

**Developing a Cost-Benefit Framework for Future Evaluation  
of SEC Mandatory Disclosure Regulation of Hedge Funds under Dodd-Frank**

Kevin Geck

Duke University

Sanford School of Public Policy

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## **Executive Summary**

This paper analyzes the information provision requirements placed on hedge funds in Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Because the legislation and rulemaking are yet to be implemented, I use three historical examples of similar information provision policies to identify areas of costs and benefits relevant to information disclosure policy. With these categories of costs and benefits established, I create a framework for consideration by economists in future cost-benefit analyses of the rule.

The 1934 Securities Exchange Act, the 1960 Amendments to the Investment Advisers Act, and the 2004 SEC decision to mandate hedge fund information disclosure are unique policy events that provide the investigative background of the relevant costs and benefits of the SEC's mandatory disclosure policies. Language from these statutes is the backbone for Dodd-Frank Title IV, which amends Section 204 of the Investment Advisers Act to include hedge funds in the SEC disclosure regulation scheme.

Research and analysis of historical disclosure policies furnishes specific categories of costs and benefits to create a framework for future analysis. The relevant areas include the following categories: firm level cost of compliance with regulation; market-wide cost of decreased hedge fund activity, capital formation, and liquidity provided by funds; market-wide cost of decreased hedge fund incentive to uncover price information and add transparency to markets; the societal cost or benefit of funding a larger SEC bureaucracy and regulatory regime; decreased risk of system-wide shock and crash; and the increased ability of the SEC to monitor and deter fraud and insider trading by hedge funds.

My research shows that the historical models suggest the benefits of mandatory disclosure to the SEC may outweigh the costs of this regulation. However, empirical

uncertainties in certain categories provide caution before stating a definitive answer to the question. Further research in 5 to 10 years should provide clearer definitions of the magnitude of these costs and benefits.

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## I. Introduction

On July 21, 2010 President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, a comprehensive financial regulatory reform bill that included unprecedented federal oversight of hedge funds. Title IV, the Private Fund Investment Advisers Registration Act of 2010, marked the end of a decade-long quest by the Securities and Exchange Commission (SEC) to bring hedge funds, unregulated pools of invested capital, under regulatory scrutiny on par with other capital markets participants, such as mutual funds and investment banks. The most important aspect of registration is the requirement that funds maintain records and file reports to the SEC on a periodic basis and that they make themselves available for periodic checks by the SEC into those records. Data in those reports must include:

“[The] amount of assets under management and use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements, trading practices, and other information deemed necessary by the SEC in consultation with the FSOC for the public interest and/or the assessment of systemic risk” (Ruane and Seitzinger 2010).

Up to this point, hedge funds used legal loopholes in multiple securities laws to avoid registration with the SEC and disclosure of the information listed above.

Hedge funds are not the first financial actors assigned to disclose their proprietary information under SEC regulation. The 1934 Securities Exchange Act, which established the Commission, set the precedent for this type of information disclosure and oversight of secondary market participants: “Section 15 authorizes the Commission to require brokers and dealers to maintain books and records and to make reports, and provides also that the books and records of broker-dealers are subject to inspection by the Commission” (Loomis Jr. 1960). The Act gave the SEC power to monitor the activities of broker-dealers in order to act as “necessary or appropriate in the public interest or for protection of investors” (Loomis Jr. 1960). In 1940, Congress passed

the Investment Advisers Act, which established a limited authority for the SEC over investment advisers and counsel. Accepted as legislation tangential to the more important Investment Company Act, the original Act did little but require the most basic information about registered funds. By 1960, explosive growth in the mutual fund industry prompted the SEC to ask Congress to amend the Act and require that investment advisers be subject to the same disclosure and oversight policies as broker-dealers in the Exchange Act: “Unless the Commission has sufficient information to bring its investigative powers into play, it has no authority to examine the books and records of investment advisers to determine whether they are engaging in fraudulent, deceptive, or other unlawful practice” (United States Senate Committee on Banking and Currency 1959). In 1960, Congress amended Section 204 of the Act to include language nearly identical to that of Section 15 in the Exchange Act.

In 2004, hedge fund oversight was the primary regulatory goal of SEC Chairman William Donaldson. In a controversial 3-2 decision, the SEC Commissioners voted to extend the powers of the Investment Advisers Act to hedge funds and force them to register under Section 203 of the Act (New York Times 2004). This rule then compelled hedge funds to disclose sensitive information and make them available to SEC inspection like other investment advisers and broker-dealers. However, a few months after the rule went into effect in 2006, a federal judge struck down the rule as unconstitutional, providing a huge setback to the SEC’s attempts to pull hedge funds into the regulatory fold (Norris 2006). The 2008 financial crisis and subsequent regulatory reform bill will compel them to register with the SEC.

Because the legislation and rule-making are so recent, it is too soon to perform a true economic cost-benefit analysis of disclosure policy in Dodd-Frank. Instead, this paper draws on the history and dynamics of disclosure debate to build a cost-benefit framework for disclosure

rules for hedge funds. As I develop how policymakers defined the costs and benefits of disclosure regulation at these specific points, I use empirical, theoretical, and legal literature on the economic consequences of disclosure to assist in my construction of a cost-benefit framework. The wide set of literature on disclosure should serve as an analytical tool to evaluate the merits of different elements in the cost-benefit framework for analysis of disclosure regulation as it has changed through time.

The paper draws upon the economic disclosure literature to construct a cost-benefit framework for Dodd-Frank Title IV based on historical contexts enriched by primary documents about the different debates, including newspaper and journal articles, and congressional testimony and reports. The history, evolution, and cost-benefit framework of SEC disclosure policy suggests that capital markets and the hedge fund industry will not be damaged significantly by new SEC rules from Dodd-Frank Title IV. The costs for firms and in the marketplace of disclosure regulation likely will not outweigh the benefits of the rightful need for the SEC to protect investors and manage systemic risk in the economy.

My economic, historical, and policy research yields a firm set of recurring categories of costs and benefits. The categories of costs and benefits I develop and examine in each section include these areas: firm-level cost of compliance with regulation; market-wide cost of decreased hedge fund activity, capital formation, and liquidity provided by funds; market-wide cost of decreased hedge fund incentive to uncover price information and add transparency to markets; the societal cost or benefit of funding a larger SEC bureaucracy and regulatory regime; decreased risk of system-wide shock and crash; and the increased ability of the SEC to monitor and deter fraud and insider trading by hedge funds. My research shows the relative value of the criteria during each period of regulatory debate.

Furthermore, I identify specific elements of the disclosure cost-benefit debate that appear in each case and influence the valuation of contemporary valuation of costs and benefits: the public interest in mandatory disclosure policies; the perceived cost of compliance on an industry; the changing jurisdictional boundaries of the SEC; and the efficacy of industry self-regulation versus government regulation. This paper demonstrates how changes in disclosure policy over time have resulted directly from policymakers' attitudes towards those issues.

## **II. Review of Economic Disclosure Literature**

Though a wide range of theoretical and empirical economic literature exists concerning mandatory disclosure, there are actually few studies in the literature that detail the economic costs and benefits of securities information disclosure policy (Leuz and Wysocki 2008). In light of the dearth of cost-benefit literature, I review relevant literature that pertains directly to the costs and benefits of information provision outlined in the introduction. This literature focuses on the firm-and market-level impacts of mandated information provision, though it also includes some research on the overall costs and benefits of hedge fund activity. First, I discuss literature detailing the economic concepts behind disclosure regulation.

The economic literature centers around the impact on firms and markets of firms' disclosure of securities information. The most important economic concept concerning securities research is that it is an information good. Information goods share certain characteristics that can be defined economically as experience goods, goods with multiple dimensions and product differentiation, goods with high fixed costs and low variable costs, and public goods (Hamilton 2004). The characteristics of information markets show why hedge fund advisers have incentives to protect securities information and why regulators and the public desire more securities information. Information goods are experience goods, meaning that consumers cannot evaluate

the merits of a good before they purchase it (Hamilton 2004). In this case, an investor cannot know the exact value of his return on an investment before he purchases the services of a hedge fund manager with private securities information.

Naturally, consumers of information goods want to know about the quality and source of a good before they purchase and use it. Producers often employ signals such as brands and reputation to give the market indicators about the quality of the good. In the case of securities information, the source of the information can give the information huge value if the source is a brand recognized for past success and quality. Information markets therefore feature significant amounts of product differentiation, in which products do not have perfect substitutes and employ the use of superstars to build brand recognition (Hamilton 2004). Industry rivals that produce, market, and sell similar goods focus on transforming the image of their products as to distinguish them from those of their competitors. Firms tailor information specifically to the needs to their clients as a form of differentiation, especially with subscription services (Shapiro and Varian 1999). Hedge funds similarly build brand recognition and product differentiate with their managers, trading strategies, firm names, and past successes (Kerr 2010).

Information markets are characterized by the high fixed cost of producing the information coupled with the low or zero cost of disseminating that information. The cost to a manager or analyst of obtaining securities information can be very high and can include time spent researching firms and strategies or information purchased through expensive specialty subscription services (Kerr 2010). But once that information is created, the marginal cost of reproducing that information is zero. Firms strive for legal control over their content so they can receive compensation for its creation (Hamilton “Demand Concepts” 2010). Though an analyst or firm may incur a high fixed cost of creation of securities information, that source is not

compensated for its discovery once information is disclosed to the public. Firms that produce securities information then have an incentive to protect that information so they can be compensated for the high fixed cost of discovery (Coffee Jr. 1984).

Information goods share characteristics of public goods, which are nonrival and non-excludable. Public goods are nonrival, which means the consumption of the good by one individual does not reduce the total amount of the good available for consumption. Public goods also are non-excludable. These are goods that exist with the impossibility of exclusion of consumption by others. Consumption of a public good generally occurs without the consumer paying for the good. Public goods exist in contrast to private goods, in which the consumption of the good by one individual precludes the consumption of the good by another (Hamilton 2004). Public goods include ideas or facts, such as securities information.

Because public goods are nonrival and non-excludable, they are underprovided for in the marketplace. Consumers can experience public goods without directly subsidizing the cost of creation. For information goods such as securities research, that information can be reproduced at zero cost and passed along freely to others because the marginal cost of passing that information along to others is zero (Hamilton 2004). If the creator of the information is not compensated adequately for the fixed costs of creation, then the creator has less incentive to produce that information, even if demand in the market exists for that information. Coffee Jr. (1984) argues that securities research is underprovided for in the market because it shares those aspects of a public good. Analysts and fund managers therefore have less incentive to produce securities information because they cannot realize the complete economic value of the research.

Coffee Jr. (1984) argues for the market failure of securities information as a justification for mandatory disclosure based on the efficiencies reaped in securities markets due to mandated

disclosure after the implementation of the Securities Exchange Act of 1934. Because securities information holds characteristics of a public good, the analyst who discovers the information cannot realize the full economic value of the information to the market. New research often is passed along as a report, and the marginal cost of reproducing this information is zero. Once the information is released publicly, other investors who did not pay for the information free-ride off of the discoveries of the analyst, who is not compensated for these investments based on his securities research. This situation decreases the incentive for analysts to discover information, implying to Coffee Jr. that there is an underinvestment in securities research:

“If market forces are inadequate to produce the socially optimal supply of research, then a regulatory response may be justified...to the extent that mandated disclosure reduces the market professional’s marginal cost of acquiring and verifying information, it increases the aggregate amount of securities research and verification provided. That is, because the analyst as a rational entrepreneur will increase his output until his marginal cost equals his marginal return, it follows axiomatically that the collectivization of securities information will produce more information. Over time, excess returns to securities analysis will induce new competitors to enter the market, which will increase the competitiveness of the industry. Casual empiricism suggests that both these predictions can be observed in the post-1934 experience of the securities industry. Certainly, the volume of securities research is much higher today than in 1934” (Coffee Jr. 1984).

A mandatory disclosure system can reduce inefficiencies and provide cost savings to a market that does not appropriately value securities information, thereby creating a more efficient capital market. If the producers of information are not compensated accordingly, then securities research may be underprovided for in the market, creating a scenario of market failure that can be remedied with mandatory disclosure.

