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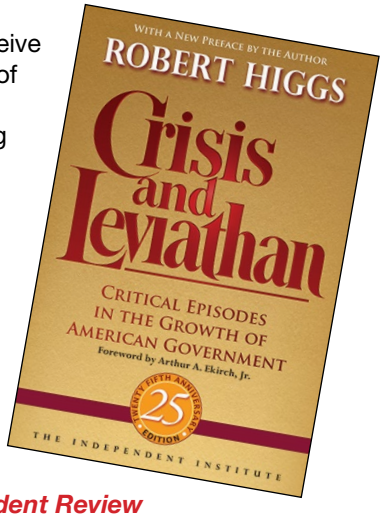

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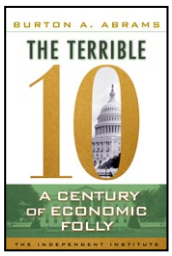
❑ 

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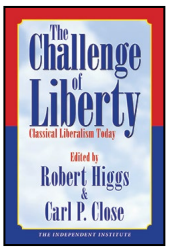
❑ 

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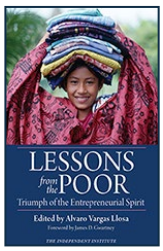
❑ 

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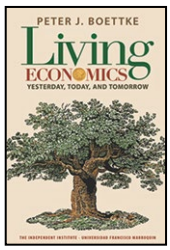
❑ 

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Does Regulation Prevent Fraud?

The Case of Manhattan Hedge Fund

CHIDEM KURDAS

Moves to enhance and expand regulation almost invariably follow financial disasters. Losses trigger calls for government action, especially when fraud is suspected. Not only policymakers, but also the media and the wider public see regulation as the natural remedy, perhaps because people tend to view financial debacles through the metaphor of misbehaving children in need of adult supervision. When you examine a real-life episode, however, the presumption that stricter regulation would have prevented the debacle is difficult to maintain. Instead, what emerges is a pattern of misperceptions and misjudgments, behavioral characteristics that apply to regulators as much as to the rest of humanity and indicate a need for better awareness of mental biases, not bureaucratic overlay.

A case in point is the failure of Manhattan Capital, a hedge fund firm. The manager, Michael Berger, misled his clients and lost several hundred million dollars of their money. This incident is particularly germane in that the U.S. Securities and Exchange Commission (SEC) used it in 2004 as part of a justification for greater regulatory control over hedge funds.

A hedge fund resembles an expensive restaurant run by a skilled chef who caters to the well heeled. By U.S. law, only people or organizations that meet certain wealth and income standards may invest in a hedge fund; the rest of us are legally limited to the less-diverse menus that mutual funds offer. Hedge fund investors are either

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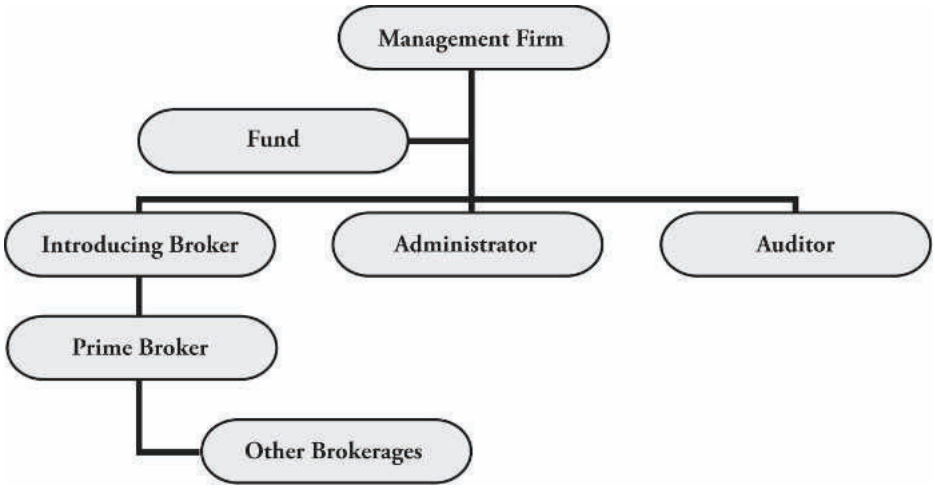
Figure 1
Structure of a Fund Business



wealthy individuals who invest their own money or, more commonly, professionals who act for others. Such people search for novel ways to get higher returns. Manhattan Capital's clients were among these sophisticated, seasoned investors with big chunks of capital to deploy. They recognized the vagaries of markets and money managers. Seemingly reasonable decisions nevertheless metamorphosed into a comedy of errors.

Hedge funds have been described as a regulatory arbitrage—a way to get around the high cost of regulation imposed on other financial organizations (Ely 1999, 248). Though subject to laws and regulations, they are freer than their mass-market cousins, mutual funds, and hence a prime target for policymakers interested in tightening the reins. As evidence that hedge fund investors need more protection, the SEC cited the Manhattan Capital example, among others. This SEC effort eventually failed, but the 2007–2008 downturn in real estate and credit markets gave rise once again to a movement to expand the government's authority over financial markets and organizations, including hedge funds. Because regulatory frenzy arises every time another fiasco occurs, the lesson of Manhattan Capital will likely remain relevant for a long time to come.

Managing a Hedge Fund

A fund is simply a pool of money, typically with no office or staff of its own. An adviser or manager creates this legal entity, develops its investment program, and hires service

providers to perform its necessary tasks: brokers to execute its trades, a custodian to hold the assets, an administrator to prepare financial documents and keep investors informed, and an auditor to vouch for the statements.

