WHAT'S PRIVATE EQUITY GOT TO DO WITH IT?

VALENTINA ELZON*

While regulators and scholars may argue about the true cause of the "Great Recession" of 2007-2009 for years to come, they generally agree that private equity funds did not cause the recent financial turmoil.[1] And yet, Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") regulates investment advisers to certain private funds, including private equity funds.[2] The reasons for bringing these investment advisers within the purview of the Securities Exchange Commission ("SEC" or "the Commission") is to protect investors and to assess systemic risk.[3,4] Title IV therefore begs the question: what, if anything, did regulators

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[1] *See e.g.,* Mark Jickling, "Causes of the Financial Crisis," Congressional Research Service (Jan. 29, 2009) *available at* http://assets.opencrs.com/rpts/R40173_20090129.pdf (offering twenty-six causes for the financial crisis, including "Imprudent Mortgage Lending," "Securitization," "Mark-to-market Accounting," the "Shadow Banking System," "Off-Balance Sheet Finance," "Complexity," "Bad Computer Models," "Credit Default Swaps," "Over the Counter Derivatives," and the "Black Swan Theory").

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376 (2010). [Hereinafter "Dodd-Frank Act"].

[3] *Id*. at § 404 (the Commission may require any "adviser registered under this title—to maintain such records of, and file with the Commission such reports regarding, private funds advised by the investment adviser, as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council"); *id. (*"An investment adviser registered under this title shall maintain such records of private funds advised by the investment adviser for such period or periods as the Commission, by rule, may prescribe as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.").

[4] Although a more detailed definition of systemic risk will be introduced later, *see infra* Part III, for now it will be useful for the reader to think of systemic risk as the risk that the failure of a given private fund will trigger a chain of failures to other institutions or financial markets.

see or foresee about the systemic risk posed by private equity funds that warranted the increased regulation?

This note argues that, based on the lack of systemic risk posed by private equity funds, the registration of investment advisers to private equity funds is superfluous and unnecessarily costly. Part I defines private equity and compares private equity funds to venture capital and hedge funds. Part II covers the historic exemptions for the registration of private equity funds and advisers, and their forthcoming regulation. Part III weighs the arguments presented in support of regulating private equity funds for systemic risk, and shows why these arguments do not stand up to scrutiny.

I. Private Equity Defined and Compared

A private equity ("PE") fund is a pooled financing vehicle by which investors provide PE issuers with capital in exchange for equity, usually a controlling block, in the issuer.[5] A wide stratum of firms may issue PE for various reasons, but common usage includes: by middle-market private firms and corporate divestitures to either change the ownership or capital structure or to expand operations; by firms in financial distress to effect a turnaround; by firms or management to finance public buyouts; or by public firms who could obtain public equity to finance general operations but choose private equity for confidentiality, convenience, or other reasons.[6] Because PE is an expensive form of financing, PE issuers are most often risky firms unable to get financing from other sources, such as public equity or debt.[7]

Institutions are the biggest investors in private equity,[8] partly because of their ability to withstand high risk, and partly because of exemptions from SEC-registration that have been available to funds with a small number of investors, as discussed in the next section. These institutions include endowments, foundations, bank holding

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[5] Although venture capital, discussed later on, is also a form of private equity, the use of the term "private equity" in this note is reserved for non-venture private equity.

[6] George W. Fenn, Nellie Liang, & Stephen Prowse, *The Private Equity Market: An Overview*, 6 *FINANCIAL MARKETS, INSTITUTIONS, AND INSTRUMENTS* 28 (1997).

[7] *Id.* at 27.

[8] Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 289 (2010).

companies, insurance companies, and investment banks, although wealthy families and individuals are also common investors.[9] PE Investors rarely invest directly in issuers, relying instead on financial intermediaries such as investment advisers or fund managers. In addition to performing fund formation activities, PE fund managers specialize in conducting due diligence to understand the business of each issuer, and often use their expertise to guide the issuer's management.[10]

Venture capital is a subset of PE, and the key difference between the two types of funds lies in their investment focus. Whereas venture capital funds generally invest in companies that are in the early stages of development, other PE funds invest in companies along all stages of a company's life-cycle. Consequently, venture capital managers tend to offer expertise in early-stage growth development. In most other respects, however, PE funds and venture capital funds are not so different. The goal of both types of funds is to develop the target company either for its initial public offering or for acquisition, hence the investment horizons in these funds commit investors to long lock-up periods.[11] Both types of funds are typically only funded by equity, meaning that they employ no leverage at the fund level.[12]

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[9] Bank holding companies will soon be required to limit their investments in private equity, venture capital, and hedge funds pursuant to the Volcker Rule enacted under the Dodd-Frank Act. Dodd-Frank Act, *supra* note 3, at § 619.

[10] Fenn, Liang, & Prowse, *supra* note 7, at 27.

[11] An investment lock-up for venture capital funds may be as long as ten to twelve years, whereas for private equity funds the lock-up may be between seven and nine years. *See Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office*: *Hearing Before the U.S. House Committee on Financial Services*, 111th Cong., 1st Sess. 3 (2009) (testimony of Mr. Terry McGuire, Chairman of the National Venture Capital Association); Ann-Kristin Achleitner & Christoph Kaserer, *Private Equity Funds and Hedge Funds: A Primer* 6-7 (Center for Entrepreneurial and Financial Studies, Working Paper, 2005) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1109100.

[12] FSOC Comment Letter from Douglas Lowenstein, President, Private Equity Growth Capital Council ("PEGCC") to Timothy F. Geinther, Chairman, Financial Stability Oversight Council 7 (Nov. 5, 2010) *available at* http://www.pegcc.org/wordpress/wp-content/uploads/PEGCC-FSOC-Systemic-Risk-Comment-Letter.pdf [Hereinafter PEGCC Comment Letter].

PE funds also share some common characteristics with hedge funds. In fact, the generally-accepted definition of a hedge-fund, "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public,"[13] could just as well describe a PE or a venture capital fund. However, PE funds and hedge funds differ in a few crucial respects. First, hedge funds employ shorter-term investment strategies relying primarily on liquid securities investments, "including stocks, bonds, currencies, futures, options, other derivatives, and physical commodities," with some investment strategies focused on long-term growth, others on active trading, while still others on shorting.[14] These investment strategies often necessitate the use of counterparties for derivatives positions and lenders to allow for leveraging returns. Another key difference between the two types of funds is that PE funds use a longer investment horizon than hedge funds; PE funds typically bind their investors for seven to nine years, whereas hedge funds often allow investors to redeem their money monthly or quarterly.[15]

However, the line between PE and hedge funds is not always clearly demarcated. Sometimes, the activities of the two overlap, as when hedge-fund-of-funds invest in PE funds, or when hedge funds buy junk bonds that PE funds issue.[16] In addition, sometimes hedge

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Some of the target companies in which PE funds invest have access to debt financing, whereas the startup companies in which venture capital funds invest generally do not have access to debt financing. However, it is important not to confuse the use of leverage at the fund level with the use of leverage by the target companies in which the fund invests.

