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# HEDGE FUNDS AND THE SEC: OBSERVATIONS ON THE HOW AND WHY OF SECURITIES REGULATION

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*This Essay addresses three topics on one aspect of the hedge fund industry: the SEC's recent efforts to regulate hedge funds. First, this Essay summarizes the regulation of hedge funds under the U.S. federal securities laws insofar as protecting hedge fund investors is concerned. The discussion highlights four basic choices facing the SEC: (1) do nothing; (2) substantively regulate hedge funds directly; (3) regulate hedge fund managers; and (4) regulate hedge fund investors. Second, this Essay assesses the boundary between government intervention and market discipline in hedge fund regulation. To what extent should hedge fund investors be left to fend for themselves? Third, this Essay highlights two factors impacting regulatory decision making that help explain why the SEC pivoted in 2004 to regulate hedge funds when it had abstained from doing so in the past. These two factors are politics and psychology.*

The hedge fund industry is a trillion dollar business. Estimates put the number of hedge funds at around 9,000. As the industry grows, so does its impact. Hedge funds add liquidity to financial markets and, as others have put it, hedge funds act as "shock

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absorbers" that can stabilize financial markets during crises.[1] Further, hedge funds promote the integrity of securities markets by engaging in the types of trading that make securities markets more efficient, and hedge funds provide opportunities for businesses and investors to shift and manage risk. More efficient and liquid financial markets promote capital formation and business enterprise.

The concern is that hedge fund activities may also upset financial markets. The industry's growth has fueled worries about so-called "systemic risk."[2] Systemic risk worries date back to the collapse of Long-Term Capital Management (LTCM) in 1998 and the private bailout of LTCM that the Federal Reserve Bank of New York orchestrated to fend off a chain reaction that threatened global markets if LTCM defaulted.[3] More recently, the multi-billion dollar loss at Amaranth Advisors tied to a natural gas trade by a single individual at the hedge fund renewed concern that a fund can

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[1] *See, e.g.*, John G. Gaine, President, Managed Funds Association, Comments of Managed Funds Association for the U.S. Securities & Exchange Commission Roundtable on Hedge Funds (May 2003), *available at* http://www.mfainfo.org/images/pdf/MFA-Comments-SEC-5.6.03.pdf.

[2] Regarding systemic risk, see generally COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005), *available at* http://www.crmpolicygroup.org/docs/CRMPG-II.pdf; NICHOLAS T. CHAN ET AL., SYSTEMIC RISK AND HEDGE FUNDS (2005), MIT Sloan Research Paper No. 4535-05, *available at* http://ssrn.com/abstract=671443. For an important speech on the topic by the President and Chief Executive Officer of the Federal Reserve Bank of New York, see Timothy F. Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, Hedge Funds and Derivatives and Their Implications for the Financial System (Sept. 15, 2006), *available at* http://www.newyorkfed.org/newsevents/speeches/2006/gei060914.html. For a summary of the concern over systemic risk, see Randall Smith & Susan Pulliam, *As Funds Leverage Up, Fears of Reckoning Rise*, WALL ST. J., Apr. 30, 2007, at A1.

For a concise set of recommendations for financial firms to follow in managing their exposure to hedge funds, see Edwin Laurenson et al., *Best Practices for Financial Firms Managing Risks of Business with Hedge Funds*, 38 SEC. REG. & L. REP. (BNA) 1477 (2006).

[3] *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000); Franklin R. Edward, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189 (1999). For a thorough report prepared by the President's Working Group on Financial Markets in the wake of LTCM's collapse, see HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT: REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (1999), *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

collapse easily and quickly with widespread consequences, although none resulted from Amaranth's collapse.[4]

Separately, there have been a noticeable number of enforcement actions for fraud and insider trading brought by the U.S. Securities and Exchange Commission (SEC) against hedge funds. Hedge funds were also implicated in the market timing and late trading scandals that plagued the mutual fund industry in the early 2000s. And while hedge funds have been increasingly active as shareholders – arguably increasing firm value by holding managers and boards more accountable[5] – there is growing concern that hedge funds are manipulating business transactions through what Professors Bernard Black and Henry Hu have termed "empty voting," a variation of vote buying.[6]

Concerns about hedge funds have to be kept in proper perspective, though. Not only do hedge funds perform a number of key functions that stabilize financial markets, promote capital formation, and facilitate risk management, but the abuses and collapses