Regulators such as the SEC require certain disclosures from firms in order to monitor the behavior of institutions on exchanges. Over the past 80 years, regulators have argued for greater information disclosure by capital markets participants, such as mutual funds and hedge funds. However, the recent financial crisis bolstered the argument that the SEC lacks the appropriate

systemic risk information to monitor market activity appropriately. Systemic risk is the probability that excessive losses or failures by funds or institutions could cause contagion in financial markets that could endanger the entire financial system (Bianchi and Drew 2010). Regulators believe that a lack of information disclosure by hedge funds heightens the chance that the collapse of a fund could threaten the entire economy.

Leuz and Wysocki (2008) review the literature concerning the firm-level costs of disclosure regulation. In the corporate disclosure literature, firm-level costs are viewed as burdensome to small firms and as detrimental to growth. According to the literature, the financial costs of compliance and disclosure may appear small, but small businesses incur a greater opportunity cost if management spends time on preparing disclosure reports as opposed to revenue-producing activities (Leuz and Wysocki 2008). High costs can simultaneously push borderline firms out of the market and discourage other firms from entering the market, making the market less competitive and potentially stifling innovation.

A set of theoretical literature discusses why it is detrimental to firms to reveal private information. Gal-Or (1987) models disclosure with a Stackelberg leader in an environment in which the follower can always determine the private information held by the leader. The game shows that the follower achieves better outcomes over a wide range of values. The implication for hedge funds is that potential transparency in disclosure rules will disincentivize leaders in securities information production. Etlinger (2008) compliments that finding with a trade secret argument, stating: “Hedge fund interests arguably constitute property that is protected by trade secret law and the Fifth Amendment. First prong requires ‘reasonable efforts’ to establish and protect a trade secret...the Second prong is improper appropriation of a trade secret...[it] requires proof that disclosure of the information to be protected would unfairly benefit or

advantage a competitor.” The literature suggests that hedge funds hold a legitimate concern that revelation of their private information will nullify their competitive advantage in the market.

The empirical literature followed closely the brief period in 2006 when the SEC mandated registration and disclosure by hedge funds. Brown, et al. (2007) found that hedge fund disclosures on Form ADV in 2006 “indeed contain information that can be used to measure operational risk [of funds]. Legal, regulatory, and other problems are highly associated with measures of conflict of interest reported on these forms.” However, their research also found that disclosure “is not material to well-informed capital market participants.” Aragon, Hertz, and Shi (2010) examined the types of holdings that hedge fund managers choose to disclose to regulators on their Form 13F filings. Prior to Dodd-Frank, hedge funds with AUM over \$100 million had to report their quarterly holdings to the SEC within 45 days of the end of the quarter, but managers could request delay of disclosure of their holdings if that information was confidential. Aragon, Hertz, and Shi (2010) compared and contrasted the holdings released within the 45 day period and the holdings kept confidential and found that confidential positions tend to earn “positive and significant abnormal stock returns.” Illiquid securities held in portfolio were usually the type of asset held confidentially by managers. Their research also showed that managers typically avoid disclosure as a means of circumventing “front-running,” as opposed to strategically hiding past losses. Their conclusion was that increased portfolio disclosure can result in free-riding by other funds and reduces the economic benefit and incentive of those managers to produce that information.

Disclosure literature from the mutual fund industry provides a similar point of departure for the analysis of hedge funds. George and Hwang (2005) corroborate the hedge fund research discussed above. Their model treats an investment company as “having a stream of investment

ideas, and as subject to redemptions that lead to early liquidation of investment profits.” Their data show that if information is costly to acquire, mandated disclosure crowds out profitable information acquisition for mutual funds. Similarly, Frank, et al. (2004) finds that mandatory disclosure could damage mutual funds if competition is allowed to mimic the portfolio activity of the leader.

Finally, there is a section of literature that discusses the benefits of hedge fund activity in the market. Brophy, Ouimet and Sialm (2006) show that hedge funds can act as investors in distressed or high-risk firms that would not have received capital otherwise from the market. With regards to hedge fund performance in the 2008 financial crisis, Romano (2010) states that the ability of hedge funds to suspend investor withdrawals, as well as purchase illiquid securities from failing financial institutions, helped ease the crisis.

The economic literature provides the tools to analyze the effects of disclosure on industries and the market. The economic data, literature, and concepts allow for an analysis the costs of the disclosure of private information and the benefits to the market and regulators of obtaining that information. The prevailing current in the literature is that mandated public disclosure of proprietary information should have a negative effect on firms in the industry. However, there is the countervailing argument that a market failure of securities information is deleterious to both investors and the systemic risk in the economy and that mandated disclosure could be cost-saving and efficient. The tension between what information must be public and what information must remain public is a critical theme in the cost-benefit framework. The literature also shows that any analysis of hedge fund disclosure must be considered carefully because that industry is much less public than others. The literature cannot provide a magnitude

of the effect of costs or benefits in the proceeding cases examined, but it provides a context for an examination of the potential effects of the categories of costs and benefits.

### **III. The Securities Exchange Act of 1934**

Section 15(d)(1) of the Securities Exchange Act of 1934 provides the SEC with the power to compel broker-dealers to register and file periodic reports with the Commission. Each broker-dealer

“shall file [a report] with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title” (United State Congress 1934).

The legislation brought broker-dealers directly under supervision of the SEC, and its language detailing “the public interest and the protection of investors” was one of the most common rationales for passage of the Act in 1934. Senator Duncan Fletcher, one of the bill’s co-sponsors, described its purpose as one to protect the general public and everyman investor from Wall Street abuses:

“It is in the light of the interests of the general public that the bill was drawn. There was no desire to hurt the few hundred men who have been obtaining, year after year, princely incomes out of the pockets of the American people trough the operation of exchanges not subject to government regulation...federal government has the power to require full disclosure, and the bill is so written that the disclosure may now become assured to the great body of our investors” (Wall Street Journal Washington Bureau 1934).

The backdrop of the Stock Market Crash in 1929 and the ensuing Great Depression provide the political and economic landscape for a framework of costs and benefits of mandatory disclosure in 1934. While Senator Fletcher sought to represent the public and the common investor, the New York Stock Exchange (NYSE) vigorously opposed the bill. The NYSE issued a large statement titled the Hoxsey Memorandum, which detailed the Exchange’s grievances and pleas for self-regulation. Disclosure requirements were among the most contentious aspects of

the bill, as the NYSE believed that the Commission should hold no power to regulate how the Exchange conducts its business:

“Under no circumstances should the Commission be empowered to prescribe the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, and in the differentiation of investment and operating income” (Wall Street Journal 1934).

Fundamentally, the NYSE argued that the cost of regulating its body was greater than the potential benefit to the public and to investors of greater transparency in the markets. However, the Pecora Report came to a different conclusion. Initiated by the Senate Committee on Banking and Currency, the Pecora Commission spent two years investigating the causes of the Great Depression and troubled nature of the American financial system. In collaboration with Senator Fletcher, who became head of the Committee in 1933, the Commission explored every aspect of the financial system, including issues with disclosure. The final report, issued on June 6, 1934 – the same day as President Roosevelt signed the Securities Exchange Act – provides the best source of elements of the costs and benefits of disclosure policies for broker-dealers. In the following sections, I identify the key elements of the cost-benefit framework in the 1930s and discuss its implication as the precedent for modern securities information disclosure regulation.

### *Cost of Compliance*

The abuses of brokers and dealers in the stock market necessitated an increase in costs of compliance for broker-dealers from greater reporting requirements to the SEC. The investigation found a significant portion of exchange members who traded with clients' money for their own account. The Commission noted that there exists an inherent conflict between the broker and his client and that the client's welfare is jeopardized by that conflict. According to the report,

“When purchases and sales for the accounts of member firms, partners thereof, and individual members are reported on the ticker tape or in the press, there is, of course, no

disclosure of the nature of these transactions. The public, in July 1933, had no means of knowing that approximately 27 percent of all transactions were executed for the account of members on the New York Stock Exchange. A volume of trading which might readily have been construed to reflect a widespread public participation in the market and a genuine revival in confidence in securities, represented to the extent of 27 percent of activities of members themselves” (United States Senate Committee on Banking and Currency 1934).

To the Commission, the lack of disclosure represented a situation in which the firms involved in the markets created a negative externality. Negative externalities are situations in markets in which there are spillover effects that impose costs on third parties from transactions in a market. This scenario results in a deadweight loss and inefficiencies in the market, and government regulation can be used to reduce negative externalities in society (Vigdor 2008). The utter lack of public knowledge of the activity of exchange members created a situation in which the public could misinterpret the actions of the market and incur losses because such a large chunk of the trading action was attributed to members of the exchange. Their considerable chunk of opaque trading activity provided them a boon and left the normal American investor in the dark. The separation of the function of brokers and dealers and subsequent reporting requirements levied on them by Section 15 of the Act represented an appropriate cost to member firms of doing their business on Wall Street.

Additional firm-level costs of disclosure and compliance are seen typically as burdensome to small firms and as detrimental to growth. Though the financial cost is easily calculable and straightforward, small businesses face an even greater opportunity cost if management has to devote a greater amount of effort to compliance and disclosure (Leuz and Wysocki 2008). If disclosure costs raise barriers to entry, firms may be less likely to enter the market, which could make the market less competitive. Though that argument was not made in the 1930s specifically regarding broker-dealer disclosures, many corporations strongly opposed

disclosure regulation for those exact economic reasons. Nearly half a million corporations sent a plea to Congress to alter the Stock Exchange bill so those corporations could avoid the disclosure and compliance costs of having their securities listed on the exchanges (New York Times 1934). These firms argued that the bad actions of a few corporations did not warrant SEC regulation for all corporations: “Registration requirements impose burdens on corporations by requiring information which is not necessary to protect investors and much of which is a confidential nature, which may become public” (New York Times 1934). The question of what information is necessary to protect investors, as well as what information must stay confidential, is a recurring theme in debates over SEC disclosure rules from this point forward.

#### *Cost of SEC Regulatory Regime*

The exchanges and their members opposed regulation under the Securities Exchange Act with the argument that novice SEC regulation was no substitute for industry self-regulation and self-discipline. In the Hoxsey Memorandum, the NYSE pushed back against the Commission’s power to set broad rules for the exchanges or strictly regulate exactly how the exchanges were to do business (Wall Street Journal 1934). E.A. Pierce, a member of the law committee of the Exchange, also cited attacks on the wide berth granted the Commission with the Act but defended the statutory latitude: “A great deal of prejudiced criticism is directed at the wide discretion left to the commission which will administer the act. Wide discretion is essential...[the securities market] can be regulated properly only through experimentation...Anything other than wide discretion is unthinkable” (New York Times 1934). In this case, the illicit and compromising behavior uncovered by the Pecora Report in the wake of the stock market crash, such as illegal and unsafe loans taken out by brokers on the exchanges, necessitated unparalleled

insight by the government into a business's practices (United States Senate Committee on Banking and Currency 1934).

The Pecora Report describes the rationale behind government regulation of exchanges and what it perceives the effect of the new rules will be on the exchanges. The Report details the history behind their resistance as well:

“For many years stock exchanges resisted proposals for their regulation by any government authority on the ground that they were capable of regulating themselves sufficiently to afford protection to investors...The view that internal regulation obviated the need for government control was unsound for several reasons...first, the interests of exchanges and their members frequently conflicted with the public interest...second, the securities exchanges have broadened the scope of their activities to the point where they are no longer isolated institutions but have become so important an element in the credit structure that their regulation, to be effective, must be integrated with the protection of our entire financial system” (United States Senate Committee on Banking and Currency 1934).

By 1934, the Commission viewed the argument for self-regulation with such ambivalence that it considered self-regulation much more costly than implementing the SEC regime. If anything, regulation in the Act would be defined as an aid to both investors and Wall Street.

The potential effects of overregulation by the federal government extend from the economic sphere to the social and political realm. As discussed in the previous section, firm-level costs of compliance could crowd out business that would otherwise enter the market, which in turn stifles overall American competitiveness and innovation. However, the debate in 1934 leaned toward a more legal argument concerning the reach of the federal government into commerce. The Pecora Report cites the Commerce Clause as the justification for the federal government to regulate securities and exchange practices. Because it is a form of interstate commerce, the federal government has the power to regulate its business. Opponents of the bill warned of the harm of the bill because it granted far too much power to a federal agency. On the day President Roosevelt signed the bill into law, Federal Trade Commissioner Landis had to

deny “emphatically that the securities and exchange legislation forms part of any program of socializing industry” (Wall Street Journal Washington Bureau 1934). In this case, Commissioner Landis defended the charge that the Securities Exchange Act was an act of government overstepping its bounds. This accusation is similar to language in the Hoxsey Report and the plea to Congress by industrial corporations: the legislation is too broad for businesses to function freely and therefore imposes a cost upon businesses.