[13] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999), *available at* www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

[14] *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, 6-8 (2009) (Testimony of James Chanos, Chairman, Coalition of Private Investment Companies) [Hereinafter Chanos Testimony]. For more on various hedge fund investment strategies and the relative size of each, see Wouter Van Eechoud et al., *Future Regulation of Hedge Funds—A Systemic Risk Perspective* 269 N.Y.U. SALOMON CTR. & WILEY PERIODICALS, appendix 2 (2010).

[15] Achleitner & Kaserer, *supra* note 12, at 6-7.

[16] *Id.* at 4.

funds that acquire a large equity stake in a company can become "activists" and have the ability to influence the management's decisions much like PE fund managers.[17] Recently, hedge funds have been blurring the line even more by investing directly in private equity and "getting into the lending business, providing capital to startups and even financing more exotic ventures such as Hollywood movies." [18] Moreover, since private-equity type investments generally have longer time horizons, hedge funds have been increasing the lock-in period to allow for ventures to become profitable before investors in the fund are allowed to redeem their shares.[19]

II. Regulation of Private Pools of Capital

Before the Dodd-Frank Act, there was little supervision of PE funds. Whereas hedge funds had undergone a brush with regulation in 2006, PE funds at the time were not of concern, and indeed were explicitly excluded from such regulation. However, private equity did come within the sweeping financial reform of the Dodd-Frank Act. Section A of this part explains the regulation of private funds prior to Dodd-Frank; Section B reviews the Commission's past attempt at regulating hedge funds; Section C discusses the bills and proposals to regulate private funds leading up to the Dodd-Frank reforms; and Section D introduces the Commission's rule proposals to enact the Dodd-Frank Act reforms.

A. Private Investment Funds Regulatory History

Private investment funds, along with their investment advisers and the securities they issue, were historically exempt from registering with the Commission.[20] While these exemptions are

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[17] Chanos Testimony, *supra* note 15, at 6.

[18] Matthew Goldstein, *Hedge Funds Jump Into Private Equity*, BUS WK., Feb. 26, 2007, *available at* http://www.businessweek.com/print/magazine/content/07_09/b4023048.htm?chan=gl.

[19] *Id.*

[20] Although private funds advisers may elect to register with the Commission, most have not done so because of the costs and disclosures that registration requires to be made to the Commission and the public. For example, investment advisers registering under the IA Act must provide information about their funds, clients and the fund's investment strategies;

connected, it is best to view them on three separate levels—the investment adviser to the fund must be exempt, the fund itself must be exempt, and the securities that the fund issues must also be exempt. The Investment Advisers Act of 1940 ("IA Act") requires any person falling within the definition of an investment adviser to register with the Commission.[21] Hence, absent an express exemption from registration, advisers to private funds would need to register with the SEC. The "private adviser" exemption is found in section 203(b)(3) for investment advisers who in the past year have had fewer than fifteen clients, who do not hold themselves out to the public as investment advisers, and who do not advise any registered investment companies.[22] Under this exemption, private investment advisers can manage up to fourteen funds, where each limited partnership is counted as one "client."[23]

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maintain books and records; undergo inspections by SEC staff; hire a compliance officer to keep up administer policies and procedures; adopt a code of ethics; and implement proxy voting policies. *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Testimony Before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, 6 (2009) (testimony of Richard H. Baker, President and CEO, Managed Funds Association).

[21] An "investment adviser" is "any person, who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Investment Advisers Act § 202(a)(11), codified as 15 U.S.C.S. § 80(b)-2(a)(11) (2006). The registration requirement for investment advisers is contained in § 203(a), as codified in 15 U.S.C.S. § 80(b)-3(a) (2006) ("Except as provided in subsection (b) and section 203A [15 USCS § 80b-3a], it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.").

[22] "Any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election." 15 U.S.C.S. § 80(b)-3(b)(3) (2006).

[23] 17 C.F.R. § 275.203(b)(3)-1(a)(2) (2008).

Investment companies are generally registered pursuant to section 3(a) of the Investment Company Act of 1940 ("ICA"), which mandates SEC-registration for any issuer which "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities."[24] Private investment funds can be exempt from such registration either under 3(c)(1) of the ICA, because they have no more than one hundred beneficial owners and do not offer their securities to the public, or under the 3(c)(7) exemption, because their investors are all 'qualified purchasers'[25]—individuals and family entities with not less than $5 million in investments, or institutions with not less than $25 million in investments.[26] PE funds, along with venture capital and hedge funds, generally fall under one of these exemptions.

Finally, under section 5 of the Securities Act of 1933, persons are prohibited from selling or offering to sell unregistered securities,[27] and the shares issued to investors of private investment funds qualify as such securities. However, private funds' securities generally fall outside this registration requirement because these securities are placed with investors through private offering under section 4(2) of the Securities Act.[28] Regulation D provides a safe harbor within section 4(2) for sales to not more than 35 non-accredited investors, and unlimited number of accredited investors, defined as individuals with net worth in excess of $1 million or income in excess of $200,000 or $300,000 with spouse, and most other entities having total assets in excess of $5 million.[29]

Despite being exempt from registering with the SEC, private fund advisers are nonetheless subject to securities laws meant to protect investors. For example, antifraud provisions protect investors and potential investors from fraud, deceit, or manipulation by investment advisers, regardless of whether they are registered or

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[24] 15 U. S. C. S. § 80a-3(a)(1)(A) (2006). The registration requirements for qualifying investment companies are contained in section 8(a) of the Investment Company Act, codified as 15 U.S.C.S. § 80a-8 (2006).
[25] *Id.* at § 77r(b)(3).
[26] *Id.* at § 80a-2(a)(51).
[27] *Id.* at § 77e.
[28] *See id.* at § 80a-3(c)(1), § 80a-3(c)(7)(A).
[29] 17 C.F.R. § 230.501 (2008). The Dodd-Frank Act changed the method by which an individual's net worth is calculated to exclude the value of the individual's primary residence. Dodd-Frank Act, *supra* note 3, at § 413.

not.[30] In addition, regardless of their registration status, private funds that acquire more than a 5% ownership stake in a publicly traded company must disclose this position under the Williams Act.[31]