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[4] *See, e.g.*, Ann Davis, *How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader: Up in Summer, Brian Hunter Lost $5 Billion in a Week as Market Turned on Him*, WALL ST. J., Sept. 19, 2006, at A1; Ann Davis et al., *What Went Wrong at Amaranth: Mistakes at the Hedge Fund Include Key Trader's Confusing Paper Gains with Cash Profits*, WALL ST. J., Sept. 20, 2006, at C1; Phil Izzo, *Getting a Grip on Hedge Fund Risk: Economists See Risk to Financial Markets and Say More Regulation Is Warranted*, WALL ST. J., Oct. 13, 2006, at C3; Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, at C1. Amaranth's loss ended up posing no systemic problem. *See, e.g.*, Gregory Zuckerman, *How the Amaranth Wreck Was Contained: J.P. Morgan and Citadel Swooped In, Assumed Risk, Proving Markets' Resilience*, WALL ST. J., Oct. 5, 2006, at C3.

[5] *See, e.g.*, WILLIAM W. BRATTON, HEDGE FUNDS AND GOVERNANCE TARGETS (2006), Georgetown Law & Econ. Research Paper No. 928689, *available at* http://ssrn.com/abstract=928689; ALON BRAV ET AL., HEDGE FUND ACTIVISM, CORPORATE GOVERNANCE, AND FIRM PERFORMANCE (2006), ECGI – Finance Working Paper No. 139/2006, *available at* http://ssrn.com/abstract=948907; MARCEL KAHAN & EDWARD B. ROCK, HEDGE FUNDS IN CORPORATE GOVERNANCE AND CORPORATE CONTROL (2006), Univ. of Penn. Inst. for Law & Econ. Research Paper No. 06-16, *available at* http://ssrn.com/abstract=919881; RANDALL S. THOMAS & FRANK PARTNOY, GAP FILLING, HEDGE FUNDS, AND FINANCIAL INNOVATION (2006), Vanderbilt Law & Econ. Research Paper No. 06-21, San Diego Legal Stud. Paper No. 07-72, *available at* http://ssrn.com/abstract=931254.

[6] *See* Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011 (2006); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); *see also* Kara Scannell, *How Borrowed Shares Swing Company Votes: SEC and Others Fear Hedge-Fund Strategy May Subvert Elections*, WALL ST. J., Jan. 26, 2007, at A1. For an analogous analysis, see Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

that have punctuated the industry are not indicative of widespread hedge fund behavior. To the contrary, most hedge funds are not engaged in fraudulent or other illicit behavior, and the vast number of hedge fund managers are disciplined traders who make informed, although risky, trades.

Against this backdrop, this brief Essay addresses three topics on one aspect of the hedge fund industry: the SEC's recent efforts to regulate hedge funds.[7] Part I summarizes the regulation of hedge funds under the U.S. federal securities laws insofar as protecting hedge fund investors is concerned. The discussion highlights four basic choices facing the SEC: (1) do nothing; (2) substantively regulate hedge funds directly; (3) regulate hedge fund managers; and (4) regulate hedge fund investors. Part II assesses the boundary between market discipline and government intervention in hedge fund regulation. To what extent should hedge fund investors be left to fend for themselves? Part III highlights two factors impacting regulatory decision making that help explain why the SEC pivoted in 2004 to regulate hedge funds when it had abstained from doing so in the past. These two factors are politics and psychology. Part IV concludes.

## I. Hedge Funds and U.S. Federal Securities Regulation

Hedge funds are characterized not only by the nature of their investments, but also by the degree to which they are not regulated by the SEC. Hedge funds typically are structured so that they avoid the principal regulatory requirements of the U.S. federal securities laws. The resulting light regulation of hedge funds is not the product of hedge fund shenanigans or the exploitation of loopholes. Rather, the Securities Act of 1933 (which regulates public offerings), the Securities Exchange Act of 1934 (which imposes

[7] This Essay does not address systemic risk or hedge funds' role in corporate governance.

ongoing disclosure and other requirements on public companies), the Investment Company Act of 1940 (which regulates mutual funds), and the Investment Advisers Act of 1940 (which regulates investment advisers) contain longstanding exclusions within which hedge funds typically fall.[8]

In 2004, in a divisive and controversial three to two vote (Commissioners Atkins and Glassman dissenting), the SEC changed course and decided to regulate hedge funds.[9] The SEC's new hedge fund rule did not substantively regulate hedge fund activities directly, but required hedge fund managers to register with the SEC as investment advisers under the federal Investment Advisers Act.