Thus, Michael Berger, the owner of the management firm Manhattan Capital, set up and controlled Manhattan Investment Fund (U.S. SEC 2000). He hired an administrator and an auditor, both Bermuda affiliates of big accounting companies. Through a small, Ohio-based firm called Financial Asset Management (FAM), whose owner he knew, he gained access to the services of Bear Stearns & Co., which became the fund's prime broker and custodian of its assets. A prime broker lends to client funds and serves as the main conduit for clearing their trades. FAM acted as introducing broker and received payment for placing the trades Bear Stearns executed (figure 1).

In combination, such service institutions function as a private supervisory network, an alternative to public regulation. Investors expect service providers to act as an external check on managers. Some managers voluntarily register with the SEC, becoming subject to closer supervision as registered investment advisers, but Berger did not register. Although he lived in New York during the time he managed Manhattan Fund, almost all his clients were non-Americans who showed no interest in having the SEC oversee their investments.

The private safeguards have one notable weakness. The manager picks the service providers and can fire them. For a fund administrator, a successful fund manager is a valuable client who can easily take his business elsewhere. Therefore, administrators tend to defer to managers. But large operations that cater to many funds, such as the prime brokerage arm of Bear Stearns, are independent of any single manager. If a fund has a diverse set of small and large service providers, at least some of them will be effective watchdogs. Although the manager puts together this structure, a hedge fund's clients can inquire about and even inspect the service providers.

At the time Berger started to raise capital in 1996, he believed that the U.S. equity market was overvalued and about to take a significant fall. He therefore advocated an investment program that consisted of short selling U.S. stocks. Most mutual funds bet that the prices of securities will go up, hoping to buy low and sell high. Short selling, a less widely practiced and more complicated type of trade, reverses the order by betting that a price will go down—one sells high first by borrowing shares from a broker and buys low later to replace them. Many hedge funds combine the two kinds of trade in a strategy called *equity long-short*.

According to Manhattan Fund's December 1995 offering memorandum, it belonged to this category of fund. As that document emphasized, borrowing shares imposes a short-term liability: the securities have to be returned to the broker by a designated date. By borrowing stocks, a trader can sell securities of greater value than the capital he controls, but if a bet goes wrong, the loss is correspondingly large. Moreover, short selling carries greater risk than a conventional long trade simply because share prices can go up without bound. When you buy a stock, the most you

can lose is whatever you paid for it, whereas when you short sell, there is no such maximum. Short-selling losses can "increase rapidly and without effective limit," as Manhattan Fund's prospectus put it. These hazards are familiar to hedge fund investors.

Berger advocated his program of borrowing and selling stocks in a weekly newsletter that he sent to clients and would-be clients during the fund's lifetime. His bearish view of the market was well known; in interviews and comments to the media, he repeatedly warned of an imminent slump. His idea attracted investors, and he succeeded in raising about $600 million over a period of almost four years. With this capital, he did what he told people he would do. By all evidence, he had confidence in his forecast and strategy. Not only did he invest the capital he raised, he threw in his own savings as well. His business was later described as a Ponzi scheme, but in fact it was a real investment operation. Week after week he told his clients that he would try to profit from short selling overvalued shares—which is exactly what he did.

From the standpoint of a dedicated bear like him, sell signs kept multiplying in the late 1990s—that is, the stock market soared. The pattern, he thought, resembled the 1920s. It followed, to his mind, that a crash was waiting to happen. "Many of the economic and technical conditions that existed before the crash of 1929, exist once again today," he argued. "When so many circumstances follow a similar path, logically the consequences have to be similar" (Berger 1997, 1). He was not alone in casting doubt on the stock boom. Federal Reserve chairman Alan Greenspan expressed concern about excessive exuberance in 1996, and another Fed official, governor Laurence Meyer, warned against high prices. Yet money flooded into equities, pushing prices up. Even shaky businesses continued to gain. Berger had to explain to his clients why the decline he predicted was delayed. He came up with an impressively prescient account.

Although companies were reporting strong performance, giving shareholders reason to be euphoric, the rosy earnings reports were not to be believed. "Extraordinary and exotic accounting practices are being exercised to maximize earnings and minimize any shortcomings," Berger wrote several years before Enron and other accounting scandals broke (1998, 1). He identified a number of ruses to which company officers were resorting, all of which became well known later. "Cookie jar" fake businesses were created to conceal declines in earnings. One-time charges and write-offs were used to get the cost of acquiring new firms off the balance sheet, thereby exaggerating reported earnings. Among the companies he identified as engaging in dubious practices were Tyco and WorldCom, whose chief executives were later convicted of financial crimes.

Berger zeroed in on employee stock options, which had become a large part of compensation, but were not included in the costs. He estimated that the earnings of even the top one hundred U.S. companies were overstated by more than 40 percent. All this was obvious to him by 1997; in his newsletter, he repeatedly railed against what he saw as deceptive corporate tactics, describing "all imaginable forms of balance

sheet cosmetics." He assured his clients that the mania could not last much longer, that reality always catches up with unrealistic expectations—and the numbers behind the bonanza were, literally, unreal.