B. The Commission Takes Charge

In the fall of 1998, the Federal Reserve Bank of New York rescued the hedge fund Long-Term Capital Management ("LTCM") by arranging for its bailout and recapitalization with an injection of $3.6 billion in capital from a consortium of banks.[32] LTCM employed multiple complex financial models, and its reputation afforded it many counterparties eager to provide easy credit—including several Wall Street banks.[33] This credit was used by LTCM to pursue a bond arbitrage strategy involving US Treasury bonds, Russian bonds, and Mexican bonds. As we have seen so often in the last few years, LTCM's complex quantitative models failed because they failed to account for the possibility of systemic risk, and when Russia defaulted on its debt, the Federal Reserve Bank of New York stepped in to avoid a potential widespread impact of LTCM's collapse.[34]

Following the LTCM debacle, The President's Working Group on Financial Markets, which consists of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the SEC and the Commodity Futures Trading Commission, issued a report with recommendations to prevent a similar failure in the future, but did not recommend for hedge funds to register with the Commission.[35] In 2004, the Commission took unilateral action and adopted a new rule that required investment advisers to hedge funds to register with the Commission (the "Hedge Fund Rule"), by reinterpreting the definition of a "client" under the 203(b)(3)

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[30] 17 C.F.R. § 275.206(4)-(8) (2008).

[31] 15 U.S.C.S § 78n(d)(1) (2006).

[32] Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part I)*, 104 NW. U. L. REV. COLLOQUY 398, 404 (2010).

[33] These included Merrill Lynch, Bears Sterns, and The Bank of Switzerland, among others. *Long-Term Capital Management: An Introduction*, *available at* http://picker.typepad.com/bailouts/2009/02/longterm-capital-management-an-introduction.html.

[34] Arewa, *supra* note 33, at 406.

[35] *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, *supra* note 14, at 12-14.

exemption.[36] Although the D.C. Circuit Court of Appeals later invalidated the rule in *Goldstein v. S.E.C.*, the Hedge Fund Rule provides valuable insight as to the Commission's perceived risk of PE funds.[37]

In enacting the Hedge Fund Rule, the Commission was concerned with tailoring the definition of affected entities so as to exclude private equity and venture capital funds from regulation.[38] The Commission reasoned that only hedge funds would be subject to the registration requirement if it limited the rule to private funds that take advantage of exemption 3(c)(1) or 3(c)(7) of the ICA, prohibit investment redemption within two years (the "lock-up period"), and sell interests in the fund based on "the investment advisory skills, ability or expertise of the investment adviser."[39] Though these three characteristics of hedge funds appear to distinguish them from PE funds in theory, in practice the distinction between hedge funds and PE funds on these three characteristics is often blurred. PE and venture capital funds, not just hedge funds, take advantage of the 3(c)(1) and 3(c)(7) exemptions of the ICA. Though lock-up periods for PE and venture capital funds may be as high as twelve years, many hedge funds pursue longer investment horizons and require lock-up longer than two years, and many others changed the lock-up period so as to avoid registration under the Hedge Fund Rule.[40] And finally, though hedge funds might tout their managers' absolute-return investment skills, while PE funds might tout their managers'

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[36] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed.Reg. 72054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) [hereinafter Hedge Fund Rule].

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

[38] Hedge Fund Rule, *supra* note 37, at 72073 ("We proposed to define a "private fund" by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds.").

[39] *Id.* at 72074-75. On the last point, the Commission elaborated: "hedge fund advisers often emphasize the portfolio manager's record when marketing their fund, and provide prospective investors with information about the adviser and individual manager. This reliance by hedge fund investors implicates the need for the protections that Advisers Act registration offers." *Id.* at 72075.

[40] Paul S. Atkins, Commissioner U.S. Securities and Exchange Commission, Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference (Aug. 2, 2007), *available at* http://www.sec.gov/news/speech/2007/spch080207psa.htm.

ability to provide better due diligence and management guidance to PE issuers, both types of private funds rely on the 'investment advisory skills, ability or expertise' of the fund managers.

Since the lines between hedge funds and private equity funds are blurred, why did the Commission go through such lengths to regulate only the former? Certainly, the benefits proffered by the Commission would be beneficial to investors in PE or venture capital funds by potentially deterring fraud, curtailing losses, screening advisers with disciplinary records, providing investors with more disclosure, and instituting better compliance controls.[41] From the Hedge Fund Rule release it appears that the Commission was simply not concerned with fraud conducted by PE funds the way that it was concerned with hedge fund fraud prevalent at the time.[42] In addition, the Commission was concerned about stretching its limited resources too thin—it did not want to bite off more than it could chew—and so it allocated its resources to address the most pressing problems first.[43]

Spreading the SEC too thin was certainly one of the reasons why Commissioner Atkins voted against passing the Hedge Fund Rule.[44] His opinion was that investors in hedge funds, as opposed to retail investors, were able to look out for themselves or else bear a

[41] Hedge Fund Rule, *supra* note 37, at 72078-79. The Commission also lists the prevention of fraud on investors in mutual funds as a benefit, but because this is not a direct benefit to investors in private funds (arguably, they would be better off under such fraud), it was not included in this list. Also included was the benefit to regulatory policy from the Commission's gathering of better data about hedge fund advisers, and the 'equal playing field' for hedge fund managers.

[42] *Id.* at 72074 ("[T]he Commission has not encountered significant enforcement problems with advisers with respect to their management of private equity or venture capital funds. In contrast, the Commission has developed a substantial record of frauds associated with hedge funds. A key element of hedge fund advisers' fraud in most of our recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors, which in some cases was used to induce a false sense of security for investors when they might otherwise have exercised their redemption rights.").

[43] *Id.* ("Because hedge funds are where we have seen a recent growth in fraud enforcement actions, we will focus our examination resources on their advisers, rather than on advisers to private equity or venture capital funds, at this time.").

[44] Atkins, *supra* note 41.

loss, without protection from the Commission.[45] Dissenting Commissioners Atkins and Glassman viewed the majority Commissioners' support for the Hedge Fund Rule as being motivated merely by recent growth in the hedge fund industry, rather than by a disproportionate number of frauds, as the Majority claimed.[46] They favored the market-based approach that had been advocated by the President's Working Group in 2007:

> Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.[47]

Following the *Goldstein* decision, the Commission passed an Antifraud Rule aimed for advisers to pooled investment vehicles[48] and did not attempt to regulate hedge funds, or any other private pool of investment capital thereafter until the passage of the Dodd-Frank Act.