The debate bears similarity to the discussion of the regulation of commercial speech first defined by the Supreme Court in the 1942 case *Valentine v. Chrestensen*. In that opinion, the Court held that commercial speech was not protected by the First Amendment: “We are clear...that the Constitution imposes no...restraint on government as respects purely commercial advertising” (Kozinski and Banner 1990). Though commercial speech has gained more protection from the Supreme Court since that decision, Kozinski and Banner (1990) argue that a distinction between commercial and noncommercial speech “gives the government a powerful weapon to suppress or control speech by classifying it merely as commercial.” Though the doctrine of commercial speech had yet to be born in 1934, the concept surrounding what type of speech the government could mandate is relevant to the mandatory disclosure debate. Kozinski and Banner (1990) identify the lack of protection of commercial speech, such as mandatory disclosure, as a cost to society, though the Supreme Court in 1942 disagreed. An analysis of costs and benefits of disclosure in 1934 should include an investigation of the potential effects of the lack of First Amendment protection of commercial speech.

#### *Benefit of Increased Investor Protection from Fraud and Unfair Practices*

In 1934, the most important benefit of disclosure was to protect investors and prevent fraud in securities markets (Wall Street Journal Washington Bureau 1934). Both President

Roosevelt and Federal Trade Commissioner Landis argued that the clarity provided by disclosure would prevent investors from being fooled by speculative schemes or defrauded by broker-dealers. The Pecora Commission espouses the purposes of the disclosure scheme: “The reporting provisions of this act will fill a long-felt need by aiding the exchanges to secure proper information for the investor. Careful provision is made against the disclosure of trade secrets and processes” (United States Senate Committee on Banking and Currency 1934). The effect of disclosure is to benefit investors by allowing the Commission to gather data and prevent fraud, insider trading, and unfair practices, but the Commission notes that it does not want to destroy the incentives of exchange members.

This language describes some of the earliest acknowledgement by the federal government in securities regulation of the heightened importance of the information goods and intellectual property produced and/or handled by securities firms and members of exchanges. Etlinger (2008) and Gal-Or (1993) each cite the theoretical disadvantages for firms who disclose proprietary information to the public. Frank, et al. (2004) and George and Hwang (2005) each corroborate that finding by showing how mutual funds and investment companies can suffer at the hands of copycat funds. The protection of the investor is paramount to the Commission, but this early understanding of the sensitive nature of securities information and proprietary data by the Commission shows that it understands how the benefit of disclosing certain information to investors could be undermined if it destroys the value of the service provided.

#### *Benefit of Decreased Risk of System-Wide Shock and Crash*

Though systemic risk was not a buzzword in 1934, the concept of the interconnectedness of exchange activity was well-recognized by the Commission. As noted above and on the very first page of the Pecora Report’s chapter on exchange practices, the size and scope of securities

markets has grown too large to ignore: “Directly or indirectly the influence of such transactions permeates our national economy in all its phases. The business conducted on securities exchanges has attained such magnitude and has become so closely interwoven with the economic welfare of the country that it has been deemed an appropriate subject of governmental regulation” (United States Senate Committee on Banking and Currency 1934). Changes in technology, especially in communication, made the effects of the actions of the exchanges even more connected to the well-being of the economy.

The Commission used the size and scope of the industry and its devastating effect on the economy to illustrate its point in the previous paragraph. On page 6 of the report, the aggregate commissions and interest received by members of exchanges between 1928 and 1933 are listed. The amount of commissions is over \$1.64 billion, and the amount of interest received over \$325 million. The industry’s net income during that period is estimated at nearly \$1 billion. The report cites that the amount “represents the amount paid by the public for effecting transactions through such members” (United States Senate Committee on Banking and Currency 1934). On the next page, that number is contrasted with the billions of dollars lost by Americans because of the speculative boom in the stock market:

“The economic cost of this down-swing cannot be gauged. The wholesale closing of banks, and other financial institutions; under no circumstances should the Commission be empowered to prescribe the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, and in the differentiation of investment and operating income” (United States Senate Committee on Banking and Currency 1934).

In the eyes of the Committee, the benefit of disclosure regulation that could help prevent a similar catastrophic event in the future far outweighed the cost of funding the SEC bureaucracy. The market failure of information provided to the marketplace concerns the under-provision of

information by the market to the public and regulators. The unregulated market produced a less than socially desirable amount of information about the activities on exchanges and imposed a cost on society and investors in the form of huge economic losses, as detailed above (Coffee Jr. 1984). In this case, a lack of transparency in the markets and a rampant culture of fraud were contributing agents to the 1929 stock market crash. There was no regulation or mechanism in place to manage the speculation and risk-taking activities of members of the exchanges, which according to the Pecora Report came at the vast expense of the American people. The benefit of disclosure in this case should create a situation that attempts to remedy the market failure and foster a more transparent and efficient environment for the market and its participants. According to Coffee Jr. (1984), a mandatory disclosure system should reduce the cost of originating securities information, as well as reduce potential negative spillover effects of that market failure.

*Political Dimensions and Implications of Section 15 as Precedent for Disclosure Regulation*

The costs, benefits, and their effects identified in the debate about the Securities Exchange Act of 1934 set the point of departure for the creation of a cost-benefit framework for disclosure policies. Firm- and societal-level costs, market failure, investor protection, and systemic risk issues become firmly entrenched in the lexicon of debate over disclosure. The apparent magnitude of the effects of those costs and benefits, however, was affected greatly by the active political dimensions in the debate. President Roosevelt and Congressional supporters of the bill used the backdrop of the Great Depression as an aid to their appeals to the common investor. As mentioned previously, Senator Fletcher had little sympathy for the bankers who lined their pockets while most of the nation suffered economic hardship. An empirical analysis

might have a difficult time fully aggregating the value of “investor protection,” but its political salience put it as a primary benefit of the bill.

The dynamic of the SEC representing a helpless “everyman investor” against the rich, powerful, and successful is closely related to each of the political dimensions of costs and benefits. The industry’s refrain of self-regulation and the demands on the other for investor protection produce a tension of rich versus poor in the disclosure debate. According to the industry, the exchanges were capable of self-regulation and investor protection because it was in their interests to do so. Internal rules for each exchange would provide more than enough disclosure and protection to investors (United States Senate Committee on Banking and Currency 1934). In 1935, the SEC chose to release the salaries of the executives of General Motors and a few other prominent firms because the SEC “determined the information to be of public importance” (Wall Street Journal Washington Bureau 1935). Immediately, the Wall Street Journal Editorial Board attacked the move as “pander to the moral sentiment of those who hate the rich or successful” (Wall Street Journal 1935). The SEC justified its choice because of the public interest, but the definition of what is in the public interest – such as the salaries of top CEOs – and what is not comes into question, framed as an attack on the rich. The title of the editorial itself – “Has the SEC the backbone?” – indicates an attitude of contempt toward the fledgling organization. The media portrayal and political dimensions of costs and benefits of disclosure regulation will have a strong influence on how policymakers weigh them when making legislative decisions.

Lastly, Section 15 of the Securities Exchange Act is the backbone of future disclosure regulation for other capital market participants, such as investment companies, investment advisers, and eventually hedge funds. At the time of its passage, that section for broker-dealer

disclosure appears to have been one of the less contentious pieces of disclosure policy in the Act. However, the choice by Congress to regulate the activities of parties in the secondary market represents a large first step for the SEC towards strengthening its mandate. At the time, much of the debate centered on the effects of the legislation on the original issuers of securities. But as my research shows, the focus of SEC regulatory power shifts towards the capital markets players, and the SEC draws repeatedly on Section 15 as the basis of disclosure regulation of various types of funds.

#### **IV. The Investment Advisers Act of 1940**

In 1940, President Roosevelt signed into law the Investment Advisers Act, which mandated registration of investment advisers with the SEC. Section 204 described what information the advisers must give to the SEC, as well as what power the SEC had to dictate what information it could collect from advisers: The text of Section 204 was as follows:

“Every investment adviser registered under Section 203 of this title shall file with the Commission such annual and special reports, in such form as the Commission by rules and regulation may prescribe for the purpose of keeping reasonably current the information contained in the registration application” (United States House of Representatives Committee on Interstate and Foreign Commerce 1940).

However, the registration form required only the most basic amount of information about the investment advisers: “...information relating to the form of organization of investment advisers, their partners, officers, directors, controlling persons, employees, the nature of their business, the nature and scope of authority with respect to investment advisory clients’ funds and accounts, and the basis of compensation” (Wall Street Journal 1940). The statute did not contain the same stringent language from Section 15 of the Securities Exchange Act. The IAA also granted exemptions for “individuals or organizations which do not hold themselves out as investment advisers generally to the public and which have had less than fifteen clients during the preceding

year” (New York Times 1940). At this time, the SEC was not granted the authority of periodic checks of investment advisers’ books or any of their financial information.

In the post-World War II boom, the number and influence of investment advisers skyrocketed. In 1941, only 753 advisers registered with the Commission; by June 1959, 1671 advisers were registered with the SEC (Loomis 1960). Congress attempted to add more stringent language, like Section 15 of the SEA, to the statute in 1949 with the Lea Bill amendments: “It is obvious that this would provide a highly effective means by which the Commission could investigate to determine whether the Act was being violated. From the remedial standpoint, this is far more efficacious than, in effect, requiring that the Commission do nothing until an investor is *actually hurt*” (Vanderbilt Law Review Comments 1947). However, increased regulation of investment advisers was not revisited by Congress until 1959. After a series of hearings in 1959 and 1960 on the activities of investment advisers, Congress passed PL 86-750, which amended Section 204 of the Advisers Act:

“Every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser (other than one specifically exempted from registration pursuant to section 203(b)), shall make, keep, and preserve for such periods, such accounts, correspondence, memorandums, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memorandums, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors” (United States Congress 1960).

The amendment was very similar to the bookkeeping and inspection powers granted to the SEC over brokers and dealers under the Securities Exchange Act. In the next section of this chapter, I explore the costs and benefits weighed by policymakers during the 1940 debate surrounding the Investment Advisers Act and their effects during the next 20 years. Then, I contrast that debate

with Congress' sentiments in 1959 and 1960 as the amendment to the Act moved through Congress and categorize the potential effects of the costs and benefits of the bill on the industry and the market.

### *Constitutionality and Public Cost*

In 1935, the passage of the Public Utility Holding Company Act mandated the SEC to investigate and prepare a report for Congress on the activities of investment trusts and investment companies. After 4 years studying those industries, the SEC prepared recommendations that resulted in the Investment Company Act of 1940. However, the SEC investigation also resulted in a short bill titled the Investment Advisers Act of 1940. According to David Schenker, chief counsel of the SEC Trust Study, the SEC held limited jurisdiction over investment advisers and received little latitude by Congress to inquire about them through the Study. But the Study made the SEC aware of the growing investment adviser industry, and the IAA sought to aggregate the most basic information about their activities, according to Mr. Schenker: "What is this registration requirement? It discloses their name and address, who are their partners, what is their background, what is their experience, what is their discretion over their customers' accounts, and we ask them if they engage in any other business" (United States Senate Committee on Banking and Currency 1940). However minor that requirement appeared, Senator Robert Taft questioned the constitutionality of this type of registration:

"Senator Taft: "What is the constitutional basis for regulating a person who simply has an office in Cincinnati, for instance, and advises people to come see him?"

Mr. Schenker: "An investment counsel gives advice with respect to the execution of orders relating to securities listed on exchanges and in a great many instances has discretionary power to execute those orders."

Taft: "That seems to me, a very thin basis for its constitutionality." (United States Senate Committee on Banking and Currency 1940).