Section 203(b)(3) of the Investment Advisers Act provides that an investment adviser, such as a hedge fund manager, does not have to register under the Act if, among other things, the adviser has fewer than 15 "clients." For purposes of Section 203(b)(3), a hedge fund manager has been able to count a fund as a single client. For example, a hedge fund with 100 investors has counted as a single client of the hedge fund manager for the 15-client threshold of Section 203(b)(3). Consequently, a hedge fund manager

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[8] For an overview of these statutes, see 1 LOUIS LOSS, JOEL SELIGMAN, & TROY PAREDES, SECURITIES REGULATION 326-425 (4th ed., 2006). For accounts of hedge fund regulation outside the United States, see INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS, THE REGULATORY ENVIRONMENT FOR HEDGE FUNDS: A SURVEY AND COMPARISON (2006), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf; Kara Scannell et al., *No Consensus on Regulating Hedge Funds: Officials Around Globe Aim to Protect Markets but Differ on Methods*, WALL ST. J., Jan. 5, 2007, at C1.

[9] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Inv. Adv. Act Rel. 2333 (2004). More information concerning the SEC's interest in hedge funds is available on the SEC's Web site at http://sec.gov/spotlight/hedgefunds.htm. For a more recent assessment of the hedge fund industry by the SEC Chairman, see Christopher Cox, Chairman, U.S. Securities & Exchange Commission, Testimony Concerning the Regulation of Hedge Funds Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 25, 2006), *available at* http://sec.gov/news/testimony/2006/ts072506cc.htm. Another recent overview of hedge fund issues was provided by the SEC staff. See Susan Ferris Wyderko, Director, Office of Investor Education and Assistance, U.S. Securities & Exchange Commission, Testimony Concerning Hedge Funds Before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 16, 2006), *available at* http://sec.gov/news/testimony/ts051606sfw.htm.

could manage up to 14 hedge funds, with an unlimited number of investors in the funds, without having to register as an investment adviser under the Investment Advisers Act.

The SEC's 2004 rule changed this. The SEC adopted a new rule – Rule 203(b)(3)-2 under the Investment Advisers Act – that would require a hedge fund manager to "look through" the manager's fund to count each hedge fund investor as a client.[10] As a result of the new rule, hedge funds would eclipse the 15-client threshold, and hedge fund managers thus had to start registering with the SEC as investment advisers. As registered investment advisers, hedge fund managers would have to (1) make certain disclosures with the SEC; (2) deliver basic information to investors; (3) adopt procedures concerning proxy voting by the fund; (4) adopt a code of ethics; (5) implement certain internal controls and compliance procedures; and (6) designate a chief compliance officer. Most importantly, hedge funds would have to maintain specified books and records and make them available to the SEC for examination and inspection.[11]

This revised regulatory regime, which went into effect in February 2006, lasted only about six months. In *Goldstein v. SEC*, the federal Court of Appeals for the D.C. Circuit vacated the SEC's new hedge fund rule, calling it "arbitrary" and effectively reinstating the earlier Investment Advisers Act regime under which hedge fund managers do not have to register.[12]

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[10] The rule included an important exception. A hedge fund manager did not have to register under the Investment Advisers Act if the hedge fund contained a "lock-up" of at least two years during which the fund's investors could not withdraw their capital. This provision gave established funds a competitive advantage over upstarts, as newer or smaller funds would have a more difficult time convincing investors to lock up their capital for two years.

[11] Hedge funds still could avoid the demands of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Even before the 2004 rule, hedge fund managers had to comply with antifraud and fiduciary obligations under federal and state law.

[12] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

The SEC did not appeal *Goldstein*, but did consider and ultimately propose a different rule in late 2006.[13] Some background is needed before explaining the SEC's more recent proposal.

The Securities Act of 1933 provides that securities offerings generally must be registered with the SEC.[14] There is, however, an important safe harbor from the Securities Act registration requirements for offerings that are limited to "accredited investors" in private placements.[15] "Accredited investors" include institutional investors and individual investors who meet certain financial qualifications. In particular, an individual qualifies as an accredited investor if her net worth (or joint net worth with her spouse) exceeds $1,000,000 or she had income exceeding $200,000 in each of the past two years (or joint income with her spouse exceeding $300,000 in each of the past two years) and reasonably believes such income thresholds will be met in the present year. The logic is that accredited investors are able to fend for themselves – in that they can asses the risk of a particular investment and/or bear the risk of financial loss – because they are sufficiently sophisticated or wealthy. Consequently, there is no compelling need for the federal securities laws to protect them – hence, the safe harbor exclusion from the Securities Act registration requirements for offerings limited to accredited investors.