C. Leading Up To The Dodd-Frank Act

In 2009, lawmakers advanced several proposals to register private investment funds with the SEC, some proposals aimed only at hedge funds,[49] while others aimed at all forms of private funds

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[45] *Id.*

[46] Registration Under the Adviser's Act of Certain Hedge Fund Advisors; Proposed Rule, 69 Fed. Reg. 45172, 45197 (proposed July 28, 2004).

[47] AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL 1 (2007), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp272.aspx.

[48] 17 C.F.R. § 275.206(4)-(8) (2008).

[49] Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009).

meeting a certain threshold.[50,51] Senator Jack Reed (D-RI) advanced the most aggressive proposal, the Private Fund Transparency Act of 2009, which required the registration of all private investment funds, regardless of size, by eliminating the private adviser exemption in section 203(b)(3).[52]

On October 15, 2009, less than a week after a hearing before the House Financial Service Committee on the oversight of private pools of capital, former Representative Paul Kanjorski (D-PA) introduced the private fund bill that would eventually be incorporated into the Dodd-Frank Act. The Private Fund Investment Advisers Registration Act of 2009 would eliminate the private adviser exemption contained in section 203(b)(3) of the IA Act,[53] but would provide an exemption from registration to advisers to venture capital funds.[54] The bill would also amend rule 204 on reporting to require

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[50] DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 12 (2009), *available at* www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.

[51] For a more detailed analysis of the various proposals, see Robert G. Frucht & Tasneem S. Novak, *No Direction: The Obama Administration's Financial Reform Proposal and Pending Legislation Proposing the Registration and Further Regulation of Hedge Funds and Private Pools of Equity are Overbroad and Fail to Address the Actual Risks That These Funds Pose to the Financial System*, 29 REV. BANKING & FIN. L. 157 (2009).

[52] Private Fund Transparency Act of 2009, S. 1276, 111th Cong. § 3 (2009).

[53] Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. § 3 (eliminating the private adviser exemption).

[54] *Id.* § 6 ("The Commission shall identify and define the term 'venture capital fund' and shall provide an adviser to such a fund an exemption from the registration requirements under this section. The Commission shall require such advisers to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors. The exemption appears to be motivated by the lack of systemic risk posed by venture capital funds: venture capital funds "do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone. Terry McGuire, Chairman of the National Venture Capital Association, wrote in congressional testimony that 'venture capital

registered investment advisers to report to the Commission information in order to facilitate the Commission in monitoring systemic risk, including:

> (A) the amount of assets under management;
> (B) the use of leverage (including off-balance sheet leverage);
> (C) counterparty credit risk exposures;
> (D) trading and investment positions;
> (E) trading practices; and
> (F) such other information as the Commission, in consultation with the Board of Governors of the Federal Reserve System, determines necessary . . . for the protection of investors or for the assessment of systemic risk.[55]

In addition to filing such reports with the Commission, registered investment advisers would be required to provide any portion of such reports to the fund's "investors, prospective investors, counterparties, and creditors" as the Commission deemed "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk" ("counterparty disclosures").[56] The Commission would be authorized to classify and prescribe different requirements to funds based on size, scope, business model, compensation scheme, or the potential to create or increase systemic risk.[57]

Former Representative Kanjorski's bill underwent several revisions before being incorporated into the Dodd-Frank Act.[58] The House of Representatives passed a version of Representative Kanjorski's bill on December 11, 2009, with the following amendments: eliminating the counterparty disclosure provisions and protecting the release of proprietary information;[59] providing an

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did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors.'").

[55] H.R. 3818 § 4.

[56] *Id.*

[57] *Id.* § 7.

[58] *Compare* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §§ 5001-11 (2009)

[59] H.R. 4173 § 5004 ("The Commission may not compel the private fund to disclose such proprietary information to counterparties and creditors. For purposes of this section, proprietary information shall include sensitive, non-public information regarding the investment adviser's investment or

exemption from registration and a reporting requirement for investment advisers to private funds with less than $150,000,000 assets under management (the "small adviser exemption");[60] and providing for a GAO study to assess the costs on industry members and investors to register and provide ongoing reporting requirements as provided by the Act.[61]

The Senate passed an amended version of the Act on May 20, 2010.[62] That version required registered investment advisers to file more information with the Commission,[63] eliminated the small adviser exemption, and added an exemption for registration to investment advisers of private equity funds.[64] The Senate explained

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trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the Commission determines to be proprietary.").

[60] *Id*. § 5007 (modifying section 203 of the Investment Advisers Act, by requiring certain exempt investment advisers to "maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors").

[61] *Id*. § 5009 (requiring a GAO Study).

[62] Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010) §§ 401-16

[63] In addition to the list contained in the Kanjorski bill, the May 20 version also required reporting of "valuation policies and practices of the funds; types of assets held; [and] side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors." *Id.* § 404. Other information that may need to be collected would be monitored by the Commission in consultation with the Council ("such other information as the Commission, in consultation with the Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised.") *Id.*

[64] *Id.* § 408 ("Exemption of and Reporting by Private Equity Fund Advisers, – (1) . . . Except as provided in this subsection, no investment adviser shall be subject to the registration or reporting requirements of this title with respect to the provision of investment advice relating to a private equity fund or funds. (2) . . . Not later than 6 months after the date of enactment of this subsection, the Commission shall issue final rules – (A) to require investment advisers described in paragraph (1) to maintain such records and provide to the Commission such annual or other reports as the Commission taking into account fund size, governance, investment strategy, risk, and

its rationale for providing an exemption to private equity advisers as follows:

> The Committee believes that private equity funds characterized by long-term equity investments in operating businesses do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Private equity investments are characterized by long-term commitments of equity capital—investors generally do not have redemption rights that could force the funds into disorderly liquidations of their positions. Private equity funds use limited or no leverage at the fund level, which means that their activities do not pose risks to the wider markets through credit or counterparty relationships. Accordingly, Section 408 directs the SEC to define "private equity fund" and provides an exemption from registration for advisers to private equity funds.
>
> Informed observers believe that in some cases the line between hedge funds and private equity may not be clear, and that the activities of the two types of funds may overlap. We expect the SEC to define the term "private equity fund" in a way to exclude firms that call themselves "private equity" but engage in activities that either raise significant potential systemic risk concerns or are more characteristic of traditional hedge funds. The section requires advisers to private equity funds to maintain such records, and provide to the SEC such annual or other reports, as the SEC determines necessary and appropriate in the public interest and for the protection of investors.[65]

The May 20 version also added the following sections: section 409, exempting family offices from registration with the Commission; section 410, modifying the registration threshold with the Commission, rather than the state in which the adviser maintains

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other factors, as the Commission determines necessary and appropriate in the public interest and for the protection of investors; (B) to define the term 'private equity fund.'"