At the time, however, attempts to bring up the issue were futile. Regulators showed no interest, even though Berger's repeated warnings suggested that anyone willing to look could see the sleights of hand. Debates about accounting questions and stock options did not come until years later, after the market bust revealed fault lines in certain companies.[1] To Berger's chagrin, the public continued to buy the bullish message, window dressing and all. Every week he predicted a 70 to 90 percent drop in stocks such as AOL and WorldCom, yet almost every week they climbed higher. Undeterred, he forecast worldwide financial trouble and went on short selling. In the summer of 1998, the market suddenly lurched his way when the Russian government defaulted on bond payments. This event precipitated the crisis that destroyed Long-Term Capital Management, a large hedge fund until then regarded as the crème de la crème of investment managers (Lowenstein 2000).

These events appeared to validate Berger's warnings. He believed the 1998 equity sell-off was only the beginning of a long-term decline and added to his portfolio of shorts. But he was wrong. Shock waves from the Russian default led to an abrupt shift in Federal Reserve policy. The Fed cut interest rates several times, confirming the widespread belief that in a pinch it would shore up the market. Stock prices resumed their upward trek (figure 2).

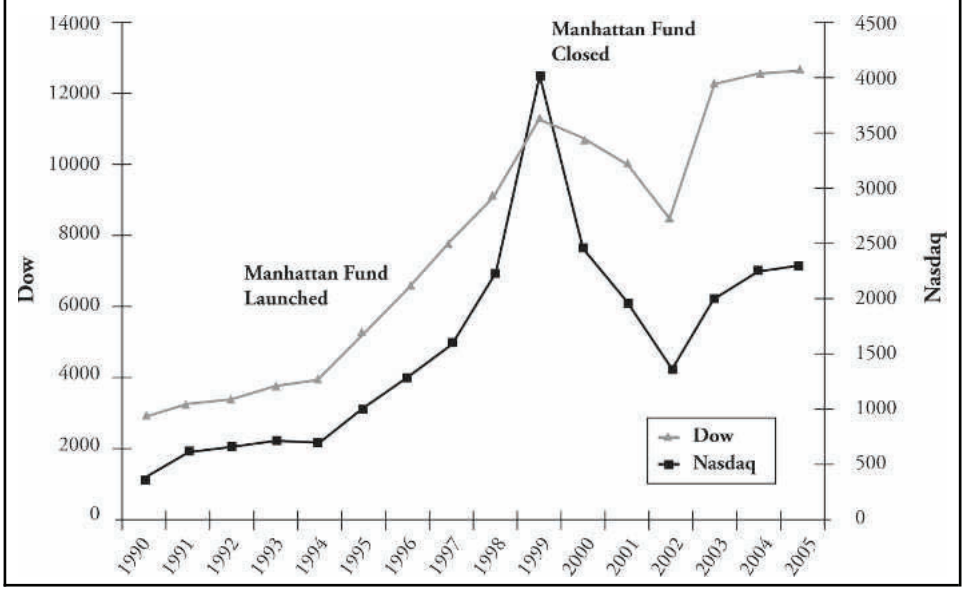
By late 1999, Berger had prematurely predicted market peaks for several years, and he was still at it. "It has been Chinese water torture to pinpoint tops in this stock market bonanza," he conceded. The seemingly endless series of disappointments forced him to qualify his forecasts. In September 1999, he added a cautionary note to his newsletter. "Even though under/overvalued stocks tend to return to fair value over time," he explained, "the timing and the exit and entry points are, in our opinion, a key element." Indeed, his short-selling spree had vividly demonstrated exactly how pivotal timing is. He had repeatedly sold borrowed stocks without a clear idea of when he might be able buy them back profitably. Again and again, he had to replace them at a loss as prices climbed.

Managing the Numbers

Manhattan Fund received its first investment in April 1996. Of the $2 million that came in, Berger lost about $700,000, or approximately 30 percent, by June. Money continued to flow into the fund, though, and he made a profit in July and August. Before the fund could recover fully, however, it took an even bigger loss in September. The administrator, a small Bermuda affiliate of Ernst & Young, was about to issue

1. Aviram 2007 documents the cyclical variation in law enforcement against financial fraud.

Figure 2
Stock Markets



a financial report that reflected this unfortunate development, based on data that came directly from the prime broker, Bear Stearns.

There could be no uncertainty as to such a report's impact. Most, if not all, investors would pull out. Faced with a large loss, they would lose whatever confidence they had in the manager's ability. Berger could no doubt imagine his clients stampeding to the exit. He clearly believed that his trades would soon succeed. That belief was plausible enough in 1996—he had done well for a while that summer. To gain time, he instructed the fund's administrator to put the asset-value report on hold, but it could not be postponed for long because investors would become curious about the delay. The upshot was that Berger gave his bookkeeper a monthly portfolio statement to send to the administrator to be used to calculate a new asset value. This document purported to be from FAM. It was substantially at odds with the Bear Stearns record.

Before Berger's instruction to delay arrived, the administrator had determined that the fund's net asset value as of September 30, 1996, was about $60 per share. That value indicated a 40 percent decline from the opening net asset value of $100. An administrator staffer obediently prepared a revised calculation using the new information supposedly from FAM. This calculation showed a net asset value of $114 per share, embodying a respectable enough profit to reassure investors.

Berger was confident that stocks would soon fall and profits would come in—confident enough to continue betting his own money as well as his clients' capital. The next month, however, the market dashed his hopes again. He decided he needed more time. Another FAM spreadsheet appeared in the administrator's fax machine to

be used for the next report to investors. That pattern was to continue for more than three years.