Senator Taft's objections echo arguments made in 1934 about the Commission's basis for regulation of the Exchanges. The Senator does not argue about potentially higher costs for investment advisers or damaging the industry. His concern rests with the belief that too much federal regulation could lead to a socialist regime in the United States. Mr. Schenker spends a portion of his testimony explaining to the Committee how investment advice is interstate commerce and therefore can be regulated by the federal government. The real cost of the legislation for the Senator is the societal cost of an oppressive federal government – the loss of freedom and liberty to tyranny. At the time, the potential effects of such a regime could have appeared catastrophic. Senator Taft was one of the most vocal Republican opponents of New Deal legislation, and he felt very strongly that legislation such as the IAA was fundamentally unconstitutional and detrimental to the United States. The social cost of federal regulation should be included in the cost-benefit framework of disclosure regulation.

The definition of the “public interest” in disclosure regulation also is manipulated by industry representatives to make the regulation appear as against the “public interest” and as a social cost. Members of the industry painted investment advisers and counsel as a profession similar to the law, in which self-regulation is the most efficient manner of regulation. Again, the breadth of power given to the SEC to define the “public interest” is under attack, this time by Douglas Q. Johnston, Vice-President of the Investment Counsel Association of America: “Just why it is thought to be in the public interest at this time to require all of the above services to register with, and be regulated by, the Federal Government we do not know... We all know that abuses exist, or may occur, in practically every field of endeavor; existing laws against fraud already cover the most flagrant, and the balance ordinarily do not require Federal regulation in order that the public interest may be best served” (United States Senate Committee on Banking

and Currency 1940). The extensiveness of SEC power to define “public interest” is therefore viewed as a public cost. If the SEC is acting in a way that is *not* in the “public interest”, then that will have a negative effect on the industry and the economy. The interesting political dimension of Mr. Johnston’s argument is that he does not represent the “public interest” in his testimony before the Subcommittee on Securities and Exchange. His definition of the public interest takes into account the interest of the members of his trade organization first. Again, an ongoing theme in SEC disclosure regulation is how well the SEC can represent the public interest and protect investors in the face of concentrated political opposition from the industry under scrutiny.

### *Costs of Compliance*

Testimony by members of the investment adviser industry in 1940 laid the groundwork for future industry opposition, include hedge fund opposition, of SEC disclosure regulation. The industry defines itself by its ability to protect confidential information of investors. Self-regulation is categorized as natural for the industry because it is in the best interests of investment advisers to maintain good standing and keep their client base happy. Furthermore, the seeds of the hedge fund industry are planted with the argument that many investment advisers do not market themselves to the general public and therefore should not fall under the purview of federal regulation. Charles O’Hearn, Vice-President of Clarke, Sinsabaugh, and Co. Investment Counsel, elucidated these arguments in his statement to the Subcommittee:

“We have the best of reasons for exercising a high degree of self-discipline... We do not deal with the general public. Our Clients represent substantial amounts of capital and have adequate means to inform themselves about us through their banking and legal affiliations. They make careful investigations of the ability and integrity of investment advisers before employing them. A principal advantage of our service to our clients is that it is confidential as against all third parties. Were this bill in force, many of our clients would undoubtedly consider that one of the chief advantages of investment counsel service to them had been destroyed. It is against the public interest to destroy this confidential relationship by subjecting our operations to public scrutiny through investigations” (United States Senate Committee on Banking and Currency 1940).

This statement demonstrates the potential costs and their effects from the industry perspective. According to Mr. O’Hearn, the confidential nature of the counsel-client relationship is what creates the most value for investment advisers. He suggests that if advisers must disclose confidential information to the public or regulators, the industry will be destroyed. Furthermore, he argues that because confidentiality creates value, all investment advisers naturally practice with a high degree of personal integrity and would be remiss to commit crimes against their clients. According to the industry, it is not in the public interest to regulate investment advisers because investment advisers do not advertise their services to the general public, and advisers are utilized only by a small percentage of the population. Finally, Mr. O’Hearn contends that the population that does employ investment advisers is intelligent and scrupulous enough to determine which investment advisers to use because of its “banking and legal affiliations.” Regulating advisers is wasteful because their clients already have the means at their disposal to properly inform themselves.

In 1959, confidentiality of client information was still the paramount concern of the investment advisers industry. However, the industry compromised on disclosure of information to regulators if clients’ information was kept confidential, according to Harold Cherry, Vice-President of the Investment Counsel Association of America: “Since Section 6 will give the SEC certain explicit powers of visitation and audit, it seems to us essential, if our clients are not to be left liable to improper exposure, to strengthen the existing secrecy provisions of 210(c)” (United States House of Representatives Committee on Interstate and Foreign Commerce 1959). Mr. Cherry later supported the bill as it sat in Committee. In its statement to the Senate Committee on Banking and Currency (1959), the SEC acknowledged the particular characteristics of the

investment advisers industry and explained how the bill would protect against potential costs of disclosure:

“The nature of the business of an investment adviser differs from that of a broker on account of the personal details of a client’s life which the adviser keeps on file to assist management of a portfolio. The industry has always feared that an investigation or examination might leave it prey to gossip-mongering...A further safeguard of these relationships is provided in section 210(b) as proposed to be amended by section 13 of the bill which will make it unlawful for the Commission to make public information obtained in an examination or investigation except in the case of public hearings or upon request of either House of Congress.”

The language in Section 210 that allows the SEC to fulfill its regulatory mission while protecting value for investment advisers represents an interesting compromise and potential remedy for the cost of information disclosure to firms. The debate over regulation of investment advisers never centered on direct, individual costs to firms of physically complying with SEC law; rather, opponents viewed the regulation as a destroyer of economic value and incentive in the marketplace. In this case, investment advisers were willing to compromise with increased disclosure because the cost of taking on more compliance responsibilities was not as high to them. Because of the self-proclaimed personal nature of their service, they probably already maintained the requisite recordkeeping standards desired by the SEC and therefore were more willing to comply with additional regulation if their information was kept confidential.

In theory, if the regulator keeps firms’ sensitive information confidential, then they will not face the firm-level cost of disclosure described theoretically by Gal-or (1987) or empirically by Frank, et al. (2004). By 1960, investment advisers could not argue that their industry would be destroyed by mandatory disclosures to the SEC, especially if those disclosures remained confidential under Section 210. The impact of the legislation on the firm-level likely raised compliance costs, but that concern was not even large enough to be a focus of the industry

representative's testimony to Congress (United States House of Representatives Committee on Interstate and Foreign Commerce 1959).

*Market-wide Costs of Disclosure*

Mr. O'Hearn's testimony also reveals an early indication of the view that the markets will be damaged by disclosure regulation of investment advisers. Though investment advisers do not hold themselves out to the general public, "Our Clients represent substantial amounts of capital" (United States Senate Committee on Banking and Currency 1940). This statement represents the industry's suggestion that there is a consequence to disclosure regulation because its clients' economic footprint is so large. A real cost of disclosure regulation in the United States is the possibility of capital flight to other countries with more relaxed rules. Though Mr. O'Hearn does not discuss that possibility, his allusion to the power of his clientele plants the idea that its wealth could go elsewhere, damaging the well-being of the US economy.

Tangential to that cost of disclosure regulation is the manipulation of political dimensions by the investment advisers industry regarding its relative importance to the US economy. The industry begins by characterizing its size as relatively small, not involving the general public and representative of only a few high-end investors who are more than capable of making decisions without the aid of federal disclosure laws. Essentially, the industry claims it should not be regulated because it is small and self-regulating. But in the same vein, the industry also asserts the size of the capital it represents as a reason to avoid regulation. According to Mr. O'Hearn, disclosure regulation would impose real economic damage to the United States. So in this case I find two inconsistent arguments – on one side "do not regulate us because we are small and can take care of ourselves" and on the other "do not regulate us because we are powerful and could

cause real harm to the economy.” This incongruity appears first in 1940 and will appear again in the debates about hedge fund disclosure policy in 2004 and 2009.

*Benefit of Increased Investor Protection from Fraud and Unfair Practices*

As Congress revisited securities regulation in 1959, one of its primary goals was to empower the SEC to inspect the books and records of investment advisers in the same way that it monitored the activities of broker-dealers under the Securities Exchange Act (United States House of Representatives Committee on Interstate and Foreign Commerce 1959). In a written statement to Congress, the Commission describes a lack of information provided by the statute as contrary to its mission to protect investors: “Unless the Commission has sufficient information to bring its investigative powers into play, it has no authority to examine the books and records of investment advisers to determine whether they are engaging in fraudulent, deceptive, or other unlawful practices” (United State Senate Committee on Banking and Currency 1959). The rapid growth of the industry since 1940 put the SEC in a situation in which it had regulatory language with no real power behind it. As investment advisers became more pervasive and popular, the SEC naturally attempted to give them due attention. But the lack of teeth in the original statute left the SEC at a disadvantage and only able to assert itself after violations were committed: “It would seem to be a fundamental proposition that if a Government agency is to be expected to regulate the activities of a group of persons, it must have some effective means of discovering what their activities are” (United States House of Representatives Committee on Interstate and Foreign Commerce 1959). Updated language in the amendments to the IAA allowed the SEC to take a more proactive approach to enforcement of securities laws and protect investors.

*Social Benefit of Larger SEC Bureaucracy*

By the time the amendment reached the executive session of the Senate Subcommittee on Securities, there was no resistance to the amendment of language in the Act to match the language in the Securities Exchange Act (United States Senate Committee on Banking and Currency 1960). After a quarter-century of securities regulation, there arose a public expectation of a certain level of disclosure:

“An investment adviser who holds himself out to the public as an expert in investment analysis should be held to minimum standards of competence and performance. The public is entitled to good faith opinions based on his independent research, or to be informed that no such research has been performed...Registration as an investment adviser imposes a duty to disclose material facts affective the independence and quality of the advice given” (Knauss 1964).

The language in this academic paper shows the change in political dimensions of disclosure regulation. The use of terms such as “entitled” and “duty” demonstrate that the reach of the public interest extended to the activities of investment advisers. Lovitch (1975) discusses how the 1960 amendments gave the SEC the power to regulate investment advisers in the way that it wanted to but could not under the statute: “The SEC concluded [in its 1939 report] that the activities of investment advisers and advisory services ‘patently present various problems which usually accompany the handling of large liquid funds of the public.’” The SEC understood the place of investment advisers in the markets when the original legislation was passed in 1940, but it took almost 20 years for Congress to make changes in the legislation to allow SEC disclosure regulation of investment advisers.

Leuz and Wysocki (2008) discuss how regulators struggle to determine the optimal level of disclosure and whether markets produce too little or too much information. In this case, the written testimony of the SEC and its experience with broker-dealers under the Securities Exchange Act show how the need for a mandatory disclosure regime for investment advisers

became obvious and necessary for both regulators and Congress. The difficulty of projecting the potential effects of disclosure decreased for the SEC because it could look back upon its experience with broker-dealers to create an understanding of the effects of the new rule. SEC Commissioner Gadsby related this sentiment in his testimony: “It seems clearly anomalous to permit us to deny registration to a broker-dealer applicant based upon willful violations of the Securities Act and the Securities Exchange Act, and still to be without authority to deny an application for registration as an investment adviser simultaneously filed by the same person” (United States House of Representatives Committee on Interstate and Foreign Commerce 1960). Mandatory disclosure by capital markets participants became an acceptable form of regulation because of the success of the Securities Exchange Act in regulating broker-dealers. The effectiveness of the Securities Exchange Act made it an easy choice for policymakers to regulate investment advisers in the same manner, using almost exactly the same language in the amended Advisers Act. The expected benefit for the market and for investors, then, is considerable. There is very little discussion in any of the 1959 or 1960 hearings about the costs of increased disclosure, as regulators and Congress appeared certain of the positive effects of the legislation on the market.

#### **V. The 2004 SEC Final Rule**

In 2004, the Securities and Exchange Commissioners voted 3-2 to close the gaps for hedge funds in the Investment Advisers Act and mandate their registration with the SEC. Mandated registration under the Investment Advisers Act made hedge funds subject to Section 204 of the IAA, which compels advisers to disclose the same type of information that mutual funds and other advisers make available to the SEC.

The failure of the hedge fund Long-Term Capital Management (LTCM) in 1998 provided the impetus to the SEC to investigate further the systemic risk issues of hedge funds in the market. LTCM failed to anticipate properly the financial crises in Asia and Russia and in August 1998, lost nearly \$2 billion. In September, the New York Federal Reserve Bank intervened, and with the help of 13 major financial institutions, constructed a bailout of \$3.6 billion in cash and made those institutions owners of 90% of the fund's holdings. According to Mark Jickling's CRS Report for Congress (2004), LTCM's precarious position in the market was magnified by several key factors. First, LTCM was a debtor to many major world financial organizations and held up to \$100 billion in securities. Second, LTCM held large positions in derivatives that amplified the exposure of its creditors and counterparties to the fund's collapse. Despite concerns about the moral hazard inherent in rescuing failed funds, the New York Fed decided that the unknowns potentially associated with LTCM's collapse presented too great a systemic risk to leave the fund to fail.

