



## THE REGULATORY PENDULUM

by Glenn E. Atkins, CFA

The intent of governmental regulation, and particularly Securities & Exchange Commission (SEC) regulation of registered investment advisors (RIA's) can be summed up fairly simply: **Don't lie, cheat**

**or steal.** It's as easy as that. The rest of the regulatory mantra amounts to a mountain of paper that takes up half of my office. Much of this, although well intentioned, does very little to protect the investing public.

I know the topic of regulation can be excruciatingly boring, but stay with me on this one. It's the ebb and flow of it, how the pendulum swings if you will, where the interest lies.

Although regulation has been around at least since the Investment Advisors Act of 1940 (the Act), the fact is that until about five or six years ago the regulatory nature of our business was very different. The advent of Enron, WorldCom, Tyco, the mutual fund scandals and Sarbanes Oxley, among many others, obliterated the regulatory landscape in our industry. The premise is the same: don't lie, cheat or steal, but the flow of it is different in the extreme.

As recently as ten years ago, SEC regulation of RIA's seemed only a blip on the radar. Currently, there seems to be a clash within the industry amongst regulators and participants and the pendulum has apparently swung heavily in the direction of more regulation, although less so recently.

One of the difficulties that advisors face is ambiguity. The SEC rules are broad, but their interpretation is narrow. In defense of the SEC, I am sure this is intentional. If they defined only the ten things that were prohibited, some miscreant would do the 11<sup>th</sup> thing. Fair enough. The problem is that many times the rules are made up as the industry moves along, mostly over a period of years and through the exhaustive process of an SEC audit or no-action letters.

A year and a half or so ago the SEC attempted to greatly expand the scope of their regulatory reach by requiring investment advisors who managed hedge funds (Garrison Asset Management does not manage hedge funds) to register with the Commission. As you might expect, the battle lines were drawn separating the one camp who favored registration and the one that opposed it.

As most hedge funds are organized as limited partnerships, the managers maintained that they had only one client, that being the limited

partnership itself. The SEC decided to expand the definition of client to include the underlying investors in the hedge fund and thus force the advisors to become registered. The problem is they did this based on staff interpretation and rule making under the Act based solely on what the SEC determined a client actually is, and without apparent legislative authority. This "moving target" of rule making was promptly and unanimously struck down in June by a three judge panel of the U.S. Circuit Court of Appeals for the District of Columbia (see original case at Phillip Goldstein, et al. v. Securities and Exchange Commission).

Well, that was the end of it you might say. Not so fast. SEC Chairman Christopher Cox issued a statement recently saying that, given the "unanimous" nature of the decision, the SEC would not seek an en banc judicial review from the entire appellate court.

***"Don't lie, cheat or steal.  
It's as easy as that."***

Instead they took the posture that "the Commission is moving aggressively on an agenda of rulemaking and staff guidance...to address the legal consequences from the invalidation of the rule." I am not making this up. He continued, "Among the significant new proposals will be a new anti-fraud rule under the Investment Advisors Act that would have the effect of "looking through" a hedge fund to its investors. This would reverse the side-effect of the Goldstein decision that the anti-fraud provisions of the Act apply only to "clients" as **the court interpreted that term**, and not to investors in the hedge fund." Emphasis added is mine. Didn't the SEC just get rebuked by the Appellate court for interpreting what a client is? Instead of getting proper legislative authority or pursuing a full appellate court appeal, they're just going to make up another rule. This is the regulatory equivalent of legislating from the bench.

Is this déjà vu all over again Yogi? Sounds like the same stuff to me. If the front door is locked, go in the back door. We can debate the merits of hedge fund regulation over dinner, but I am in favor of it. I will always come down on the side of more disclosure is better. However, the problem currently in the regulatory environment is two fold. First, the regulatory abyss in which our industry operates is mind-boggling and provides little direct benefit to investor protection. Second, over the years, the SEC appears to have a tendency to interpret the rules as we go along.

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## PROXY NON-VOTING

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Without going into stock/stock options received via their different Plans for outside directors, the back of the envelope annual cash amounts received by Mr. Cash and Mr. Hernandez for all their directorships is \$270,000 and \$375,000, respectively, plus all board related expenses.

These compensation and award issues are highly complicated and unique to every company. I doubt that each of these directors is conversant on all these issues at five different companies in five different industries. And how independent are you when you are getting paid this much money, not to mention stock?

So please don't throw your proxy statements in the trash - read them. It is important that you vote your common sense on these issues. 🍌

## THE REGULATORY PENDULUM

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Again, I am in favor of regulation because it tends to weed out the bad actors that give our industry a bad name. I would just like some guidance along the way as Garrison Asset Management tries to do the right thing. The pendulum of regulatory requirements should balance the needs of investor protection and oversight with the real world practices of our industry. Don't forget, the natural position, or state, of a pendulum is straight down, at rest, and in the middle between the two extremes of its apex. At some point investors themselves should be held to a higher standard and know that investing your life savings in Venezuelan oil futures with someone you just met at Starbucks is probably a bad idea. So is spilling that Starbucks coffee in your lap, but that's probably a better way to make a quick buck. 🍌

## OPTIONS TIME MACHINE: MONEY FOR NOTHING

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Note everyone owns stocks, but we all pay taxes. The government got shortchanged in this scheme as well. By not reporting the in-the-money portion of the grant as compensation, payroll taxes as well as income taxes were avoided or deferred.

Options backdating seems to have been surprisingly widespread in the late 1990s. The Wall Street Journal maintains a growing list of at least 85 companies involved in some way with the practice, many of them in the high tech sector. Even household names such as iPod maker Apple Computer and HMO United Healthcare are under investigation. How did the problem get so big? Executive greed, of course, combined with complacent or incompetent boards who rubber-stamped management's proposals. This was also an era of euphoric stock returns in the tech sector, where shareholders with huge gains did not care much about the details and companies pulled out all the stops to attract and retain employees.

The fallout from this scandal is sure to include earnings restatements as companies go back and factor in compensation expense and tax liability. In fact some companies face the potential of being delisted from the Nasdaq as they delay their SEC filings while researching this issue. We have already seen management resignations, terminations, and a fugitive CEO leave the country rather than face charges. Hopefully, standards for board competence and independence will be raised. No doubt government will insist on more regulation and oversight as well. Worst of all, expect further deterioration in the public's trust of the executives managing our public companies and the boards of directors who nominally protect shareholder interests. 🍌

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