street firms to address, without regulating, matters concerning the credit derivatives market, including shortcomings in how trades are processed and settled).

213. U.S. Securities and Exchange Commission, Protect Your Money Avoid Trouble—Investor Alerts, http://www.sec.gov/investor/alerts.shtml (last visited Nov. 6, 2005); *see also* Judith Burns, *SEC Hedge-Fund Warning Uses Clicks, Tricks*, WALL ST. J., Feb. 13, 2003, at D2. The introductory paragraph to the SEC's Investor Alerts reads: "Get the facts on how to invest wisely and avoid fraud. Be wary of swindlers and scam artists. To learn more about how to avoid costly mistakes and fraud, read the SEC's 'Investor Alerts.' These publications will help you spot trouble before you lose money." Although the Investor Alerts are oriented toward retail investors, there is no reason the SEC could not adopt similar alerts directed toward sophisticated investors.

214. For more on SEC Interpretive Guidance, see U.S. Securities and Exchange Commission, SEC Interpretive Releases, http://www.sec.gov/rules/interp.shtml (last visited Nov. 5, 2005). For more on SEC Staff Legal Bulletins, see U.S. Securities and Exchange Commission, Staff Legal Bulletins, http://www.sec.gov/interps/legal.shtml (last visited Nov. 6, 2005).

215. Investor Risk Comm., Int'l Ass'n of Fin. Engr's, *Valuation Concepts for Investment Companies and Financial Institutions and their Stakeholders* (2004), *available at* http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf; *see also* Investor Risk Comm. *Hedge Fund Disclosure for Institutional Investors* (2001), *available at* http://www.mfainfo.org/images/pdf/IRCconsensus7-27-01.pdf; *cf.* Int'l Swaps & Derivatives Ass'n, ISDA Master Agreements and Bridges, along with related documentation, *available at* http://www.isda.org (private sector standard form contracts for derivatives transactions).

group for hedge funds, put out its *2003 Sound Practices for Hedge Fund Managers*, which recommends a number of practices for hedge funds.[216] Even without the SEC's endorsement, these industry-sponsored codes of conduct assist hedge fund investors in performing their diligence and in exercising oversight and holding fund managers accountable.

This is not to say that investors will demand that a particular hedge fund adopt the best practices that are offered or that a hedge fund manager will agree to any such practices, even if pressured by investors. Rather, the basic premise of the best-practices approach is that hedge fund investors, with help from their financial and legal advisers, can assess for themselves the appropriateness of particular best practices for particular funds. The ultimate outcome is left for the parties to determine.

This article has only begun to sketch a more market-oriented approach to securities regulation, but one that still preserves a role for the SEC. More work is needed to identify the particular institutional features and circumstances under which defaults or best practices are preferable to mandates for regulating securities markets. At a minimum, though, if the SEC was bent on regulating hedge funds, there was much to recommend a default or best-practices approach in that instance.

## VI. CONCLUSION

Because federal securities regulators, like all regulators, regulate under uncertainty, the SEC inevitably will get it "wrong" sometimes. The impact cognitive bias and politics can have on regulatory decision making exacerbates the risk that the SEC will get it wrong by overregulating, at least after periods of crisis. Instances, let alone longer episodes, of overregulation are not self-correcting. The SEC is often reluctant to roll back regulation. Further, there is no meaningful opportunity for parties to use regulatory arbitrage to escape the federal securities laws, with the possible exception of moving transactions offshore. The SEC, in other words, does not face any stiff competition—in the sense that parties have a choice of which securities law regime to be subject to—that might moderate its regulation. Since the SEC cannot be relied on to unwind prior regulations, and since regulatory arbitrage cannot be relied on

216. Managed Funds Ass'n, *Sound Practices for Hedge Fund Managers* (2003), *available at* http://www.mfainfo.org/images/PDF/2003SoundPractices_forHedgeFundManagers.pdf; *cf.* Mutual Fund Dirs. Forum, *Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004), *available at* http://www.mfdf.com/userfiles/file/best_pra.pdf. For other private sector best practices for the hedge fund industry, see LESLIE RAHL, HEDGE FUND RISK TRANSPARENCY: UNRAVELLING THE COMPLEX AND CONTROVERSIAL DEBATE apps. 1–6 (2003). *The Wall Street Journal* published a useful checklist for hedge fund investors shortly after a nearly $500 million fraud was uncovered at Bayou Management, a failed hedge fund. *See* Erin E. Arvedlund, *Spotting a Bayou Before You Fall Into It: A Checklist for Hedge Fund Investors*, WALL ST. J., Aug. 31, 2005, at D1; *see also* Geraldine Fabrikant, *Want a Hedge Fund? Here's Your Homework*, N.Y. TIMES, Sept. 11, 2005, § 3, at 6.

to keep federal securities regulation in check, the right to opt out of the federal securities laws can provide important protection against the risk of overregulation. A particularly strong case can be made for default rules or best practices when regulating hedge funds, although including defaults and best practices on the SEC's regulatory menu is worth considering across securities regulation. The risk of overregulation is by no means limited to the hedge fund industry. A dose of reality, however, is in order. It is precisely when the risk of overregulation is most acute—namely, when political pressure to regulate is mounting and when psychological biases inflame concern—that the SEC is least likely to embrace defaults and best practices as worthy alternatives to mandates.

Nonetheless, in the future, as a general proposition, the SEC increasingly should consider a more restrained style of securities regulation that relies more on default rules around which parties can contract. In some cases, the SEC should consider doing nothing more than articulate best practices that market participants can evaluate for themselves. Administrative agencies, such as the SEC, can shape behavior simply by taking a stance.