The potential systemic risk issues associated with large funds prompted President Clinton's Working Group on Financial Markets to gather a report on hedge funds. The report's main finding was that excessive leverage caused by unregulated hedge fund activities exposed global financial markets to untenable systemic risk. The Working Group Report recommended that hedge funds increase their disclosure of confidential financial information to regulators, as well as more basic information to their investors. Legislation to increase hedge fund disclosure requirements in proceeding Congresses failed, however. In 2003, the SEC issued a report recommending that hedge fund managers register as investment advisers and become subject to Sec 204 of the IAA (Jickling 2004). Despite opposition from the industry, Alan Greenspan, and his own party, Republican SEC Chairman William Donaldson sided with the two Democratic

commissioners and voted in favor of bringing hedge funds under the SEC's purview in the Investment Advisers Act and mandate information disclosure (New York Times 2004).

The rule, implemented on February 1, 2006, lasted only a few months before it was struck down as unconstitutional by a federal judge. In the case *Goldstein v. Securities and Exchange Commission*, the court ruled that the SEC "lacks the authority to regulate hedge funds...the Commission exceeded its power by treating investors in a hedge fund as 'clients' of the fund manager" (Norris 2006). Goldstein's argument focused on the technicality that the language in the IAA was ambiguous and therefore did not grant the agency the power to make this ruling about hedge funds. The court stated that the rule was arbitrary and that the "Commission has, in short, not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter" (Seitzinger 2006). The new SEC Chairman, Christopher Cox, decided not to pursue an appeal of the decision. The proceeding section details the costs and benefits of disclosure regulation of hedge funds under the Investment Advisers Act with the 2004 Final Rule.

#### *Market-Wide Cost of Decreased Liquidity and Capital Formation*

One of the largest changes in the framework of costs and benefits of disclosure regulation of financial institutions is the concept of systemic benefit and risk. In prior frameworks, market-wide costs and benefits play an important role, but the examination of the worldwide exposure of a particular fund or institution and what its failure might mean for the market as a whole was not a policy concern. In the new normal, hedge funds provide the market with liquidity and capital formation that it would not normally obtain. Federal Reserve Chairman Alan Greenspan did not support the SEC's effort because he felt that hedge funds contribute to liquidity and flexibility in the international financial system (Colter 2004). According to Randal Quarles, former

Undersecretary for Domestic Finance in the Treasury Department, hedge funds' contributions to markets have changed rapidly and are very important: "What has been less discussed...are the benefits that these funds bring to our financial markets as their role is evolved over the years. First and foremost is liquidity" (United States Senate 2006). According to this narrative, the market relies on alternative investment vehicles and funds for daily liquidity.

Academic literature lends credence to the argument that hedge funds are providers of necessary liquidity to the market. Romano (2010) argues that hedge fund flexibility allowed funds to suspend investor withdrawals during the 2008 crisis, which actually helped staunch the crisis. Because hedge funds do not face high regulatory burdens with regard to their holdings, leverage, and exposure, they can purchase illiquid assets from failing financial institutions and help prevent crises from becoming worse. Brophy, Ouimet, and Sialm (2006) show empirically that hedge funds can provide equity capital to high-risk companies who would not otherwise have access to funds. Their research demonstrates how hedge funds can invest in firms with weaker fundamentals because they have few regulatory requirements and the ability to hold long-term positions, lowering the risk of the investment to the fund.

The potential effect of disclosure regulation on market liquidity and capital formation provided by hedge fund activities is unclear and hotly debated. The hedge fund industry and its supporters put forward the claim that hedge fund disclosure regulation will "mess with an industry whose risk-management services are vital to US financial markets...new regulation will lead to fewer ways of leveraging risk and higher cost of capital" (Wall Street Journal 2004). There is little to no empirical evidence proving or disproving how integral hedge fund activity is to liquidity or capital formation in financial markets as a whole. Hedge fund trading activity and total assets under management of the hedge fund industry are well-known figures. They are not

specific enough to answer the empirical question of how disclosure regulation would crimp hedge fund activity and damage overall market liquidity and capital formation. Further research is required in this area in order for policymakers to understand better the functional role of hedge funds in markets.

### *Costs of Compliance*

Though hedge funds engage in capital market activities much like tradition institutions, in many ways they resemble Silicon Valley start-ups who receive seed money and experiment with a business idea: a few succeed wildly, but most fail. According to the Congressional Research Service, the average life-span of a hedge fund is 3 years, with an attrition rate of almost 20 percent per year (Jickling 2004). The vast majority of hedge funds are small organizations with relatively small AUM and few clients. The entrepreneurial spirit of hedge funds makes the industry highly competitive and a fertile ground for financial innovation. A potential firm-level cost of disclosure regulation is the direct and indirect cost of hedge fund compliance with new SEC rules: “Most likely, a new registration requirement will hit small hedge funds that will find the rule burdensome and expensive...if the new rule prevents entrepreneurs from starting hedge funds, then its impact will be anti-competitive” (Wall Street Journal 2004). Chairman Donaldson testified before Congress that the Commission projected that a normal annual compliance cost for a small fund might to be around \$45,000. Though the sum appears paltry when juxtaposed with the usual AUM for even small funds, but the added barrier to entry is a potential deterrent to managers who wish to start their own small funds.

The industry’s concerns about cost for individual firms are the backbone to their belief that individual costs will damage financial innovation and entrepreneurship. If fewer managers choose to start hedge funds because of higher barriers to entry, the US may suffer, according to

Charles Gradante of The Hennessee Group LLC: “The integrity of the entrepreneurial spirit of the hedge fund industry should be protected, and we believe that this protection is essential the concept of an open marketplace” (United States Senate 2004). Damaging the entrepreneurial environment is seen as providing an open door for funds to go offshore or leave the United States altogether, as funds may choose to move to countries where they do not have to obey strict disclosure rules (Solomon, SEC Wants Hedge Funds in Open 2004). According to Aktins (2006), hedge fund compliance costs will ultimately be passed by funds to investors, thereby counteracting the SEC’s stated goal of investor protection.

The costs of compliance fall into direct and indirect categories. At the direct firm level, Chairman Donaldson did not believe that compliance costs would place a significant burden on funds. Empirically, it is unknown how many managers will shutter their funds because they cannot afford the compliance costs. Furthermore, it is unknown how many managers will be deterred from starting funds because of compliance costs. The small window in which funds were mandated to register in 2006 did not provide a large enough sample to determine how big of an effect those costs would have on firms.

In his testimony to the Senate in 2004, Chairman Donaldson detailed the SEC’s projected firm-level costs of compliance as a small regulatory burden for funds. The Commission estimated the average total cost for annual compliance to be around \$45,000. However, the Chairman went further than describing firm-level costs as minimal. He viewed the imposition of compliance requirements as integral to the creation of “a culture of compliance” that “should heighten their [hedge funds] sensitivity to their already-existing fiduciary obligation” (United States Senate 2004). A calculus of the total cost of compliance should include consideration of the spillover effects and positive externalities of compliance. While \$45,000 appears small for

even the smallest funds, many smaller funds do not have a compliance department or infrastructure in place already. In an economy of shrinking AUM, it is possible that some firms could not afford that extra cost. Also, the figure does not include potential indirect costs of the manager's time if he or she has to perform compliance tasks personally.

The damage to the entrepreneurial and innovatory financial environment through compliance costs is unclear. Hedge funds already choose to move offshore to take advantage of regulatory arbitrage. At this point, there is no empirical estimate of how many more would leave under that sort of compliance cost. If the data show that a negligible amount of firms leave the market and that managers are not deterred significantly by compliance costs, then that would not indicate the innovatory or entrepreneurial environment is damaged by regulation. Researchers could also look at data concerning the growth of offshore hedge funds to determine if there is a drain of resources and talent from the US to offshore funds. According to the Managed Funds Association, there are over 18,000 hedge funds and funds of funds worldwide, but the top 200 firms manage around 75 percent of the total AUM of the industry. The top 26 hedge funds control over \$530 billion in assets (Pensions & Investments 2010).

#### *Market-wide Cost of Decreased Price Transparency*

The hedge fund information edge is arguably its most important feature and a primary reason why funds are loathe to disclose their confidential information to regulators. They use a variety of methods and spend considerable expense to build an information advantage that they can exploit because they have few disclosure requirements. Hedge funds can purchase information from specialty information sources, such as Debtwire, mergermarket (both owned by the Financial Times), pharmawire, DerivativesWeek, and dealReporter. These firms charge expensive subscription services for access to information about more opaque investment tools.

Funds hire political consultants in Washington in order to understand how regulatory movement may affect different industries and firms (Kerr 2010). More conventionally, funds hire former Wall Street analysts with specialties following certain companies or industries to produce information for the fund's trading strategy. Hedge funds differentiate themselves by their ability to generate unique information on company fundamental data that will allow the fund to beat the market. Funds also hire companies that employ expert networks, such as Gerson Lehrman Group and Guidepoint Global, and tap those networks for industry- and firm-specific advice (Kerr 2010). Larger funds, such as SAC Capital, hire Wall Street veterans to facilitate information flows with corporate executives in informal settings (Goldstein 2010).

The information produced and used by hedge funds adds to transparency in the market by moving prices to their most efficient levels. Undersecretary Quarles also testified in 2006 about the price efficiency benefits of hedge fund activity (United States Senate 2006). If hedge fund managers are forced to disclose that information to regulators or to the public, their service loses value, according to Senator John Sununu: "The investment managers are selling their internal knowledge, their expertise, their investment capability. To the extent that they have to disclose daily, weekly, even monthly, what their positions are, that takes away from the value of the advice that they are providing. Also, it can be counterproductive" (United States Senate 2003). Senator Sununu's statement harkens back to similar testimony in 1940 by representatives of the investment advisers industry. The value of hedge funds inherently exists in their ability to gather and act on private information. If that information is open to the public via disclosures to the SEC, it is possible that hedge fund managers will have less incentive to purchase and produce sensitive information that adds transparency and price efficiency to the market.

Gal-Or (1987) is the theoretical refrain that details the negative effects to a first mover with private information in a market. Theoretically, hedge fund managers and research services could stop producing altogether if all of their information was disclosed to the public, thereby degrading its value. Fortunately, there are a few empirical studies that examine the types of disclosures made by hedge funds during their brief registration period in 2006. However, the results of those studies are mixed. Brown, et al. (2007) observes that disclosure is not material for the typical well-informed capital market participant because they may choose not to act on it: “Disclosures do indeed contain information that can be used to measure operational risk. Legal, regulatory, and other problems are highly associated with measures of conflict of interest reported on these forms.” The authors suggest that a cost-benefit analysis of regulatory disclosure should consider the endogenous production of information in the hedge fund industry and the subsequent marginal benefit for individual investors of obtaining that information via mandatory disclosure policies (Brown, et al. 2007).

Aragon, Hertz and Shi (2010) examine data from quarterly hedge fund filings between 1999 and 2006 and scrutinize the type of information that managers kept confidential. The authors find that confidential positions earn positive and significant abnormal stock returns. According to their data, managers avoid disclosure of holdings to reduce the cost of free-riding by other funds on their research, not to strategically hide past losses. A potential cost of mandatory disclosure is the reduced incentive of a manager to acquire security information, which reduces the amount of information in security prices and decreases transparency. However, how much information is disclosed, when it is disclosed, and what information in particular will be most relevant is extremely difficult to identify. The SEC wants data immediately in the case of crisis, and it wants to be able to examine more than just the holdings of the funds every quarter.

The systemic risk profile of big funds includes leverage, counterparty credit risk, and exposure to other regulated entities. Given the quickness in which the last crisis occurred, the SEC seeks little compromise on the issue of when disclosures should be made.