As a matter of practice, hedge funds limit the offering of their securities to accredited investors.[16] Yet regulators and others have worried that individuals who

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[13] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Sec. Act Rel. 8766 (2006). As of this writing, the SEC has not yet adopted the proposal as a final rule.

[14] *See* 1 LOSS, SELIGMAN, & PAREDES, *supra* note 8, at 580-801.

[15] *See* 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1361-1455 (3d ed., rev. 1999).

[16] If a hedge fund did offer its securities to the public, the fund would be subject to much more demanding regulation under the federal securities laws. For examples of public offerings by hedge funds, see Alistair MacDonald, *Hedge Funds to Tap the Public: Two More Firms Plan Listing on Exchange*,

satisfy the current financial thresholds for accredited investor status are not able to protect themselves. Indeed, the financial thresholds have been fixed for over two decades.

In its post-*Goldstein* rulemaking, the SEC proposed a new accredited investor definition.[17] The SEC proposed a new class of accredited investor – the "accredited natural person" – that would apply to securities offerings of hedge funds. An individual would qualify as an "accredited natural person" if she meets the financial thresholds described above and owns $2.5 million or more in investments (individually or with her spouse).[18] This $2.5 million threshold amount would be adjusted for inflation in later years.

Amending the definition of accredited investor might be seen as a relatively technical regulatory development; it is certainly a less intrusive change than the SEC's earlier 2004 rule. The SEC's accredited investor proposal should have a relatively modest impact on the industry as a whole, even though the rule change would deny some investors the chance to invest in hedge funds and thus cut off some capital inflows, particularly for smaller or newer funds.

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WALL ST. J., Jan. 10, 2007, at C2; Gregory Zuckerman, Henny Sender, & Scott Patterson, *Hedge-Fund Crowd Sees More Green as Fortress Hits Jackpot with IPO*, WALL ST. J., Feb. 10, 2007, at A1.

[17] The SEC's 2004 hedge fund rule would have impacted the accredited investor concept indirectly. As a registered investment adviser, a hedge fund manager would have been subject to certain rules under the federal Investment Advisers Act that generally prohibit an investment adviser from charging a performance fee (for example, the 20% or so "carry" or profit interest that hedge fund managers typically charge) from any investor who is not a "qualified client" (that is, 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). Under relevant rules, a registered adviser has to look through the fund to determine whether its investors are qualified clients who can be charged a performance fee. Thus, many accredited investors who would not qualify as qualified clients, even though they are accredited, would have been kept from investing in hedge funds as hedge fund managers took steps to ensure they did not forego their performance fee.

[18] This investment threshold would exclude the value of an individual's personal residence or place of business or other real estate that is not held for investment purposes.

The SEC's accredited investor proposal is important for reasons aside from its impact on hedge funds. The SEC's approach informs our understanding of securities regulation by illustrating the range of levers the SEC can pull in protecting investors. One option for the SEC is to do nothing else and leave the regulatory regime in place as it existed before 2004. A second option would be for the SEC to regulate hedge funds directly. For example, one could imagine (although the SEC has not proposed this) regulating the types of investments hedge funds can make, how much leverage they can take on, and how managers are compensated. A burdensome regime along these lines presently governs mutual funds under the Investment Company Act of 1940. A third option is for the SEC to regulate hedge fund managers, as it sought to do earlier.

The accredited investor proposal illustrates a fourth option. Namely, the SEC can regulate investors.[19] By redefining who qualifies as an accredited investor, the SEC effectively regulates who can invest in hedge funds. This proposal does not confer upon the SEC greater regulatory authority – unlike the 2004 investment adviser registration requirement did – but it does target the particular concern that unsophisticated investors, who are not especially wealthy, might invest in hedge funds.

Such investor-side regulation is not new. The SEC has for some time drawn distinctions between various categories of investors, including not only "accredited investors," but also "qualified clients," "qualified purchasers," "sophisticated" investors, and "qualified institutional buyers." The proposed "accredited natural person" adds a new category.

[19] For an interesting proposal for regulating investors instead of issuers, see Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000).

It is beyond this Essay's scope to consider how investor-side regulation might feature more prominently in securities regulation. For now, suffice it to say that more refined investor-side regulation – such as the SEC offered when crafting an accredited investor definition for hedge funds that would not upset the private placement market more broadly – should not be overlooked as an option.