Every day, Bear Stearns put all the trades it executed for the fund online for the administrator to download. In addition to online data, the prime broker sent out monthly and yearly statements to both the administrator and the FAM headquarters in Ohio. The Bear Stearns statements tracked steep losses with brutal clarity, giving trade dates, the nature of the securities traded, and the prices. The ostensible FAM spreadsheets persistently indicated that the fund was profitable, even as the trades in the Bear account lost large sums. Not that Berger's strategy always failed; at times, the companies he bet against did go down, and the fund realized a profit, but the losses dwarfed the gains.

The accountants at the Bermuda administrator were fully aware of the inconsistency between the Bear Stearns record and the FAM spreadsheets they used to calculate the fund's returns. They repeatedly asked Berger if the FAM data were correct. He confirmed that the spreadsheets were accurate, so the administrator went on using the spreadsheets that showed up every month. The reconciliation of the two sets of numbers was left to an annual audit.

The auditor, a Bermuda offshoot of Deloitte Touche, immediately spotted the divergence between the FAM and Bear Stearns data. Berger was ready with an explanation. Because he wanted to borrow and sell a wide variety of stocks, some not available from Bear Stearns, he relied on other brokerages on occasion. He used this explanation as a smokescreen. He said Bear did not have the full picture because it had data only for the particular trades it executed. By contrast, the FAM documents showed all the trades, he explained. His allies at FAM, to whom he paid large brokerage commissions, backed him up.

He muddied the water further with specious explanations of why the administrator and auditor should not pay attention to the Bear Stearns numbers. The impression he conjured up was of a bright young manager, very busy, with no time to explain boring details to accountants who lack the wits to figure things out on their own. A brash challenge, "If you don't understand, it's your problem," became a recurring refrain in his dealings with the Bermuda firms. His confidence and audacity helped to convince people. He wouldn't dare tell such barefaced lies, would he? His explanation had to be true.

In reality, borrowing shares from other sources made no difference for the financial record. Bear Stearns was Manhattan Fund's only prime broker and the custodian of its assets. All the fund's transactions went through and were recorded by Bear Stearns, even when other brokers provided securities. The fund's prospectus, which the administrator kept on file and sent to would-be investors, described this arrangement, but very few people read the fine-print legalese of fund prospectuses. Because a hedge fund can have multiple prime brokers, Berger's assertions, though unlikely, were not implausible.

So he continued to report robust profits while making hefty losses. The reported

assets diverged from the Bear Stearns record in ever-larger amounts. In December 1996, the FAM spreadsheets indicated net assets of $15.6 million. According to Bear Stearns, the fund's assets at the time were worth $5.6 million—a disparity of $10 million. A year later, at the end of 1997, on the basis of FAM spreadsheets the administrator informed investors that the fund had $81 million in assets, whereas Bear Stearns showed holdings of $39 million—a difference of $42 million. In 1998, the gap ballooned to almost $260 million. By 1999, it was pushing $400 million.

This chasm widened continually in plain sight, with the Bear Stearns data always available to the administrator and the auditor. In 1999, Bear Stearns executives repeatedly warned people who were known to be invested in the fund that a discrepancy appeared to exist. They also warned the administrator and the auditor. Yet many investors apparently did not hear the warning and continued to provide Berger with capital. He continued to short sell and to lose money. Finally, in late 1999 Bear Stearns informed the SEC of the problem, and the regulator closed down the fund. Berger was arrested and pled guilty to fraud charges, but escaped in 2002 before he was sentenced. He was apprehended in Europe about five years later.

All That Glitters

The various players in this drama acted in ways that turned out to be against their own interest. A significant number of experienced hedge fund investors favored Manhattan Fund for several years and lost money. The administrator and the auditor were willing to accept Berger's explanations, yet this acceptance had disastrous consequences for their business. Berger ruined his own career and gambled away everything he possessed. What impelled them along this path?

There was nothing unusual about a short seller losing money; doing so was par for the course, a logical implication of betting against a roaring market. Short selling is the toughest possible way to turn a buck; a miniscule number of people succeed at it over time. As the boom gathered steam from 1995 through 1999, short sellers lost money in four out of five years. As it neared its zenith, they lost even more. In 1999, they went down 14 percent, whereas the S&P 500 gained 21 percent (Tran 2006, 66). Anyone could see short sellers' losses by consulting the indexes. Berger's reported profits were thus highly unusual. He claimed a return of almost 30 percent for 1997, a more-than-respectable performance for any money manager, but an astonishing one for a short seller in a strong market.

A short-selling program that made such gains was exceptionally attractive to people who shared Berger's bearish view. Experienced investors strongly suspected that the giddy market in the final years of the twentieth century was not long for this world. They wanted to take advantage of rising prices, but at the same time they sought to protect themselves against a downturn. Some of them invested heavily in booming technology stocks and needed to diversify. To balance their portfolios, they wanted an alternative to bullish stock buyers. This was Berger's niche. If and when

conventional wisdom turned out to be mistaken, this contrarian was sure to turn a splendid profit. The 1998 crisis showed that the market was fragile, so putting a small fraction of one's wealth into Manhattan Fund appeared to be a sensible precaution.

Time proved that these investors were farsighted in their search for diversity. Short-bias hedge funds demonstrated their mettle after the bubble popped: they raked in 18 percent in 2002 as the S&P 500 dropped 22 percent (Tran 2006, 39). Investments in short-selling funds did indeed act as cover when the slump came, just as Berger's clients expected. But few short-selling funds lasted that long because although they provided insurance against a slump, their performance was dismal until the market turned. In effect, those losses were the cost of the insurance. Such insurance, never cheap, was even more expensive in the late 1990s as prices rose at a rapid pace. To get cover against a future bust, you had to sacrifice a big current gain. Few people are willing to lose money in the midst of a thriving market.