*Cost of Larger SEC Bureaucracy and Regulatory Regime*

The purpose and function of the SEC in securities markets once again plays a powerful role in understanding the costs and benefits of SEC disclosure regulation. In 2004, that role was magnified because the new rules were not mandated by legislation. The SEC Commissioners controversially voted to extend their powers to the hedge fund sphere. That extension of power sparked another debate about how the SEC should best use its resources and function in securities markets. The SEC's rules are viewed as misguided and costly to investors because they will not even give the SEC the data it needs to manage systemic risk and simultaneously pass along the costs of compliance to investors, reducing choice and competition (Aktins 2006). According to Mann (2008), the SEC's "diminutive funding level" indicated that the agency was not capable of monitoring funds that had registered voluntarily, let alone those who had not.

Critics of the rules also charged that the new rules would actually prove very costly to the unsophisticated investor that the SEC wanted to protect. The average small investor actually would be hurt by the SEC's attempt to regulate hedge funds:

"The reason investors, including pension funds, have turned to hedge funds is because the returns in traditional asset classes have been so poor. It would be a blow if, just as they began to pour their money into hedge funds, the SEC were to cut the returns they could achieve. Ultimately, if the SEC has the interests of investors at heart, it should not vote for increased regulation" (Wright 2004).

Because investors have been struggling with traditional investments, regulators should allow them to take the risks of investing in hedge funds because they might be better off. Not giving investors that option might restrict investors and limit their potential future returns. Furthermore,

the new rules were panned widely by both liberal and conservative sources as unnecessary and overreaching, and again unhelpful to unprotected, unsophisticated investors: “Unfortunately, the Commission’s proposed new rule for hedge funds would impose a needless regulatory burden while doing little to protect vulnerable investors...the agency would better serve investors and deploy its own limited resources with a more focused set of reforms” (New York Times 2004). Alan Greenspan again panned the rules as unhelpful as deterrents to fraud and market manipulation (Wall Street Journal 2004). The social cost of the regulation therefore extends as well to mom-and-pop investors who will see diminished returns because of restrictions on hedge funds.

A crucial aspect of the social cost of SEC regulation is the apparent redundancy of regulation of an industry that maintains self-discipline and attends only the most sophisticated clients. As in previous regulatory episodes, the dynamic of the SEC targeting the wealthy with disclosure regulation appears as an undercurrent in the debate about costs of the regulation. To the industry, the SEC is wasting its time because the industry can take care of itself: ““This is an industry that has high accreditation standards, sophisticated strategies, and sophisticated investors,” said James Hedges, who runs hedge fund advisory firm LJH Global Investments in Naples, FL... ‘It’s a waste of time and money’” (Schmidt and Burton 2004). The Chairman of the Managed Funds Association, the largest trade association for alternative investment funds, echoed that sentiment in his testimony before the Senate in 2004: “We believe the current reporting obligations already in place provide significant sources of information about hedge funds and their trading activities to a wide range of regulators” (United States Senate 2004). The SEC is portrayed as an overwhelmed, overworked agency that is simply in over its head. Hedge fund activity is an affair of the ultra-wealthy who are intelligent enough to make decisions

without a regulator's assistance: "Critics of the hedge fund plan say the SEC already has too much to do without worrying about the affairs of rich people who ought to be able to look after themselves. They say hedge fund registration alone will not provide the SEC with the data it seeks" (Michaels 2004). Because the SEC cannot possibly regulate the sophisticated hedge fund industry, it should not even attempt to regulate hedge fund managers.

The magnitude of each aspect of societal cost becomes dependent on how much society values regulation. If the SEC has a limited budget that Congress refuses to expand, then mandatory disclosure regulation of hedge funds will spread thin the resources of the SEC. It is possible that it will be even less effective at protecting unsophisticated investors and that a greater level of securities fraud will occur, which would present a cost to society that includes litigation and decreased investor confidence in markets.

If SEC disclosure regulation is redundant for the hedge fund industry and restrictive to wealthy investors, then regulation will stifle innovation, slow investment, and encourage investors to look elsewhere to invest their funds. Brown, et al. (2007), however, provide an interesting point about the capabilities of "sophisticated" investors in understanding risk they take on when investing in hedge funds. According to Brown, much of the information disclosed probably is known by sophisticated investors already, even if the SEC lags behind. But even if well-informed capital market participants receive the appropriate level of information, via mandatory disclosure or through normal market operations, that information is moot if investors choose not to act on it anyway. An evaluation of the social cost of mandatory disclosure should include variations based on how much of that information actually is used by investors.

*Benefit of Decreased Systemic Risk to the Economy*

By 2004, Chairman Donaldson believed that the hedge fund industry was too big and too powerful to exist in the dark (Solomon, SEC Wants Hedge Funds in Open 2004). Though the collapse of LCTM in 1998 provided the catalyst for federal interest in hedge funds, Chairman Donaldson viewed the body of research on hedge funds too great to ignore. His primary argument focused on the systemic risk that hedge funds posed to the greater economy: “SEC needs to know more about hedge funds to prevent large-scale problems that could affect all investors...SEC needs more information about hedge funds to understand ‘what impact their market activities have on the other participants in our equity markets’” (Solomon, SEC Wants Hedge Funds in Open 2004). In his testimony before the Senate in 2004, the Chairman used even stronger language to describe why the SEC must regulate hedge funds:

“I am convinced it would be irresponsible for the Commission not to consider appropriate regulatory oversight of the hedge fund industry...The SEC currently oversees and regulates mutual funds, broker-dealers, and many other investment advisers. The ability to oversee the increasing number of hedge fund advisers more effectively through the registration process would give the Agency a much needed and more complete picture of who the key players in our securities markets are” (United States Senate 2004).

Chairman Donaldson’s statement to the Senate reflects his position on the role of the SEC in regulating securities markets. He references SEC regulation of each of the other major players in securities markets as the precedent for SEC regulation of hedge funds. But the key phrases are “complete picture” and “key players.” In the eyes of the Chairman, the purview of securities regulation and the SEC has extended itself to maintaining a systemic risk profile of the most influential players in the markets. His testimony suggests that the Commission cannot ignore some of the biggest players in equity and debt markets, even if many hedge funds are small and do not pose a systemic threat. The societal benefit of monitoring those funds will be far greater than the cost of a catastrophic collapse, like LCTM, that spirals too far out of control.

The testimony of Dr. Adam Lerrick of the American Enterprise Institute reinforced Chairman Donaldson's opinion about the risk/reward impact of mandatory disclosure. The SEC's traditional role is reshaped with the changing demands of the market:

"The last group is basically those that must be concerned about systemic risk, the policymakers, the official sector. And there, I think there is a hole in the information process. And I think the danger there is that there is an ignorance of some of the risks that are in the international financial system. In that, there is a role for the official sector to require aggregation of the types of information about leverage, about borrowing, about concentrations, so that policymakers can themselves identify potential sources of risk...Remember, market crises come from surprises" (United States Senate Committee on Banking, Housing, and Urban Affairs 2006).

The SEC's function of protecting investors has transformed to monitoring the risks of the international financial system. To Dr. Lerrick and Chairman Donaldson, monitoring systemic risk *is* protecting investors. Therefore, the SEC's transformation is natural, and the historical progression of aggregating and monitoring more and more complex financial data from market players is the logical and beneficial growth of the Commission. The benefit of monitoring systemic risk is exactly as Dr. Lerrick described it: to prevent surprises. Estimating the magnitude of the value of a complete systemic risk profile is complicated, but if the SEC and the public have greater confidence in market players and institutions during crashes, then it is possible that confidence might limit the severity of sell-offs during crises.

*Benefit of Increased Ability of SEC to Deter Fraud and Insider Trading by Hedge Funds*

The SEC's increased ability to monitor, deter, and prosecute fraudulent and illegal activities of hedge funds is a second key benefit to mandatory disclosure rules. The meteoric rise and spectacular success of hedge funds made them a chic choice for many investors, but Chairman Donaldson believed that the current regulatory structure could not protect those investors adequately:

“I think there is a need for more information. The market will demand it. In other words, as we have gone through a bad stock market and you put your money in a hedge fund and after a couple of years, you have lost a lot of money, you are going to be demanding that you have more information as to how that money was lost and what you are doing now than has been true in the past. In a bull market, people do not really care what you are doing, so long as you are making money for them” (United States Senate 2003).

The Chairman’s foresight underscores his fundamental belief about how the SEC should regulate institutions in securities markets. Representatives of the SEC in 1934, 1940, and 1959 argued that the Commission must have the power to be proactive in its regulatory scope in order to be effective. The institution cannot deter fraud if it has no means of deterrence. Investigating and prosecuting crimes after the fact allows some justice to be served, but it does not protect investors from further damage if no rules are in place.

Chairman Donaldson acknowledged that the SEC lags far behind in its duties to protect investors. The SEC needs better information both to deter efficiently bad behavior through more focused and significant examinations and to enforce the rules adequately when firms are under investigation and eventually prosecution. The upfront cost of imposing a regulatory burden appears much higher than the benefit because no one has incurred the benefit yet and the costs generally are concentrated on a specific industry that can formulate a powerful response. The benefit exists in the future costs avoided of fraud on individuals and investor confidence. The Chairman’s cautionary testimony reveals just how difficult a task the SEC faces in regulating securities markets. In good times, players and investors have incentives to ignore warning signs because they benefit from bull market conditions. To conduct regular regulatory processes is extraordinarily difficult because on the surface there appears to be little reason for it. In down times, a regulatory burden is portrayed as stifling innovation and threatening the growth of a feeble economy.

## **VI. The Dodd-Frank Act Title IV**

Proposals for financial regulatory reform in the wake of the financial crisis culminated in July 2010 with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. One of the greatest areas of concern for Congress, regulators, and the Obama Administration was the systemic threat to the economy that large financial institutions pose. The collapse of LTCM in 1998 is evidence that certain hedge funds could present systemic risk to the economy if they fail (Jickling 2010). There is also evidence to suggest that some of the largest hedge funds could fall into the category of systemically important, or “too big to fail.” Because hedge funds remained exempt from reporting requirements under the Investment Advisers Act, a primary focus during the debate over financial regulatory reform was the elimination of exemptions for hedge funds to bring them under the purview of the SEC (Ruane and Seitzinger 2010).

The Dodd-Frank bill closes several of the common legal loopholes exploited by hedge funds in order to bring their activity under the mandate of the SEC. This portion of the bill is called the Private Fund Investment Advisers Registration Act of 2010. The legislation defines “private funds” as those funds who use exemptions 3(c)(1) and 3(c)(7) of the Investment Company Act and have assets over \$150 million. It requires their registration with the SEC under the Investment Advisers Act. Registered advisers must maintain records and file reports with the SEC. These reports must contain the following data:

“[The] amount of assets under management and use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements, trading practices, and other information deemed necessary by the SEC in consultation with the FSOC for the public interest and/or the assessment of systemic risk” (Ruane and Seitzinger 2010).

In addition to these reports, the SEC holds the power to conduct periodic examinations of the funds’ records and implement these examinations outside of the scheduled date if necessary.

When the bill was passed, any proprietary information gathered by the SEC and examined by the FSOC or any other government agency would be exempt from the Freedom of Information Act (FOIA) in order to protect confidential holdings and strategies. The SEC would not be able to prevent Congress or a United States court from requesting such information in a subpoena (Ruane and Seitzinger 2010). The SEC has used the broad language of Dodd-Frank to propose two different rules for hedge fund reporting.

In November 2010, the SEC issued its first rule proposal for hedge fund regulation under the Dodd-Frank Act. The proposal echoed the language in Title IV, requiring funds with AUM over \$150 million to register and submit an annual report via Form ADV to the SEC. These reports will contain identifying information about the firm, form of organization, business activities, financial industry affiliations, ownership of the fund, and any disciplinary information of the managers. Funds must disclose a categorical breakdown of their investment strategies, classes of assets and liabilities, the number and type of investors in the fund, and information about service providers such as prime-brokers (Securities and Exchange Commission 2010). Funds under \$150 million must fill out similar registration forms, but in less detail, and are subject to SEC inspection. The SEC issued a 45 day comment period on the rules and is currently reviewing feedback before it takes a final vote and implements the new rules (Ahmed 2010). The information filed annually with the SEC on Form ADV will be available to investors and potential investors. According to the SEC (2010), this information is similar to, but less extensive than, the due diligence performed by investors before they move money into a fund. On April 8, 2011, the SEC revealed that the date of required registration for funds likely will be moved to the first quarter of 2012, granting the funds an extension from the current deadline, July 21, 2011 (FINalternatives 2011).