## II. Government Intervention vs. Market Discipline

A primary goal of the SEC is to protect investors. Without question, hedge fund investors have limited information, particularly when it comes to understanding a hedge fund's investments. But it does not follow that more hedge fund regulation is warranted to protect hedge fund investors.[20]

Hedge fund investors are accredited investors and, if the SEC's 2006 proposal is adopted, individuals will have to meet the higher investment requirement to qualify as accredited natural persons. Such investors, by assumption of the federal securities laws, are able to protect themselves, militating against more government intervention on their behalf. That well-heeled, sophisticated investors choose to invest in a hedge fund that provides its investors with little information should not trigger more SEC oversight. Neither the complexity of hedge fund strategies nor the fact that hedge fund investors may lose money because of a hedge fund fraud or risky hedge fund trade is grounds for

[20] Whether hedge fund regulation is warranted to serve some other goal is beyond this Essay's scope. In February 2007, the President's Working Group on Financial Markets (PWG) – chaired by the Treasury Secretary and consisting of the chairmen of the Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission – issued a set of principles and guidelines concerning private pools of capital, including hedge funds. A copy of the Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital is available on the Treasury Department's Web site at http://www.treas.gov/press/releases/hp272.htm. The PWG advanced a market-oriented approach to hedge fund oversight that relies on market discipline both to protect hedge fund investors and to ensure that private pools of capital undertake effective investment and operational risk management.

more hedge fund regulation. To the contrary, the risk of loss incentivizes investors to do the kind of diligence that positions them to protect their own interests, and hedge funds and their managers are already subject to antifraud requirements. Just as hedge fund investors can assess the information they do possess about a fund's investment strategy, back office operations, controls, track record, valuation techniques, and disclosure commitments, they can assess and "price" the risk of having imperfect information. Indeed, investors can simply walk.

I do not make the strong claim that institutional investors and wealthy individuals always perfectly price the risk of a particular investment. Due diligence is costly, and sometimes people are simply wrong in their assessments. In addition, as behavioral finance has taught us, when making investment decisions, people are boundedly rational and suffer from various cognitive biases.[21] Consequently, even sophisticated investors with good information make mistakes. Furthermore, in recent years, investing in hedge funds has become fashionable. As investors develop a taste for hedge funds, they may rush to invest without doing adequate diligence and analysis.

Notwithstanding these breakdowns in market discipline, the SEC has not engaged in a more textured study of what it means for investors to be able to fend for themselves. The SEC does not delve into the details of investor behavior. Instead, the regulator has relied on certain proxies – reflected in the definition of accredited investor – as acceptable measures of investor self-protection.[22] One may not agree that these are the

[21] For more on behavioral finance, see generally ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2001); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003).

[22] An integral benefit of such clear-cut proxies is that they create a more certain and predictable regulatory environment in which issuers and investors can operate. The shortcoming is that proxies are always imperfect measures.

right boundaries for separating when SEC intervention is warranted from when it is not. But it is worth underscoring that this demarcation limiting SEC oversight in deference to market discipline is engrained in federal securities regulation and part of the longstanding accepted structure of the regulatory regime.[23]

This does not mean that the SEC has no role to play when market discipline predominates. The securities regulator can always look to expand its reach by moving the regulatory line delineating the boundary between SEC oversight and market discipline. The SEC has proposed doing just this by raising the financial hurdle an individual must clear to qualify as an accredited investor. Under the SEC's proposal, fewer individuals would be accredited and thus fewer individuals would be viewed as able to fend for themselves when investing in a hedge fund. Notably, although the SEC's accredited investor proposal narrows the potential pool of hedge fund investors, the SEC does not propose to regulate a fund or its manager so long as the fund's investors solely comprise institutional investors and accredited natural persons. This is a qualitatively different approach from the SEC's vacated 2004 rule, which provided for SEC regulation of hedge fund managers, even when all investors were accredited.

Instead of (or in addition to) redrawing the government intervention/market discipline boundary, the SEC can actually facilitate market discipline so that it is more

[23] It also is worth stressing that this demarcation is thought to further the goal of capital formation by reducing the regulatory burden in those instances where market discipline adequately holds issuers and their managers accountable.