Investors wanted a shelter for the end of the boom, but they didn't want the losses that were the price of that shelter. Berger gave them the comforting impression that they were buying a safeguard plus a solid return. What he appeared to offer was especially tempting because it was a deal that you really cannot get: free insurance. Other short sellers were not faking, and their performance was at best mediocre. It looked as if his clients were having their cake and eating it, too. No wonder they were happy to pour money into the fund.

But how could this one man be pulling in substantial gains persistently when no one else was making much money by short-selling stocks in the midst of the hottest market ever? An investor was later quoted as saying that Berger's numbers were genius numbers, but he did not look like a genius (Shogren 2000). The investors bolstered each other's belief, an example of the herding effect, a central theme of behavioral finance.[2] Word of well-known investors in the Manhattan Fund got around. "So-and-so is also a shareholder," would-be clients told each other. The more people talked about how this short seller made good money as he protected you against a slump, the more believable the story became. Figuring out new investments is difficult, so imitation saves you trouble and time. Investors followed each other to Berger's elegantly furnished office on Park Avenue.

Behavioral finance highlights a common pattern called *belief perseverance,* also known as *confirmation bias.* Once people form an opinion, they cling to it and become reluctant to search for data that contradicts their conviction. Moreover, if they happen to come across evidence that challenges the belief, they treat that information with extreme skepticism and sometimes even misinterpret it, perversely concluding that it supports the favored opinion (Barberis and Thaler 2002, 14). Berger found plenty of reasons to bolster his conviction, especially because his diagnosis of the bubble and the accounting shenanigans was in fact broadly correct. But he did not

2. Herding behavior is associated with information cascades in which individuals observe others' behavior in order to decide what to do (Bikhchandani, Hirshleifer, and Welch 1998).

notice information that would have cast doubt on the timing of his trades. As for his clients, once convinced that they were getting a great deal, they did not look for evidence of failure.

The administrator and the auditor were also resolute in holding onto their belief. Having accepted the faxed spreadsheets, they worked hard to ignore the real trade information coming from Bear Stearns. Again and again they sought reasons to explain away the anomaly and cling to the false returns to which they were committed. They repeatedly put aside contrary data and warnings. This behavior was by no means unique or unusual. The administrator and the auditor treated the troublesome divergence in the same way other accountants treated intimations of malfeasance in corporations or people who were vested in the stock bubble treated arguments that the glittering prospects were not real or homeowners treated warnings that property would not continue to gain 20 percent a year. Wishful thinking is ubiquitous; we all fall into it some time. Adam Smith knew this fact centuries before anyone did cognitive research on it (Paganelli 2003, 32).

Beset with uncertainty, we need reasons to justify our choices—these reasons act as *psychological anchors,* to use another term from behavioral finance (Shiller 2001, 138–42). Faced with an ambiguous situation, people look for a plausible basis for making a decision. Berger fashioned excellent anchors both for himself and for others. The coherent and dramatic picture of a bubble about to collapse appealed to skittish investors. His clients knew that short sellers lose money in a buoyant market, but the more stock prices soared, the more plausible the collapse scenario became and the more they wanted the insurance he offered.

He used the right anchor for the administrator and the auditor as well, providing them with reasons to do what was convenient for them. They wanted to avoid a nasty confrontation. After all, he was their client. The hedge fund–service business is lucrative, and competition for clients is intense. Berger's explanation that Bear Stearns did not have full information because it was only one of the fund's several brokerages created sufficient doubt and gave the accountants enough reason to go along with his scheme. He constructed convincing tales to give people credible justification to do what he wanted them to do.

Wildly successful at persuading others, he was also very effective at persuading himself that his scheme would likely work out, even after hope turned into full-fledged delusion. Recovery was initially a possibility. A sustained market drop a month or two after the first bogus statement might have brought enough gains to recoup the losses. As the gap between reality and make-believe widened over time, it became impossible for Berger to recover. But he was such a good con man that he believed in his own game. Doubling his bets in pursuit of a massive gain, he sank deeper into the morass.

After the Fact

These events became part of a public-policy debate that continues to this day. In 2003, the SEC, under then chairman William Donaldson, started a campaign to

increase its authority over hedge funds. "Because hedge funds typically are not registered with us, we are limited in our ability to detect problems before they result in harm to investors or the securities markets," he told a U.S. Senate committee (Donaldson 2003). In 2004, the regulator proposed to make registration mandatory for hedge fund advisers. This mandate would require managers to report regularly to the SEC, keep elaborate records, and submit to routine examinations. One argument the agency used to justify the proposal was that examinations conducted by its officers would deter fraud (U.S. SEC 2004, 72061).[3] Manhattan Investment Fund made an appearance in the *Federal Register* as an example of what happens without regulation (U.S. SEC 2004, 72063 n. 99, 72074 n. 235, 72078 n. 287).

Paternalism rests on the justification that individuals fail to take care of their own best interest.[4] Proponents of public policy and private actions to save people from themselves point to the mental biases documented by cognitive psychology, behavioral finance, and related behavioral disciplines.[5] A growing body of evidence shows that people make systematic cognitive errors, such as ignoring inconvenient facts. The paternalists argue that the government—or private parties such as employers empowered by the government—can correct the detrimental effects of such mistakes. If so, government agents can nip destructive schemes such as Berger's in the bud.