On January 25, 2011, the SEC proposed a rule to require that private fund advisers to disclose information to the SEC and the Financial Stability Oversight Council in order to monitor systemic risk in the US financial system (Securities and Exchange Commission 2011). The Commission's proposal creates a new reporting form, Form PF, that would require advisers with total AUM greater than \$1 billion to report on a quarterly basis to the FSOC and the SEC the following information:

“Large hedge fund advisers would report on an aggregated basis information regarding exposures by asset class, geographical concentration and turnover. In addition, for each managed hedge fund having a net asset value of at least \$500 million, these advisers would report certain information relating to that fund's investments, leverage, risk profile and liquidity” (SEC 2011).

The rule discriminates between large private fund advisers and small private fund advisers. Large advisers hold a total of \$1 billion combined AUM, while small advisers lie below that level.

According to the SEC, this requirement applies to about 200 large fund advisers, but that these advisers manage more than 80 percent of AUM in the hedge fund industry. Furthermore, information disclosed on Form PF would remain confidential. The comment period for the rules was 60 days, and the SEC currently is reviewing that input before taking a final vote on the rule. (Securities and Exchange Commission 2011). This rulemaking by the SEC represents the most substantial regulatory effort yet to gather the requisite information for the SEC and FSOC to understand the systemic risk of hedge funds in the economy. The following section will examine the costs and benefits of hedge fund disclosure in the wake of the financial crisis and use the historical framework of disclosure cost-benefit to discuss potential effects of the new rules.

#### *Market-wide Costs of Decreased Liquidity and Capital Formation*

Though the role of hedge funds in the financial crisis was debated hotly, preliminary research suggests that they were not the primary cause of the crisis (see Romano 2010, Brown,

Green and Hand 2010, Krug 2009). As the industry and its supporters discussed in 2004, hedge funds play an important role in 21<sup>st</sup> century financial markets, providing an important liquidity and capital formation function, according to Congressman Ed Royce (R-CA): “They are an important source of capital formation and liquidity to the broader financial system” (United States House of Representatives Committee on Financial Services 2009). SEC Commissioner Casey echoed the Congressman’s sentiments before the Senate: “I believe that these are still areas where sophisticated investors can protect themselves adequately. I think that if Congress or the SEC were to regulate the structure of or redemption rights associated with a private placement, we risk stifling innovation and capital formation” (United States Senate Committee on Banking, Housing, and Urban Affairs 2009). Commissioner Casey and Congressman Royce hold the position advocated by former Fed Chairman Alan Greenspan that growth and innovation in capital markets is highly important and should not be overregulated, even after the crisis.

The potential effect of the regulation hinges on whether the sensitive data gathered by the SEC will remain confidential. Romano (2010) and Krug (2009) detail the market-wide benefits of hedge fund activity especially during the crisis. Conversely, regulators had a difficult time gauging the costs and benefits of saving various financial institutions because they did not understand all of the exposure and connections between regulated financial institutions and hedge funds. That hidden systemic cost may counteract the ability for hedge funds to soak up distressed assets, but there is no empirical way to determine that balance. Also, there is no research to predict how much liquidity or capital formation will be limited by disclosure rules. If high compliance costs and a lack of information confidentiality push hedge funds from the market, then the market could see a considerable tightening of liquidity and a slowing of capital

formation. But the structure of the hedge fund industry suggests that the 200 largest firms, which account for over 80 percent of the industry's AUM, are large enough to continue their capital formation and liquidity function normally under Dodd-Frank.

*Cost of SEC Bureaucracy and Regulatory Regime*

In hearings in 2009, less than a year after the collapse of Lehman Brothers and Bear Stearns, the ability of the SEC to oversee the hedge fund industry was a strong point of contention in regulatory debates. At this point, the Commission's arguments for information disclosure made in 1934, 1940, 1960, and 2004 were validated by the 2008 crisis, but the unprecedented disclosure desired by the SEC presents an unprecedented cost to develop and maintain a large regulatory infrastructure to govern hedge funds. In a hearing before the Senate Committee on Banking, Housing, and Urban Affairs in 2009, Senator Jim Bunning detailed the arguments against an expansion of SEC power on the grounds that the SEC could not possibly keep up with hedge funds:

“I am skeptical of the idea of a Government regulator being smart enough to recognize concentration of risk and act to reduce it... Who in the Federal Government knows the markets well enough to effectively regulate and understand what hedge funds and other firms are doing and the risks they might be creating?... My problem is, I don't know if we can afford to find the brains that we need to hire to get a hold of this problem, if you see it as a major problem. I know that you just said \$1.2 trillion, 20 percent of the daily activity on the New York Stock Exchange. That is pretty substantial when you are talking about these types of entities. So if I were an investment adviser or somebody who was a hedge fund manager, I sure wouldn't want to work for the SEC. I would want to do my own thing, and where are you going to find somebody with that kind of expertise?”  
(United States Senate Committee on Banking, Housing, and Urban Affairs 2009).

Though the Senator's language is blunt, his point is well-taken: the SEC was overwhelmed by the last crisis, notwithstanding other scandals, such as Bernie Madoff's Ponzi scheme.

Comprehensive SEC regulation of hedge funds would require a substantial increase in the size of the SEC, as well as an increase in its latitude to investigate and prosecute hedge fund advisers. In

his FY2012 budget, the President proposed a \$300 million increase to the SEC's budget from FY2010 to \$1.4 billion, which would include the hiring of 780 new staff members (Holzer and Trindle 2011). Besides the issues of funding, the SEC likely would need to persuade some industry members to work for the SEC and the FSOC to provide the advice and context required to analyze data culled from hedge fund disclosures. However, the SEC's budget is controlled presently by a Republican House that seeks to cut the agency's funding back to 2008 levels (Holzer 2011). The likely public cost of the SEC's expansion will depend on the compromise reached between Democrats and Republicans in Congress.

Even if the SEC secured the budget the President requested, it will be a difficult task to ramp up the infrastructure and intelligence of the organization to handle the hedge fund industry appropriately. The SEC stated in its proposed rules that information from Form ADV will allow it to better understand the connections and practices of the hedge fund industry. This data should give the SEC an edge in monitoring against fraud and illegal business practices. According to the SEC's rule proposal for changes to Form ADV (2010), data gathered from Form ADV should allow the SEC to efficiently allocate examination resources, better prepare for examinations of funds, and focus actively on funds that have been identified as potential compliance risks. If the SEC has the appropriate data to monitor the legal activities of hedge funds, it can take proactive action against funds it suspects to be in violation of securities laws. Consequently, the SEC should have increased ability to prosecute cases of insider trading, illegal short sales, late trading and market timing cases, and conflicts of interests (Rashkover and Kleiman 2007). The proposed rules give the SEC the power to inspect the books and records of funds at any time (Securities and Exchange Commission 2011). Information gathered from Form PF should allow the SEC and the FSOC to monitor systemic risk in the economy of the largest hedge funds. If the SEC

and the FSOC are abreast of the activities of a shaky fund, these regulators are prepared to organize action to save the fund or wind it down in an orderly fashion.

#### *Market-wide Cost of Decreased Price Transparency*

The theoretical and empirical literature concerning information disclosure suggests that if private hedge fund information is disclosed to the public, hedge funds will have less incentive to produce that information. A decrease in securities information leads to greater opaqueness of prices and an overall decrease in market transparency. Proprietary information on Form PF should remain confidential, according to the SEC. Many hedge funds, though, are loathe to register with the SEC and submit Form ADV. They will try to resist divulging any information to the Commission (Wall Street Journal 2011).

A review of the SEC's work with broker-dealers under the Securities Exchange Act and investment advisers under the Investment Advisers Act indicates that the SEC will keep hedge fund information confidential. Undoubtedly, hedge funds face an increased risk of information divulgence via SEC or Congressional inquiry. There will be a cost to them of increased compliance and diligence, as well as the risk of disclosure during public investigation. But the historical examples suggest that hedge funds should continue to operate in their normal function. Hedge fund managers likely will not be dissuaded from uncovering sensitive price information or purchasing it from third-party researchers. In five years, empirical studies concerning information aggregation in hedge funds and changes in prices may be able to give a glimpse into the effect of mandatory confidential disclosure on price transparency.

#### *Cost of Compliance*

The proposed rules will affect hedge funds differently depending on their AUM. Though smaller firms (AUM less than \$150 million) do not have to disclose information to the SEC, they

still must hire compliance officers in case of audit by the SEC (Strasburg 2010). The financial cost and opportunity cost of time for these funds to implement compliance structures creates a higher barrier to entry for the industry. Some fund managers may be deterred from starting their own funds because the cost of compliance is too high. In the SEC's rulemaking proposal, it estimates that the average total collection of information burden for an adviser in the first year of completion of Form ADV to be 40.74 hours. For advisers that are already registered, that figure represents an increase of 4.5 hours annually on average. The Commission projects an annual amortized burden of 23.77 hours for the completion of updated Form ADV (Securities and Exchange Commission 2010). Though those numbers appear small, as the regulatory debate from 2004 indicated, those barriers to entry may be anti-competitive and affect hedge fund activity and entry into the market.

However, there is little empirical evidence to indicate that the hedge fund market will see a drastic decrease in firms entering the market. Fund managers will pass the higher cost of compliance to their clients. Though this transaction results in an overall higher cost for investment, Congress already decided in Dodd-Frank that investors' threshold for investment in hedge funds was too low. Dodd-Frank altered the formula for the minimum net worth requirement for accredited investors, and the SEC recently proposed a rule that would exclude the value of the person's primary residence (Securities and Exchange Commission 2010). The policy concerns of crowding out of investors due to increased compliance costs should not weigh heavily in the cost-benefit framework.

#### *Benefit of Decreased Systemic Risk*

As stated by the Obama Administration, the understanding of which financial institutions hold systemic risk in the US financial system is a key goal of financial regulatory reform. The

worldwide effect of the 2008 financial crisis shows that the failure of individual institutions could trigger a collapse of the world financial system. Before Dodd-Frank, regulators held inadequate means to determine the systemic risk profile of hedge funds in the economy, according to Senator Jack Reed: “No regulator is currently able to collect information on the size and nature of hedge fund or other funds to identify an act on systemic risk that may be created by these pools of capital” (United States Senate Committee on Banking, Housing, and Urban Affairs 2009). The failure of SEC rulemaking in 2006 with *Goldstein* decision indicates that unless the SEC receives greater statutory power under Dodd-Frank, it will not be able to monitor systemic risk appropriately.

The industry’s testimony to Congress does not place hedge funds in the category of systemically important. Despite testimony in both the 2004 and 2009 episodes that hedge fund activities are integral to well-functioning capital markets, the industry repeatedly denied that its activities were substantial enough to merit significant regulation. When Richard H. Baker, President and CEO of the Managed Funds Association, testified before the House in 2009, he espoused the benefits of hedge funds but downplayed their position in the market:

“We have not sought a dollar of taxpayer money, nor to my knowledge have any hedge funds been a significant concern in the current market environment as a contributor to potential systemic risk. That is in part the result of our relative size to the broader financial universe, with an estimated \$1.5 trillion-and that number varies depending on market conditions-our industry is significantly smaller than the \$9.4 trillion mutual fund industry or the \$13.8 trillion US banking system” (United States House of Representatives Committee on Financial Services 2009).

Mr. Baker’s comparison of the hedge fund industry to the mutual fund industry or the banking is denominated in dollar amounts – assets under management. However, regulators are well aware that hedge fund trading activities account for 20 percent of the daily activity on the NYSE (United States House of Representatives 2009). Despite the industry’s claims that its financial

footprint is small, its daily activities, leverage, exposure, and counterparty risk are expansive and completely dark. As the case of LCTM showed, the physical cash of the fund is not necessarily indicative of its systemic risk profile.

Brown, Green and Hand (2010) provide empirical evidence to dispute regulators' claims that hedge funds are systemically important. In order to determine the systemic importance of hedge funds, they investigate hedge fund activity and returns during the recent financial crisis. They claim that if hedge funds played an important role in the crisis, then they must be systemically important. Their results show that hedge funds were not the initiators of the financial crisis. The authors identify certain hedge fund trading strategies that may have contributed to systemic risk during the crisis, but find that hedge funds did not contribute to systemic risk during the crisis. They also identify potential issues with disclosure regulation for hedge funds. The authors contend that high levels of disclosure at other types of financial institutions did not limit the financial crisis and that approach may not be successful with hedge funds as well. They also argue that in-depth disclosures from funds may not provide the correct type of information about the systemic risk of funds, if those funds exist.