An important distinction is needed. The above discussion is from the particular perspective of whether hedge fund investors can adequately protect their own interests. Hedge funds have been criticized in recent years (and sometimes charged criminally or civilly) for activities that, although benefiting the hedge fund's investors, may harm investors in other enterprises and other market participants. Even if greater SEC oversight to protect hedge fund investors is not warranted, hedge funds should not get a free pass from law compliance. 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 Essay 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.

effective and informed. The SEC wields considerable influence as the dominant securities regulator in the United States, and it is well respected. The SEC could take advantage of its status and reputation in adopting a best-practices mode of regulation. That is, the SEC could express its view of best practices without imposing legal requirements. The SEC could articulate best practices formally through SEC releases or informally through the speeches and writings of individual commissioners and division directors. For example, the SEC could stress best practices for the hedge fund industry. Imagine the potential impact on the industry if the SEC chairman, particularly if joined by other commissioners and the directors of the Divisions of Investment Management and Corporation Finance, pushed a set of hedge fund best practices in a series of speeches, interviews, and op-eds in publications such as the *Wall Street Journal* and the *Financial Times*.

By emphasizing particular best practices, the SEC would provide investors concrete guidance to use in assessing investment options. Such guidance would be a yardstick against which investors could evaluate the investment opportunity to see how it measures up. Investors could then allocate their capital as they saw fit with the benefit of the SEC's input. Further, a hedge fund manager could take the initiative in adopting the SEC-endorsed practices to distinguish the manager and the manager's fund as cooperative and willing to go above and beyond what the law requires.[24]

[24] *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).

This is not to say that all best practices urged by the SEC would (or should) be followed. The ultimate outcome would be left for the market participants to determine in the shadow of what the SEC has urged is the right thing to do.[25]

When the SEC does regulate more substantively, it still can allow room for flexibility and private ordering by finessing the government intervention/market discipline boundary. Regulators often view themselves as having two choices: (1) impose one-size-fits-all mandates; or (2) sit tight and do nothing.[26] However, a third choice sits between the "impose mandates" and "do nothing" poles. That is, regulators, such as the SEC, can use 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.[27] Further, the ability to opt out of the regulatory regime provides an important safety valve when regulators otherwise would overregulate. A default rule that required a hedge fund manager to register under the Investment Advisers Act or disclose why it has chosen not to register would have been a particularly apt alternative to the SEC's earlier rule mandating investment adviser registration for hedge fund managers. Just as hedge fund investors can evaluate other aspects of a fund's operations, the investors could assess the value of

[25] A best-practices approach to regulation does present some challenges. A fundamental challenge is deciding what the best practices are. The five SEC commissioners may not reach agreement on hedge funds or any other topic. A best-practices strategy would depend on effective coordination at the SEC.

[26] Even when "do nothing" is the best course, it might not be a realistic option for political or other reasons.

[27] It is worth noting that defaults are often "sticky," in which case defaults, in practice, act more like mandates. *See, e.g.*, Omri Ben-Shahar & John Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998); Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998); Kathryn E. Spier, *Incomplete Contracts and Signalling*, 23 RAND J. ECON. 432 (1992). One account of stickiness can be traced back to Ronald Coase, who most famously illustrated that the initial legal allocation of entitlements – such as the "right" to have your hedge fund manager register as an investment adviser under the Investment Advisers Act – may be sticky because of transaction costs. *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

investment adviser registration against the backdrop default that managers must register with the SEC.[28]

Although used sparingly in the United States, some precedent exists for such a default-rule approach to securities regulation. Two specific examples can be found in the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley requires public companies to adopt a code of ethics for senior financial officers or explain why no code was adopted. The Act also requires public companies to have a financial expert on the audit committee or explain why it does not.[29]

In the future, when it does regulate, the SEC should give more serious consideration to using defaults over mandates, and in some instances, the SEC should do nothing more than take a stance by exhorting particular best practices.

## III. The Politics and Psychology of Securities Regulation

My third topic concerns the SEC as an institution and a decision-making body.[30] Although my observations are couched in terms of the SEC's efforts to regulate hedge funds, the observations apply to any legislative or regulatory body and to risk regulation generally.

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[28] The SEC's investment adviser registration rule did include a sort of default. If a hedge fund required its investors to commit their capital to the fund for at least two years – the two-year lock-up provision – the fund's manager did not have to register under the Investment Advisers Act. Indeed, many funds began to institute two-year lock-ups. The rule, though, did not allow a hedge fund manager whose fund did not have a two-year lock-up to choose not to register. A true default would have allowed any manager to opt out.

[29] Such a comply-or-explain approach – which essentially is a default rule – is popular in the United Kingdom.