Federal and state laws against fraud have been on the books for centuries, and at this stage they are so voluminous that it would take a long time simply to read all of them. Deceiving one's clients is illegal, regardless of the exact regulatory regime in place. Public agencies do not lack the authority to tackle the problem wherever it occurs. The SEC can demand access to any hedge fund if it suspects fraud and ask a court to take action against the manager—as it did with Manhattan Capital when Bear Stearns expressed concern. Courts usually defer to the government when it alleges fraud against a money manager. Despite the massive power that regulators possess, however, the government typically catches fraudulent claims only when an interested party complains after the fact—that is, after the damage is done.[6]

One aspect of the Manhattan Fund story vividly demonstrates regulation's failure to deter fraud. Berger was able to circumvent the private controls and to deceive people mainly because his allies at the brokerage FAM covered for him. The auditor and the administrator were hoodwinked owing to the complicity of FAM's owner and

3. The argument that greater government oversight can deter fraud assumes that would-be perpetrators will fear detection by the government more than detection by private watchdogs. If regulators do not in fact detect fraud more effectively than do market players, however, such fear has no basis.

4. An example of paternalistic policymaking in the United States is Prohibition, and Robert Higgs (2004) documents myriad other efforts. For a discussion of recent paternalist arguments, see Whitman and Rizzo 2007.

5. Shiller 2001 is probably the most widely known application of behavioral economics.

6. The SEC disputed this point, citing five cases that arose from routine or sweep examinations of registered advisers (2004, 72062), but those cases did not involve false returns (72062 n. 94). Law enforcement against fraud relies heavily on tips and complaints (Kurdas 2006).

president, James Rader, who was Berger's long-time associate. FAM, however, was fully subject to U.S. regulation. It was formally licensed as a broker-dealer and thus in theory supervised by the SEC. Both Rader and his colleague Debra Kennedy, the firm's vice president and treasurer, held U.S. securities licenses. The extensive regulatory system for broker-dealers did nothing to prevent or reveal this complicity for several years. Only after Bear Stearns set off the alarm did the SEC investigate FAM.

Then the SEC decided that "FAM, Kennedy and Rader repeatedly took steps that contributed to the fraudulent scheme perpetrated by Berger" (2002, 7). One of these actions was to go along with Berger's demand that correspondence to the auditor be sent to him rather than directly to Deloitte Touche Bermuda. "Notwithstanding the unusual nature of Berger's request, and without consulting Deloitte about its propriety, Kennedy complied with Berger's request," stated the SEC complaint against the FAM executives (2002, 4).

As part of its auditing process, Deloitte Bermuda asked FAM to confirm Manhattan Fund's financial information—that is, the phony spreadsheets. With Rader's approval, Kennedy prepared a cover letter on FAM letterhead addressed to Deloitte, attached account statements from Bear Stearns, and mailed the package not to the auditor, but to Berger. This arrangement allowed Berger to produce account statements designed to look as if they were generated by FAM and to send to Deloitte what appeared to be official confirmation of the data. What was supposed to be an independent check on Berger instead helped him pass off counterfeit reports. "This circumvention of the audit confirmation process . . . made it possible for Berger to perpetrate his fraudulent scheme," the SEC found (2002, 4).

Even as the deception was about to be exposed in early 2000, Berger asked for and received help from his associate at FAM to keep the administrator in the dark. Rader signed and faxed to Bermuda a letter saying that FAM had custody of the fund's assets and provided monthly trading and loss/gain statements. He did so knowing full well that the Bear Stearns reports showed immense losses and that people suspected Berger was cooking the books.

Rader benefited substantially from his connection to Berger. The SEC estimated that commissions from Manhattan Fund accounted for 10–33 percent of FAM's annual revenue over the years in question (2002, 3). Rader and Kennedy had to be aware that as long as Berger stayed in business, they themselves would receive a hefty stream of income. They readily accommodated his demands, which could be explained only as ruses to mislead the administrator and the auditor. But for their willingness to support him, the game would have ended quickly.

The SEC had more extensive powers over FAM than the authority it later tried to acquire over unregistered hedge funds. FAM derived credibility from being a U.S.-regulated, licensed brokerage; hence, the Bermuda administrator and the auditor accepted the fake numbers confirmed by FAM. The long-established regulatory regimen for brokerages did not deter the FAM executives, but instead gave them the status to assist Berger's cover-up. Rader played a key role in subverting the private

policing system that otherwise might have detected Berger's trick earlier. The aura of being supervised by the U.S. government almost certainly helped him play that role.

The state's traditional role with regard to fraud is to punish it once it comes to light and to provide courts in which the victims can seek restitution. Judging by the legal sequel to the Manhattan Capital situation, U.S. regulators and courts perform this function with a remarkable degree of arbitrariness. The SEC ordered Rader and Kennedy to cease and desist from securities law violations in the future and to return $642,000 in commissions from the fund. They settled without admitting or denying guilt, but they did not have the money, so the SEC agreed that they would pay only $25,000. Rader and Kennedy neither gave back their gains from the scheme nor faced criminal charges. The investors did sue FAM as well as the fund's other service providers, and the judge found that the facts supported "a fair inference that FAM knew of Berger's fraud," making Berger and FAM jointly liable for $288 million in damages (Cote 2004). By then, however, Berger was on the lam, and FAM did not have assets that could to be seized for this purpose.