Van Eechoud, et al. (2010) provides a counter to Brown, Green, and Hand's argument that hedge funds are not systemically important. Van Eechoud et al. acknowledge that hedge funds did not cause the financial crisis. This point has been reinforced by regulators, and empirical studies are clear that hedge funds were not responsible for the last crisis. Van Eechoud's argument is as follows: acknowledging that hedge funds were not principals in the last financial crisis does not imply that some hedge funds do not pose a systemic risk threat to the economy. Large hedge fund collapses have already provided that threat in 1998 with LTCM. Though tougher regulation of hedge funds may appear to be a side-effect of regulatory fervor

after the crisis, there is a growing consensus among policymakers and regulators worldwide that *all* financial institutions must face stricter disclosure regulation because of the interconnectedness of the world economy. Policy initiatives such as Dodd-Frank Title IV are proactive measures to minimize the risk of future hedge fund collapses. Even if a hedge fund collapse did not cause the latest crisis, regulators want to ensure that future hedge fund failures will not jeopardize the vitality of the global financial system.

*Benefit of Increased Ability to Deter Fraud and Protect Investors*

Though insider trading and fraud were not the focus of the regulatory debate about Dodd-Frank disclosure rules, recent investigations by the SEC into hedge fund fraud indicate that mandatory disclosure could help the SEC deter fraud and insider trading. In the release of its proposed rules for hedge fund registration, the SEC cited information gathered from Form ADV as integral to the SEC's continued effort to protect investors. As opposed to systemic risk information, the SEC desires basic information about the business practices, conflicts of interest, regulatory compliance, and legal setup of fund activity (Securities and Exchange Commission 2010). Brown, et al. (2007) support the SEC's claim that disclosures from Form ADV should allow investors and the SEC to monitor exposure of investors to legal and regulatory issues related to the funds in which they invest. This information should provide a more level playing field to investors as they perform due diligence on prospective funds. Increased SEC scrutiny of funds via disclosures on Form ADV should deter funds from engaging in illegal activities.

In comparison to previous disclosure debates, protection of individual investors was not the most prominent argument by supporters of regulation. However, the overriding theme of the regulatory debate in 2009 and 2010 was an attack on Wall Street for nearly ruining the US economy completely: "Representative Kanjorski: Our job today is to swing the regulatory

pendulum back toward the interests of hardworking Americans...Billionaires on Wall Street have had their day” (United States House of Representatives 2009). Again, the definition of the “public interest” is invoked as a reason for disclosure regulation. Any institutions affiliated with Wall Street and its wealth provided targets for Congress during hearings:

“Representative Capuano. “Again, if some billionaire wants to risk \$100 million and lose it, that doesn’t jeopardize my life, it doesn’t jeopardize my mother’s pension, but it does when those players expand exponentially and start getting money out of pension funds. When they start getting money out of public funds, that is when I believe we have a societal interest in what is going on, and that is really what this is all about today” (United States House of Representatives Committee on Financial Services 2009).

The fact that some hedge funds invest (and lost) with “the people’s” money during the financial crisis creates a source of consternation for the Congressman. Even though some institutional investors require hedge funds to register with the SEC before they receive funds, the implication is that mom-and-pop investors are under attack by Wall Street funds and require protection.

However, the Galleon Group case has provided the starkest evidence that the SEC needs more information about the activities of hedge funds. The SEC accuses Raj Rajaratnam, the co-founder of the Galleon Group hedge fund, of 14 counts of securities fraud and conspiracy related to a complex network of insider trading that resulted in \$45 million of profit for his firm. The amount of fraud alleged by the SEC is so extensive that almost 2 dozen former traders, executives, and lawyers have already pled guilty. On March 1, the SEC accused Rajat Gupta, the former managing director of McKinsey and Company, of providing insider information to the Galleon Group (Winter, Glovin, and Daniel 2011). Regardless of the outcome of this case, the cost to the SEC and DOJ of investigating this fraud is enormous. Rajaratnam alone has accrued \$20 million in legal fees to this point. If hedge funds disclose their sensitive information to the SEC, the Commission will have a better chance at catching fraud in its early stages or deterring it altogether.

## VII. Conclusion

The mandatory disclosure debate from 1934 to the present yields specific areas of costs and benefits that merit observation over the next five years after the final implementation of SEC rulemaking derived from Dodd-Frank Title IV. Congress, regulators, academia, and the industry should monitor these potential categories of costs and benefits: firm level cost of compliance with regulation; market-wide cost of decreased hedge fund activity, capital formation, and liquidity provided by funds; market-wide cost of decreased hedge fund incentive to uncover price information and add transparency to markets; the societal cost or benefit of funding larger SEC bureaucracy and regulatory regime; decreased risk of system-wide shock and crash; and the increased ability of the SEC to monitor and deter fraud and insider trading by hedge funds. These categories are identified as costs and benefits because the history of disclosure regulation suggests that costs and benefits will accrue in these categories. However, it is entirely possible that a category of benefits or costs may become the opposite in the face of empirical evidence. These elements provide a framework for research into the efficacy of mandatory disclosure regulation for hedge funds as a result of Dodd-Frank.

The history of SEC mandatory disclosure regulation demonstrates a fascinating insight into the changes in both perception and reality of Wall Street activity over the past 87 years. The CBA framework tracks changes in those attitudes over time. The most important change is the gradual (if not inevitable) expansion of the jurisdiction of the Securities and Exchange Commission. The systemic risk oversight mandate handed down to the Commission by Dodd-Frank is an evolutionary leap from the nascent Commissioners justifying the SEC's existence with the Interstate Commerce Clause. Despite the SEC's almost constant barrage from the industry in question and its supporters, the agency has taken on more and more responsibility as

financial markets have become more and more complex. Investor protection is still the primary goal of securities regulation, and regulators from 1934 to 2011 have requested wide discretion in their purview under securities legislation. The SEC repeatedly demonstrated an understanding of how incentives to produce securities information could be affected by mandatory disclosure policies. In general, history has proven those policies successful. Regulating an industry that is innovating constantly requires a wide berth. Investor protection now includes managing the systemic risk of the biggest players in the US economy in an attempt to prevent another financial crisis.

The cost-benefit dynamic of investor protection versus industry self-regulation and confidentiality highlights an ongoing tension between the SEC, representing the everyman investor, and the investment management industry, whether it is investment advisers or hedge fund managers. The battle of “rich vs. poor” is played out throughout the various debates, as the industry paints itself as one more than capable of self-regulation that just wants to be left alone. The SEC is labeled as incapable of even regulating private funds and as abusive of its mission to protect investors to expand its own power. For the purposes of the cost-benefit framework, it appears that costs and benefits are weighted differently depending on the contemporary political dimensions of the debate. The costs of disclosure regulation are concentrated in a specific industry with the tools to vehemently oppose regulation. The benefits are dispersed wide to every American investor. There is no trade association that represents damaged investors before Congress – that duty falls to the SEC. The pervasive political nature of the debate necessitates empirical studies to search for objective criteria by which policymakers can measure costs and benefits of regulation.

The constant “rich vs. poor” debate stands in great contrast to the evolution of private funds. In 1940, private investment funds were accessible only by the wealthiest clients and were built on a foundation of personal relationships and accountability to produce returns. Though those similar attributes are espoused by hedge funds today, private funds are now integral pieces of the US financial system. The ability of fund managers to gather private capital and invest long-term in illiquid assets is an aid to the economy. That change also makes hedge funds so important that the SEC must have an idea about what these funds do. Though the wealth of their clientele is still great, the type and scope of hedge fund activity in the market push the issue beyond the realm of personal relationships to the crucial area of systemic risk.

Mandatory disclosure regulation also faces a challenge because it lags behind the events that spark its creation. Crises are generally the impetus for the SEC to push for more regulation of private funds, as the political support for regulation has been strong enough only during these times. Chairman Donaldson’s vote to regulate hedge funds in 2004 was blasted because the 1998 LTCM was far removed from the public’s imagination. In general, innovation and freedom are given the benefit of the doubt versus any sort of preemptive regulation. Though hedge funds argue that they are targeted unfairly by Congress and regulators, increased regulatory attention towards all financial institutions and their systemic risk was needed sorely before the crisis. It is possible that SEC rulemaking from Dodd-Frank Title IV can prevent a hedge fund from being the catalyst of the next crisis.

A consideration of effects of disclosure regulation through time suggests that firm-level costs of compliance with disclosure policy will not destroy an industry or its entrepreneurial spirit. Broker-dealers and investment advisers argued that their industries would suffer precipitously if they disclosed their private information to regulators. History suggests that they

were incorrect, as securities markets and the primary players in them have only grown in influence since the passage of the Securities Exchange Act and the Investment Advisers Act. Similarly, I do not expect the hedge fund industry to fade away because of disclosure regulation from Dodd-Frank. On the margin, a few small firms will suffer because of increased costs of compliance. But the largest firms will incorporate those costs into their cost of business and pass it along to investors.

However, there are several areas of uncertainty that may alter the outcome of a cost-benefit analysis. A first area concerns the ability of the SEC to use effectively the information disclosed by hedge funds in Forms ADV and PF to protect investors and manage systemic risk. Disclosure regulation from Dodd-Frank is meant to change the incentive structure for hedge funds in a way that is beneficial for the public interest and for the protection of investors. This regulation will not be effective if the SEC does not have the manpower or the funding to collect data or conduct oversight appropriately. The SEC wishes to engender a culture of compliance in the industry, but if Congress does not support the agency with the adequate increases in funding and staff, industry incentives may not shift.

Furthermore, the SEC has a challenge in understanding what systemically risky funds look like before they fail. Recent literature such as Krug (2009) discusses the difficulty in discovering exactly what types of activities present the greatest systemic risk. Though regulators have a large history of financial collapses to review for insight, modern hedge fund activity is relatively new, with the LTCM case only 13 years old. The SEC must work diligently to grasp completely the understanding of systemic risk in large hedge funds. Considering the unprecedented responsibility given to the Commission in the wake of the 2008 financial crisis, a

similar collapse in the future will not be viewed kindly by those who opposed stricter regulation of hedge funds in Dodd-Frank.

The calculation of the costs is an empirical question that must be addressed in future analyses of Dodd-Frank hedge fund rules and could affect the cost-benefit outcome of these rules. The cost of compliance for funds is increasing – will fewer funds open in the next 5 years? Will funds on the margin choose to move offshore to jurisdictions with little to no regulation? The magnitude of the effect on the hedge fund industry is unknown, and its size has the potential to alter greatly a cost-benefit analysis of these rules. Alternatively, will hedge fund disclosure of information in Forms ADV and PF limit drastically the activities of the largest funds? A future analysis should examine the effect on daily trading activity, investment in non-traditional and illiquid assets, and price transparency initiated by hedge fund trading. Hedge funds fear that the disclosure of their confidential information on strategies and leverage to the SEC will lead the SEC to regulate the types of risks that funds take in the market. If the SEC uses systemic risk information from Form PF to monitor but not intrude on hedge fund activity, then I would not expect a radical change in fund behavior. If the SEC takes an activist approach in its management of confidential data from funds and begins to police fervently the risk-taking of hedge funds, there could be movement out of the hedge fund industry that could reduce significantly the benefits of funds.

The history of SEC mandatory disclosure regulation suggests that the wide discretion granted to the SEC by Dodd-Frank Title IV is necessary for the Commission to fulfill its mandate. Historical precedents also indicate that the SEC should be able to protect the proprietary information of hedge funds, thereby preserving their incentives to benefit the market with liquidity, capital formation, and price transparency. The SEC's statements regarding the

new disclosure rules indicate that they understand the potential costs of allowing private fund information into the public. Hedge funds will face a cost of compliance and vigilance for the possibility of SEC audit, disclosure, and public investigation. But confidentiality should protect the incentives to produce securities information enough as not to incur dramatic negative market-wide effects. In five years, researchers should have appropriate data to analyze the magnitude of the costs and benefits of mandatory disclosure regulation of hedge funds under Dodd-Frank.

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