[30] For an article discussing the SEC as an institution and decision-making body but from a different perspective, see DONALD C. LANGEVOORT, THE SEC AS A LAWMAKER: CHOICES ABOUT INVESTOR PROTECTION IN THE FACE OF UNCERTAINTY (2006), Georgetown Law & Econ. Research Paper No. 947510, *available at* http://ssrn.com/abstract=947510.

We can gain insight into regulatory decision making by better understanding why the SEC might have pivoted in 2004, as it did, in deciding to regulate hedge funds when it had not done so in the past. Nobody knows for sure what impacts a particular regulator's decision making. Group decision making complicates the analysis. That said, the SEC's decision to regulate hedge funds is consistent with two views. First, that the securities regulator did not want to get caught flat-footed and criticized again, as it had been by the scandals at Enron, WorldCom, 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 regulator had abstained from doing so.

The political economy of regulation is well-trodden turf, so I will target my comments. In considering the political economy of securities regulation, it is important to recognize a distinctive feature of U.S. securities markets. There is an expanding investor class in the United States. About 50% of households are invested in stocks.[31] Coupling this with an active business and financial media you get more attention and scrutiny trained on securities markets and their regulation than before. Regulatory decision making is bound to be impacted as securities markets increasingly enjoy widespread participation and as securities- and corporate-related questions become leading topics of serious public and political debate. The predicted product of this

[31] SECURITIES INDUSTRY ASSOCIATION, 2006 SECURITIES INDUSTRY FACT BOOK 64.

process is a kind of democratization of securities regulation as regulators are more responsive to public pressure and the political agenda.[32]

The SEC's desire to protect its regulatory domain contributes to this dynamic. On several occasions, for example, Congress has held hearings on hedge funds, and some legislation has even been introduced. The SEC may have correctly believed that it had to do something when it came to hedge funds to fend off a Congress that may be anxious to fill any perceived regulatory void with new legislation. The SEC has an institutional interest in assuring its position as the predominant securities regulator in the United States and staking out its turf against potential incursions by Congress or the states.

The comparative advantage of an administrative agency over other lawmakers – namely, the agency's subject matter expertise and its independence and impartiality[33] – is compromised when its members are responsive to political agitation or public demands in how they regulate. The risk is that regulators will tend to overregulate under these circumstances. To avoid painting with too broad of a brush, it is worth recognizing that there may be times when the SEC needs to supply regulation when there is demand for it. First, a strong regulatory response may be needed at times – such as during a period of crisis as followed Enron's collapse – to buttress investor confidence. Second, the SEC may need to regulate *enough* to avoid stirring public outrage for taking a lax stance and to preserve its own legitimacy as a regulatory body. If the SEC did not respond to the hedge fund industry boom, especially given some of the headline-grabbing conduct involving

[32] The assumption is that the public will have different risk perceptions than the experts at regulatory agencies. Individual investors, for example, likely are particularly attuned to investor losses as compared to the cost of greater investor protection. *See generally* PAUL SLOVIC, THE PERCEPTION OF RISK (2000); Cass R. Sunstein, *The Laws of Fear*, 115 HARV. L. REV. 1119 (2002).

[33] For a classic treatment of the benefits of independence for administrative agencies with subject matter expertise, see JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS (1938).

hedge funds, investors may lose faith in the SEC for allowing the industry to go unchecked. More generally, Main Street may simply demand that "power" be held accountable, and hedge funds are increasingly powerful.[34] The consequences here extend beyond the SEC, because if investors lose faith in the SEC, they may lose faith in the integrity of U.S. securities markets.

The SEC's decision to regulate hedge funds fits the general contours of the above take on the political economy of securities regulation.

Psychology also impacts regulatory decision making.[35] For example, a psychological (or behavioral) explanation for the "precautionary principle" of risk regulation exists.[36] Simply put, the precautionary principle holds that it is better to be safe than sorry – a proactive regulatory policy of anticipation and preemption. The benefit of a precautionary approach to regulation is that it can lead regulators to take prophylactic steps instead of sitting back and only reacting to problems once they arise. However, taking precautions can also lead to excessive regulation as regulators try to avoid some perceived harm.

Further, the precautionary principle is misleading as a regulatory lodestar. As Professor Cass Sunstein has emphasized, precautionary steps with respect to one risk

[34] *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"). I appreciate Professor Donald Langevoort's highlighting this point to me.