The lawsuits concentrated instead on the service providers with deep pockets. The auditor and the administrator settled with the investors. In a truly bizarre outcome, the only defendant still being actively sued after eight years was Bear Stearns, the one party that tried repeatedly to stop the numbers game Berger played and FAM facilitated. The prime broker provided accurate data and warned people; it functioned properly as a private watchdog, at least by commonsense criteria. Nevertheless, it received a much larger penalty than did other service providers, as if to demonstrate the perversity of tort law.

Toward Paternalistic Bliss

The mandatory hedge fund registration rule proposed by the SEC passed in 2004 with an unusually close vote of three to two. Two SEC commissioners voted against it after presenting a detailed critique. One point they made was that some of the fraud cases cited to justify the new rule occurred in firms that were registered.[7] That is, the fraud happened in settings where the regulator already had the authority it sought through the new rule. The case of Manhattan Capital's Ohio broker is just one of many examples in which government supervision was already extensive and yet ineffective in preventing malfeasance.

Decade after decade, illegal schemes crop up in closely regulated industries. Numerous instances of window dressing happened in public companies such as WorldCom, which are obliged to provide financial information regularly to the SEC. The corporate accounting tricks of the late 1990s were detectable—Berger detected

7. SEC commissioners Cynthia Glassman and Paul Atkins attached their critique to the rule and presented it at an open meeting. See Kurdas 2004 and U.S. SEC 2004, 72089–98.

them, and he was not alone. A short seller noticed the problems at Enron.[8] Market players without the powers that government agents possess nevertheless discerned what was going on. Only after the stock-market collapse, after the horse had long fled the barn, did various arms of the government swing into action. Confronted with such regulatory failures, proponents of increased oversight have two responses. One, they cannot be expected to stop every fraud. Two, they would be more effective if they had a little more power and more resources to go with it.

Thus, the SEC argued that although unregistered hedge fund advisers are subject to antifraud provisions, "our ability to enforce those provisions is hampered because in the absence of a registration requirement we cannot identify and examine those advisers" (2004, 72060 n. 65). As we saw, however, the Manhattan Capital debacle happened with the connivance of a registered broker-dealer that the SEC should have had no trouble identifying or examining. Even when armed with extensive mandates, regulators cannot prevent schemes. One reason why is almost certainly behavioral.

Mental blind spots are common to all humanity, whether in the markets or in the government. The people Berger misled were experienced, highly sophisticated investors with immense resources and every ability to intervene. The fiasco happened because they misperceived the situation. If insiders are subject to knowledge gaps and cognitive biases, outsiders must also be subject to such gaps and biases. Although government agents are independent, they are outsiders with less information, no special cognitive advantage, and weaker incentives. Unlike private actors who bear the costs and benefits of their own choices, public decision makers do not face all the consequences of their choices (Whitman and Rizzo 2007, 442–43), especially when their failures are attributed to a lack of power or resources so that they escape responsibility for their mistakes. A fund's investors, administrator, and auditor are in a better position to understand its operations and have far more reason to try to do so. They miss some problems, but so do public bureaucrats.

Suppose Berger had been registered, and the SEC had conducted a routine examination of his firm. (In fact, the chance of an inspection was slim because the SEC visited registered advisers only once every five years during this period, but for the sake of argument let us ignore that issue.) Would government inspectors have seen through the excuses that fooled everyone else? Berger was a very resourceful, adaptive person and a master at manipulating perceptions, which explains how he succeeded in getting his way. If there had been a chance of an SEC examination, he certainly would have prepared for it. Plenty of others in regulated firms managed to hide their shenanigans from the government. He probably would have done so, too. Greater regulation would therefore have brought forth only greater dissimulation.

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8. In a statement at an SEC Roundtable, James Chanos (2003) recounted how he, a short-selling money manager, grew suspicious of Enron in November 2000. Regulators had access to the same information, of course, but they did not show interest until the business was near collapse.

Judging from existing regimes' inadequacy, the only way to make reasonably sure a fraud will be detected early is to give regulators such intrusive powers that they will be aware of everything going on in a business and intervene whenever they suspect an irregularity. A regulatory regimen this extensive would impose immense costs in resources spent and efficiency lost. In addition, the impression that supreme civil servants are watching over everyone would undermine private safeguards and create the usual moral hazard of causing people to act recklessly. Moreover, there would be another more insidious and less recognized effect. Protection creates cognitive hazard (Klick and Mitchell 2006; Whitman and Rizzo 2007). It reduces the incentive to become aware of one's biases and to correct errors. This danger is present for all investment choices, whether in hedge funds, mutual funds, real estate, or any other asset.

For example, companies have started to enroll employees automatically in 401(k) programs at a prescribed saving rate. Touted as a successful example of private paternalism, this practice generates greater savings, but automatically enrolled employees tend to stay with the default investments, which bring lower returns (Choi et al. 2002). By contrast, in programs where enrollment is by active choice rather than by default, enrollees pay more attention to the investments, showing willingness to learn. Cognitive shortcomings may lead to wrong choices, but a paternalistic setup discourages learning, thereby perpetuating the cognitive deficit.[9]

Government activity ratchets up during wars and other crises.[10] A similar boom-bust pattern marks the making and enforcement of securities laws.[11] In good times, these activities are relatively dormant, in part because they offer less political gain. In addition, a boom masks financial weaknesses, and government agents do not discern hidden problems any better than market players do. Come the cyclical downturn, businesses fail, and adversely affected groups demand public action. The failures are attributed to insufficient regulation, and politicians strengthen the apparatus. When the stock bubble burst in the early 2000s, Congress passed the Sarbanes-Oxley Act to impose more control over corporations.