[65] S. REP. NO. 111-176, 75 (2010).

its principal office, from $25 million to $100 million; section 411, providing for the custody of client assets; section 412, adjusting the accredited investor standard to a net worth of $1,000,000, excluding the individual's primary residence; and other sections providing for several studies by the Commission and the GAO.[66]

The Dodd-Frank Act, however, does not contain a registration exemption for investment advisers to PE funds. Instead, it incorporates part of the Reed Amendment to register advisers to PE funds. Senator Reed offered up contradictory reasoning for this amendment, saying that as "[h]edge funds, private equity, and venture capital fund[s'] . . . role has grown so have the risks they pose,"[67] while at the same time admitting that there is "no reliable data on the number and nature of these firms or ability to calculate the risks they pose to America's broader economy."[68] He also expressed concern that "advisers who today are managing hedge funds could tomorrow be operating a private equity or venture capital fund in order to avoid registration."[69] As discussed *supra* in Part I, there is a blurring of the line between hedge funds and private equity funds, but Senator Reed did not explain why registering investment advisers to PE funds was preferable to preventing hedge funds from investing in private-equity-type investments, or even more basically why hedge funds no longer operating as hedge funds still posed a systemic risk.[70]

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[66] Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. §§ 409-412 (2010).

[67] Press Release, Reed Offers Amendment to Strengthen Rules on Managers of Hedge Funds, Private Equity Funds, and Venture Capital Funds (May 10, 2010) (*available at* http://reed.senate.gov/newsroom/details.cfm?id=324807) (quoting Senator Reed) (internal citations omitted).

[68] *Id*.

[69] *Id.*

[70] Moreover, as the Senate Committee Report initially suggested, there is no reason why the line between hedge funds and private equity could not simply be demarcated by clearly defining each fund type. S. REP. NO. 111-176, 75 (2010) ("Informed observers believe that in some cases the line between hedge funds and private equity may not be clear, and that the activities of the two types of funds may overlap. We expect the SEC to define the term 'private equity fund' in a way to exclude firms that call themselves '"private equity' but engage in activities that either raise significant potential systemic risk concerns or are more characteristic of traditional hedge funds.")

In addition to removing the private adviser exemption, the Dodd-Frank Act amends section 203(b) of the IA Act to add a registration exemption for investment advisers who qualify as foreign investment advisers, those registered with the Commodity Futures Trading Commission as a commodity trading adviser, or those who only advise small business investment companies.[71] The Act also tasks the Commission with exempting investment advisers to private funds with assets under management less than $150,000,000 and determining appropriate records and reports for them to keep.[72] Investment advisers who do not fall within one of the section 203 exemptions must register with the Commission and maintain records and file reports as the Commission may require "for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council," and may be subject to periodic inspections and examinations by the Commission.[73]

Other reforms include an exemption from registration for investment advisers to family offices,[74] clarification of the threshold between registration with the SEC or with the appropriate state regulator,[75] a new custody rule[76] and a new definition of the meaning of an individual "accredited investor" as one having a net worth of $1,000,000, exclusive of one's primary residence.[77]

D. Implementation of the Dodd-Frank Act

Following its mandate, the Commission issued proposed rules on November 19, 2010 and January 26, 2011 to implement

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[71] Dodd-Frank Act, *supra* note 3, at § 403.
[72] *Id.* § 408 ("Registration and Examination of Mid-Sized Private Fund Advisers. – In prescribing regulations to carry out the requirements of this section with respect to investment advisers acting as investment advisers to mid-sized private funds, the Commission shall take into account the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.'')
[73] *Id.* § 404(2). *See supra* note 64 and related text for the required records to be maintained.
[74] *Id.* § 409(b)
[75] *Id.* § 410.
[76] *Id.* § 411.
[77] *Id.* § 413.

provisions of Title IV under the Dodd-Frank Act.[78] The proposals modify Form ADV to gather information on private funds, propose a new rule to gather systemic risk information about these funds for use by the Financial Stability Oversight Council ("FSOC"), and define and exempt from registration venture capital funds and certain other funds.

The proposals contained in Release IA-3110 modify Form ADV to gather more information about both registered and exempt advisers to private funds.[79] This form is the main data collection mechanism the SEC uses to oversee investment advisers; it helps the Commission to "[A]llocate [its] examination resources based on the risks [they] discern or the identification of common business actives-ties from information provided by advisers. The information is used to create risk profiles of investment advisers . . . . [and] better understand the investment advisory industry and evaluate the implications of policy choices."[80] Information gathered on Form ADV is made publicly available by the Commission.[81]

Several of the amendments to Form ADV would apply to both registered and unregistered investment advisers to private funds.[82] Amended Item 7B, for example, would require these investment advisers to disclose "basic organizational, operational and investment characteristics of the fund; the amount of assets held by the fund; the nature of the investors in the fund; and the fund's

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[78] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3110 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3111 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3111.pdf; Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3145 (Jan. 26, 2011), *available at* http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.

[79] Release No. IA-3110, *supra* note 79, at 14-15.

[80] Release No. IA-3110, *supra* note 79, at 47. The proposals were open for public comment until January 24, 2011.

[81] *Id.* at 56.

[82] *Id.* at 49. The Dodd-Frank Act defines a "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act." Dodd-Frank Act, *supra* note 3, at § 402.

service providers."[83] The service providers include the five categories of those who act as "gatekeepers" for the fund: "auditors, prime brokers, custodians, administrators and marketers."[84] Amendments to items 6 and 7 would gather more information about financial services provided by either the adviser or related parties in order to identify advisers' affiliated financial services providers and potential conflicts of interest.[85] Advisers would need to identify whether they or their related parties engage in business as a "trust company, registered municipal advisor, registered security-based swap dealer, and major security-based swap participant," or are "accountants (or accounting firms) and lawyers (or law firms)" or whether they are "a sponsor or the general partner or managing member of a pooled investment vehicle."[86]

In contrast, Release IA-3110 proposes other amendments to Form ADV that would only need to be completed by registered investment advisers. Item 5 of the form, which currently collects information about advisers' business and clients, would be expanded to gather information about the number of the adviser's employees; the type of clients, and assets under management for each; the type of services investment advisers offer; and the types of investments on which they advise.[87] Item 8, which currently gathers information about investment advisers' transactions and asks about whether the adviser determines or recommends the broker or dealer for a client's transaction, would also ask whether such a broker or dealer is related to the adviser.[88] Expanded item 8 would also gather information about whether advisers' soft-dollar arrangements fall within the safe harbor of the Securities Exchange Act of 1934, and whether the adviser or a related person receives compensation for client referrals.[89]