[35] *See generally* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

[36] Regarding the precautionary principle of risk regulation, see generally CASS R. SUNSTEIN, LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005) [hereinafter SUNSTEIN, LAWS OF FEAR]; 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, *Precautions Against What? The Availability Heuristic and Cross-Cultural Risk Perception*, 57 ALA. L. REV. 75 (2005).

inevitably lead to other risks.[37] The difficult question, then, is what risks do regulators regulate to avoid and what risks do regulators tolerate? What risks weigh most heavily in the regulatory balance? To a large degree, the answer depends on value judgments – the value placed on various outcomes. But the answer also depends on various psychological influences that affect human judgment and decision making by making certain risks more fearful, even when in fact they are not as threatening as they seem.

Investor losses, hedge fund collapses, and jarring frauds are salient events that are readily recalled when crafting regulation, particularly in light of the journalists and politicians who play up the losses and abuses. Accordingly, these events likely will feature more prominently in regulators' decision making than the actual magnitude of the events warrant. This disproportionate impact of especially salient events on decision making is associated with the so-called "availability heuristic," whereby salient risks are more available to one's mind and thus receive more attention than they deserve, as well as the "representativeness heuristic" and "probability neglect," according to which people tend to overstate the probability that some bad recent occurrence will happen again.[38] Plus, regulators may be inclined to regulate in response to a perceived risk because regulators may view themselves as there to regulate, after all. The other side of the regulatory scale includes the costs of greater securities regulation. These costs are generally described in such sterile and impersonal terms as the risk that more regulation

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[37] *See, e.g.*, Sunstein, *Beyond the Precautionary Principle*, *supra* note 36, at 1020-29.

[38] *See generally* 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). For more particularized treatment of these biases in the context of the precautionary principle, see, for example, Dana, *supra* note 36, at 1321-36; Sunstein, *Beyond the Precautionary Principle*, *supra* note 36, at 1035-54. For a critical analysis that questions these 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.

will undercut the flexibility, efficiency, and liquidity of financial markets. These risks are not nearly as salient or stirring as the supposed costs of not regulating. Additionally, regulators may be overconfident in their skill at regulating with the right touch, believing that they can get the benefits of investor protection without the attendant costs. Perhaps the regulatory assessment would differ if the costs of regulation were defined more concretely in terms of fewer jobs, lower returns for investors, or fewer investment opportunities.

The bottom line is that 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. This is not to say that the costs of regulation are unaccounted for, but only that the costs often do not receive their appropriate due. This is especially true in the wake of a wave of scandal, such as Enron ushered in. As a result, regulators' assessment of the costs and benefits of regulating get skewed toward avoiding a particularly salient harm. In practice, this means more investor protection – indeed, perhaps too much investor protection at the expense of other goals, such as capital formation.[39] This might explain why the SEC chose to regulate hedge funds in 2004 when it did not do so earlier.

To craft an effective securities law regime, regulators have to appraise objectively and rationally the costs and benefits of regulating; regulators' judgment cannot be obscured by cognitive biases. An unbiased, more probabilistic analysis of the consequences of risk regulation should lead to a more effective regime that better

[39] During other periods – such as a sustained bull market – other biases may be triggered resulting in too little regulation and overly lax regulatory oversight.

advances regulatory goals. Even an SEC that emphasizes investor protection may by its own lights overregulate if it irrationally fears another series of scandals.

Recognizing that regulators, like all of us, are human and imperfectly rational introduces a new set of regulatory challenges. How do regulators guard against the kind of unconscious biases that can frustrate good decision making? There are no easy answers to this challenge. However, some possibilities worth considering include more rigorous cost-benefit analysis, "harder-look" judicial review of administrative agency decision making, new organizational structures that might be mined from the experiences of companies, and the use of internal "prediction" markets.[40]

## IV. Conclusion

This inquiry into the SEC's recent attempts to regulate the hedge fund industry suggests a few basic insights into the how and why of securities regulation. First, investor-side regulation is an option as an investor protection strategy. Second, instead of adopting mandates, regulators could adopt defaults or simply urge best practices without adopting any new legal requirements. Third, regulators need to be aware of, and guard against, the impact of politics and psychology in securities regulation. Although the focus has been on the SEC, these core points inform the crafting of financial regulation more broadly in both the United States and abroad.

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[40] For analyses of these and other proposals, see, for example, SUNSTEIN, LAWS OF FEAR, *supra* note 36; Michael Abramowicz, *Information Markets, Administrative Decisionmaking, and Predictive Cost-Benefit Analysis*, 71 U. CHI. L. REV. 933 (2004); William N. Eskridge & John Ferejohn, Comment, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical Review*, 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); 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).