Agencies, powers, and mandates accumulate through these cyclical regulatory rushes. Thus, we move toward an all-encompassing regulatory regime that promises to free us of the unpleasantness of making our own financial mistakes, but instead

9. For this reason, behavioral findings may support less paternalism rather than more; see Ribstein 2005 and Whitman and Rizzo 2007.

10. Higgs 1987 provides an analytical framework and historical evidence for the episodic development of big government.

11. Ribstein 2003 points to regulative frenzy in downturns, when fraud shows up. Aviram 2007 explains the connection between the cyclical regulatory pattern and public misperceptions of fraud. Ely 1999 argues that federal deposit insurance encourages regulatory failure for banks, which leads in turn to additional restrictions and to the development of new ways to sidestep them.

subjects us to the errors of government agents, not to mention their interests.[12] "If men were angels, no government would be necessary," wrote James Madison (Hamilton, Madison, and Jay [1788] 1961, no. 51). If those who govern men were angels, controls on government would not be necessary. If regulators were selfless, wise, and unerring, perhaps one would not need to worry about the limitless escalation of their authority. As Madison knew, however, public overseers are no more virtuous than the rest of us. Hence, paternalistic bliss appears to resemble the wonderful returns Michael Berger achieved.

Hedge fund managers are emphatically no angels, but they exhibit one quality that some may find admirable: a preference for independence. One of them went to court to challenge the SEC's registration rule and, against widespread expectation, won the appeal. The new rule was based on a change in the interpretation of the word *client*. It previously meant a fund, but now it meant an individual investor—so that any manager with fifteen or more investors would be forced to register. "That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable," concluded the U.S. Court of Appeals. "But the Commission may not accomplish its objective by a manipulation of meaning" (*Philip Goldstein et al vs. Securities and Exchange Commission,* No. 04-1434 [D.C. Cir. 2006], 16). This rare reprieve from regulatory encroachment appears to be temporary, however.

Today there is a perception of economic emergency owing to the downturn in real estate and the contraction of credit. In early 2008, Bear Stearns, near bankruptcy amid rumors that caused hedge funds to withdraw their assets from its prime brokerage unit, was sold to JP Morgan Chase in a deal sponsored by the Federal Reserve. The central bank intervened in the name of containing a threat to the entire financial system. Press stories highlighted a gap in the Fed's mandate: it did not have the authority over investment banks such as Bear Stearns that it had over commercial banks. The fact that investment banks are securities broker-dealers and as such are heavily regulated by the SEC did not get as much attention.

The U.S. Department of the Treasury (2008) floated a plan that gives the Federal Reserve wide new powers, including oversight of hedge funds and investment banks. Prominent commentators argue that this plan does not go far enough and that tougher, more extensive regulations are necessary (Krugman 2008). Yet the government's inability to prevent the crisis caused by excessive lending, like its inability to prevent fraud, is almost certainly not owing to any lack of authority or information. The Fed intervened to sell Bear Stearns—evidence of abundant power. As members of the President's Working Group on Financial Markets, created in response to the 1987 stock-market plunge, the Fed, the SEC, and the Treasury can share an immense

12. A financial "perpetual childhood" (a term borrowed from Alexis de Tocqueville [qtd. in Higgs 2004, 87]).

pool of information. The situation was not simply one in which regulators did not prevent excesses in mortgage lending; a reasonable case can be made that politicians and the Federal Reserve actively encouraged those excesses.[13]

Hence, the current difficulties evince government failure at least as much as market failure. Odds are that mental biases were involved in both failures: as long as markets were on the up cycle, people in the government were comforted by the same rosy picture that beguiled homeowners and Wall Street. But government failure typically results in more government, whereas market failure results in less market. The notion that regulators fail because they have insufficient power, but market players fail because they are insufficiently supervised naturally gives rise to this asymmetry. In fact, both regulators and market players are subject to cognitive biases and hence make mistakes. The conventional response of boosting government watchdogs magnifies the impact of their mistakes while reducing both the watchdogs' and the public's incentive to learn. It creates a vicious spiral of more regulation, regulatory failure, and even more regulation.

On that account, the notion that regulators, if endowed with a few more weapons, will protect us against human nature resembles the slump insurance Berger offered—the real price is immensely higher than the supposed price. To have a fair chance of being effective, an extensive panoply of interventions would be required, almost certainly costing more than the failures they are supposed to prevent.

Perhaps it sounds naive to say that the genuine solution is to find ways around the mental traps that make all people prone to systematic errors. Hopeful delusions will admittedly always be hard to resist, whether the delusion pertains to a hedge fund's returns or to the government's ability to transform financial markets into an orderly brood. But studies of cognitive failure increasingly illuminate how our thought process goes askew, and the topic attracts much interest, so much that sophisticated books even make it onto best-seller lists.[14] If we try, maybe more of us will notice contrary evidence and guard against the penchant to ignore unpleasant facts. That wariness would improve decision making by all parties—investors, money managers, auditors, and possibly even regulators.

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13. Years before the downturn, James Grant (2005) accused the Fed of encouraging a real-estate bubble. Gregory Ip, James Hagerty, and Jonathan Karp (2008) describe politicians' efforts to ease limits so that people with shakier finances can get mortgages.

14. Such as Taleb 2007, a must-read for people in the financial industry.

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