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[83] Release No. IA-3110, *supra* note 79, at 51.
[84] *Id.* at 54.
[85] *Id.* at 60.
[86] *Id.*
[87] *Id.* at 57-59.
[88] *Id.* at 62.
[89] *Id.* at 62-63. "Soft dollar arrangements" are defined as "arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer." U.S. SEC. & EXCH. COMM'N, COMPLIANCE, INSPECTIONS AND EXAMINATIONS, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998)

Pursuant to section 404 of the Dodd-Frank Act, the Commission and the Commodities Futures Trading Commission jointly issued Release IA-3145 to propose rule 204(b)-1, which would gather information on a new form, Form PF, about private funds' systemic risk for use by the FSOC. [90] Only SEC-registered investment advisers that advise one or more private funds would need to complete this form,[91] and information contained therein would not be made public.[92] The amount of information that would need to be disclosed on this form correlates with riskiness. Proposed rule 204(b)-1 assumes that large private funds, defined as those with $1 billion or more in aggregate assets under management, pose more systemic risk than smaller private funds.[93] Likewise, rule 204(b)-1 assumes that hedge funds and liquidity funds pose more systemic risk than private equity funds, so more information is required to be disclosed on Form PF by the former.[94] The release specifies that Form PF is the floor, not the ceiling, for information gathered about private funds; the FSOC may direct the Office of Financial Research to collect more information on any nonbank financial company to better assess systemic threats.[95]

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available at http://www.sec.gov/news/studies/softdolr.htm#FOOTBODY_7 (citing Disclosure by Investment Advisers Regarding Soft Dollar Practices, Advisers Act Release No. 1469 (Feb. 14, 1995)).

[90] Release No. IA-3145, *supra* note 79, at 14.

[91] *Id.*

[92] *Id.* at 15, n. 39.

[93] *Id.* at 18-19, 32.

[94] *Id.* at 19. Form PF defines "hedge fund" as "any private fund that (1) has a performance fee or allocation calculated by taking into account unrealized gains; (2) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (3) may sell securities or other assets short." It defines "liquidity fund" as "any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors." And it defines "Private equity fund" as "any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course." *Id.* at 29. Although the release states that PE poses less risk than certain other types of private funds, it cites the use of leverage and investment in systemically important entities as the source of systemic risk posed by PE funds. *Id.* at 24-26.

[95] *Id.* at 16.

All private fund investment advisers would need to complete Sections 1a and 1b of Form PF. This section requires identifying information about the adviser and its related persons.[96] It also requires information about the funds under management, such as each fund's assets, the funds' borrowing activities, its investment value in derivatives, its investors and their relative holdings, and its performance.[97] Release IA-3145 states that the FSOC would use this information to track risk activities and correlation between funds and market performance,[98] but it does not explain how this would be done.

Only particular funds would need to complete other sections of Form PF. Only investment advisers to private equity funds managing more than $1 billion would need to complete section 4 of Form PF. This section requires information about the fund's borrowings, guarantees, and leverage so that the FSOC can assess the leverage used by large PE firms and the exposure of lenders to private equity.[99] All investment advisers to hedge funds, regardless of the hedge funds' size, would need to complete section 1c, which requires information about their investment strategies, use of "computer-driven trading algorithms," trading practices, and "significant trading counterparty exposures."[100] Hedge funds with aggregate assets of at least $1 billion would need to also complete section 2, which requires more specific information about the fund's

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[96] *Id.* at 43-44.

[97] *Id.* at 44-45.

[98] *Id.* at 45.

[99] *Id.* at 58-59. Specifically, this section would require information about: "the outstanding balance of the fund's borrowings and guarantees;" "the weighted average debt-to-equity ratio of controlled portfolio companies in which the fund invests and the range of that debt to equity ratio among these portfolio companies;" "the maturity profile of its portfolio companies' debt, for the portion of that debt that is payment-in-kind or zero coupon, and whether the fund or any of its portfolio companies experienced an event of default on any of its debt during the reporting period;" and "the identity of the institutions providing bridge financing to the adviser's portfolio companies and the amount of that financing." *Id.*

[100] *Id.* at 45-46. The release specifies that "proposed questions 19 and 20 on Form PF would require the adviser to identify the five trading counterparties to which the fund has the greatest net counterparty credit exposure (measured as a percentage of the fund's net asset value) and that have the greatest net counterparty credit exposure to the fund (measured in U.S. dollars)." *Id.* at 45 n.116.

holdings so that the FSOC can track hedge funds' exposure and liquidity in various asset classes.[101] This section requires additional information about any qualifying hedge fund with assets of $500 million or more that is advised by a large hedge fund adviser.[102] Investment advisers "managing at least $1 billion in combined liquidity fund and registered money market fund assets" would need to complete section 3 of Form PF.[103]

In Release IA-3111, the SEC proposed new rule 302(l)-1 to define exempt investment advisers who solely advise venture capital funds, [104] and rule 302(m)-1 to exempt investment advisers managing less than $150 million in US private fund assets.[105] This release summarizes the definition of "venture capital fund" as a fund that:

> (i) invests in equity securities of private companies in order to provide operating and business expansion capital. . . and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the

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[101] *Id.* at 47. This information includes the market value of assets broken down by class, "the duration of fixed income portfolio holdings (including asset backed securities), to indicate the assets' interest rate sensitivity . . . ," "the turnover rate of the adviser's aggregate portfolios during the reporting period to provide an indication of the adviser's frequency of trading," and the "geographic breakdown of investments held." *Id.* at 47-48.

[102] *See id.* at 49-52.

[103] *See id.* at 55-58.

[104] *See* IA-3111, *supra* note 79, at 32. Despite being exempt, these advisers would still need to file with the Commission parts of Form ADV. The Commission explains the authority for these filing requirements: "[u]nder section 204(a) of the Advisers Act, the Commission has the authority to examine records, unless the adviser is 'specifically exempted' from the requirement to register pursuant to section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on section 203(l) or 203(m) of the Advisers Act are not 'specifically exempted' from the requirement to register pursuant to section 203(b)." IA-3110, *supra* note 79, at 32 n.113.

[105] For the full text of Rule 203(m)-1, see *id.* at 133-35. As the Commission clarifies, if a single client of an investment adviser to private funds with less than $150 million assets under management has a single client with more than $100 million assets under management, then this adviser would not qualify under the 203(m)-1 exemption. IA-3145, *supra* 79, at 38.

> qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act and has not elected to be treated as a BDC [or business development company].[106]

The proposed definition is fairly narrow, excluding activities that venture capital funds have traditionally engaged in: "[f]or example, the fund will not be able to make debt investments in private companies or private investments in public companies—both of which some venture capital funds have done in the past—as these types of investments would, at a minimum, violate [the criteria in the SEC proposed rule that "a fund . . . must invest only in equity securities of private operating companies who use the investment proceeds primarily for operating or business expansion capital, hold the proceeds in cash, or invest them in short-term U.S. Treasury securities']."[107]

III. Aligning Private Equity Risk with Regulation

Under the Dodd-Frank Act, Congress charges the Commission with writing rules for the purpose of protecting investors and

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[106] IA-3111, *supra* note 79, at 13. For the text of the proposed rule 302(l)-1, see *id.* at 130-33. "A 'business development company'—commonly known as a venture capital company—is defined in 15 USC 80a-2(a)(48) as a 'closed-end company' which operates for the purpose of making investment in certain securities and making 'available significant managerial assistance with respect to the issuers of such securities.'" Goldstein v. Securities and Exchange Commission, 451 F.3d 873, 879 n.4 (D.C. Cir. 2006). As the Commission explains, investment companies qualifying as BDCs are exempt from certain provisions of the IA and IC Act, and that Congress provided these exemptions in 1980 to BDCs rather than venture capital funds in order to "avoid 'semantical disagreements' over what constituted a venture capital or small business company." IA-3111, *supra* note 79, at 12 (citing H. REP. NO. 96-1341, at 22 (1980)).

[107] William K. Sjostrom, Jr., *A Brief History of Hedge Fund Adviser Registration and Its Consequences for Private Equity and Venture Capital Advisers*, 1 HARVARD BUS. L. REV. ONLINE 39, 41 (2011).

assessing systemic risk.[108] Yet in light of the original exemption from regulation, an inevitable question arises: what, if anything, changed about private equity in the past four years so as to warrant concern about its exemption from regulation? After all, there were no failures of private equity funds that caused a systemic disturbance. Requiring regulation to protect investors may be a worthy goal, but the goal is incompatible with the principles of securities laws, which presume that investors in PE funds, who are necessarily wealthy and sophisticated investors, are able to protect themselves without the Commission's intervention.[109] Thus, the SEC's rules under the Dodd-Frank Act may be viewed as superfluous and inefficient to the extent that their purpose is to protect PE investors able to protect themselves.[110] If regulation is needed to protect other investors in the market from systemic risk that may be caused by PE funds, though, such regulation may be justified.[111] This section explains, however, that PE funds do not pose systemic risk concerns. Absent either a need to protect investors or a need to reduce systemic risk associated with private equity, the Dodd-Frank Act's regulation of private equity is unwarranted.

This note adopts the definition of systemic risk as:

> [T]he risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in

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[108] *See* Dodd-Frank Act, *supra* note 3.

[109] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 991 (2006) ("[T]he notion that investors who can 'fend for themselves' do not need SEC protection is an animating principle of securities regulation that helps demarcate the appropriate boundary of SEC regulation across the federal securities laws.").

[110] *See* Vijay Sekhon, *Can the Rich Fend for Themselves? Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010*, 7 HASTINGS BUS. L.J. 1 (2011).

[111] Interestingly, the Commission and other regulators have been concerned with regulating systemic risk for decades, yet did not propose to regulate PE funds until the recent financial crisis. DEPARTMENT OF TREASURY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE & SEC, JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET (Jan. 1992), *available at* http://www.ustreas.gov/offices/domestic-finance/debt-management/gsr92rpt.pdf.

> increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.[112] This definition highlights that systemic risk focuses on 'a chain' of failures or losses. Links on this chain are the connections amongst institutions that cause failures and losses to spread. Andreas Heed divides these links, or as he terms them, "channels of contagion," into four categories: the inter-bank markets that funnel funds from institutions with surpluses to those in need; the payment-system through which institutions settle obligations to one another; the lack of information concerning the assets that institutions hold and whether these are sufficient to cover their obligations; and the psychology of consumers that causes them to lose confidence in one institution if another institution fails.[113]

The use of leverage by institutions relates to the first channel of contagion cited by Heed, inter-bank markets. Lending connects institutions to one another, and the failure of a leveraged institution to repay its obligations causes risk to spread amongst institutions that lent to it. Proponents for the regulation of PE funds often claim that PE funds cause systemic risk by using leverage.[114] However, PE funds barely utilize debt at the fund level.[115] This is a crucial distinction. Where debt is used in PE transactions, it is "taken on by the companies that are acquired, not by the fund itself."[116] Hence,

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[112] Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

[113] Andreas Heed, *The Regulation of Private Equity,* 12 J. OF BANKING REGULATION 24, 37-38 (2010).

[114] *See e.g.* Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 191 (2008) ("[T]he leverage utilized by private equity creates greater individualized corporate and systemic risk.").

[115] "With the exception of certain real estate funds, private equity funds almost never borrow, and frequently they are prohibited by their partnership agreements or other governing documents from borrowing. To our knowledge none are reliant on short-term credit markets or regularly roll-over debt as part of their operations. Private equity funds rarely borrow because of the particular tax concerns of tax-exempt LPs concerning—unrelated business taxable income." PEGCC Comment Letter, *supra* note 13, at 7.

[116] Tim Jenkinson, *Private Equity, in* THE EUROPEAN ECONOMIC ADVISORY GROUP REPORT ON THE EUROPEAN ECONOMY 125 (2009).

PE-backed companies, those in which PE funds invested, are responsible for the debt obligation. If a PE-backed company defaults on its debt, lenders can look only to the assets of the company, not the assets of its equity holders (here, the PE funds' assets or equity in other portfolio companies), for recourse.[117] This is true even in leveraged buyouts, where debt investors contribute approximately 70% of the capital and PE funds acquire approximately 30% of the equity in a shell company that invests in the target company.[118]

The way in which PE-backed companies use leverage is no different from the way in which companies backed by private or public investors use leverage, hence the regulation of PE funds seems disproportionate absent a showing that PE-backed companies are more likely to default on their debt. The Commission justifies this disproportionate regulation of PE funds in part by arguing that if "private equity funds conduct a leveraged buyout of an entity that could be systemically important, information about that investment could be important in FSOC monitoring and assessing potential systemic risk."[119] The Commission relies on the fact that the PE firm Cerberus invested in GMAC and the Chrysler Group, two companies that later required a government bailout.[120] The Commission did not elaborate, however, that Cerberus is a PE firm that typically invests in distressed companies,[121] and that its investments in Chrysler and GMAC was exactly of this sort.[122] Just because two Cerberus-backed

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[117] *Id.* The only exception is that shares in the portfolio company that the PE fund holds may at times secure the borrowing by the portfolio company and hence the lender could claim this asset of the PE fund in the event of the portfolio company's default. PEGCC Comment Letter, *supra* note 13, at 7 n.8.
[118] Heed, *supra* note 113, at 27.
[119] IA-3145, *supra* note 79, at 26.
[120] *Id.* at 26 n. 75.
[121] Casey Ross, *Cerberus' Success Hurt by a Pair of Gambles*, THE BOSTON GLOBE, Mar. 25, 2010.
[122] *See* Tom Krisher, *Cerberus to Pay $7.4B for Chrysler Stake,* USA TODAY, May 14, 2007. ("[DaimlerChrysler] found itself, like competitors Ford and General Motors, battered by rising pension and retiree health costs in the United States as Toyota and other Asian manufacturers won the hearts of U.S. consumers with what many view as more reliable, fuel-efficient models."); Emily Thornton, David Welch, Mara Der Hovanesian, Diane Brady & Dean Foust, *Cerberus To KKR: Eat Our Dust*, BUSINESSWEEK, Apr. 24, 2006 ("'GM, whose own rating had sunk to junk level, badly

companies required bailouts does not necessarily mean that PE-backed companies as a whole are riskier. For all we know, Cerberus's investment could have just delayed an inevitable bailout of GMAC and Chrysler. We could even draw the opposite conclusion—that by investing in distressed companies and successfully turning them around, Cerberus could have actually *prevented* the bailout of companies that otherwise would have been bailed out by the government. This is impossible to determine either way without empirical research that specifically compares the default rate of PE-backed companies and non-PE-backed companies.[123] What is certain is that PE-backed companies are, "like their sector peers, already subject to sector specific rules regarding capital requirements and prudential equity ratio," and it is unclear that PE-backed companies require more supervision to reduce a generic systemic risk associated with the use of leverage.[124]

When lenders to PE-backed firms issue such debt they *do* pose systemic risk to the financial system, but information asymmetries about the lender's other investments dictate that it is only sensible for the lender, and not the borrower, to regulate its exposure in the private equity market. Heed argues that there are "three key issues that may serve as a trigger for a systemic crisis in private equity,"[125] yet all three of these issues focus on the lenders and not the funds themselves. First is the existence of 'Warehouse Risk' by which lenders could lose the value of their investment due to "a change in market conditions [that makes] it difficult to repackage and/or distribute a block of debt at previously expected prices."[126] Second is the acceptance by some lenders of payment-in-

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wanted GMAC to get its own, higher, rating' by selling the GMAC division to a bank, but banks were not interested because GMAC was 'too risky.'").

[123] My research did not reveal any empirical studies that have attempted to make such a comparison. The Commission certainly does not cite such a study as a basis for its proposed regulation in Release IA-3145.

[124] EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION, PRIVATE EQUITY: LEVERAGE AND INVESTMENT POLICY AT PORTFOLIO COMPANY LEVEL (March 5, 2010), *available at* http://www.evca.eu/BTF/leverage_and_investment_policy_at_portfolio_company_level_final.pdf.

[125] Heed, *supra* note 113, at 38.

[126] *Id.* (quoting COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, PRIVATE EQUITY AND LEVERAGED FINANCE MARKETS 15-16 (2008), *available at* www.bis.org/publ/cgfs30.pdf). Warehouse Risk could arise either by the downturn of market conditions between the time a bank commits to underwrite debt and the time the bank distributes it, or from the failure of a

kind notes rather than cash payments for the repayment of accrued interest on outstanding investments. Stated more simply, it is the situation by which lenders allowed PE-backed companies to "pay for debt by issuing new debt."[127] And third is the "originate to distribute (OTD) model" by which lenders issue debt for resale, rather than for holding.[128] This model may cause lenders to mistakenly believe that they have less exposure to a given asset class than they actually have.

The three systemic risk triggers that Heed points to are not only generated by lenders, but can also be reduced or eliminated by regulating lenders. For example, shortening the time period between when lenders commit to issue debt and when they actually distribute it could reduce Warehouse Risk.[129] Even if the Warehouse Risk cannot be entirely eliminated, the systemic effects of borrowers' defaults could be minimized by requiring lenders to hold more capital in reserve to guard against the risk that a borrower's default will cause the lender to collapse.[130] Dealing with the payment-in-kind notes is even easier—lenders could just be forbidden from accepting them in lieu of cash payment. Alternatively, lenders' acceptance of payment-in-kind notes could be limited only to borrowers that "maintain certain financial ration (for example total debt to EBITDA)."[131] Finally, the risk associated with the OTD model could be reduced by requiring lenders to keep 'more skin in the game' for loans they originate, or by instituting better control of counterparty risk exposure.

In proposing rules to regulate PE investment advisers per its mandate under the Dodd-Frank Act, the SEC adopts a disclosure model for PE funds that rests in part on the use of leverage by PE-backed companies.[132] Yet requiring PE investment advisers to answer

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securitization vehicle that is unable to pay off its line of credit at a bank, forcing the bank to use the vehicle's leveraged loans as collateral. *Id.* at 38-39.

[127] *Id.* at 40.

[128] *Id.*

[129] *Id* at 39.

[130] Heed even suggests that such reserve requirements could be "calibrated in relation to alternative assets [that] would require banks to hold adequate capital in relation to such assets." *Id.*

[131] *Id.* at 40.

[132] The Commission explains that it has "taken into account" a recommendation by the International Money Fund to expand the reporting obligations for "all financial activities conducted on a leveraged basis,

part 1b on Form PF about their funds' borrowing activities and file this form with the Commission for systemic risk assessment by the FSOC is not only a circuitous approach given the previous discussion about how limiting lenders' lending is more efficient than limiting borrower's borrowing,[133] it is also ineffective, if not counterproductive, to minimizing systemic risk. One reason the approach will be ineffective is that it requires funds to disclose a lot of the information that is already being provided to PE investors by the funds voluntarily.[134] Given the particular investment strategy, even sophisticated investors may not be able to appreciate the full extent of risks involved.[135] Thus, the mere claim that a fund has complied with regulations might give investors a false sense of security in a fund. Another reason is that even if an investor understands the disclosures made by the fund, that investor may not care about the systemic risk implications of failure if the investor expects to profit nonetheless.[136] Finally, disclosure may lead to negative consequences if "market participants . . . become more cautious, demanding that prices move farther before making trades, thereby ultimately reducing market liquidity."[137]

The Commission claims that Form PF will also gather information on systemic risk posed by PE funds that "may arise from a variety of sources, including interconnectedness, changes in market liquidity and market concentrations."[138] These other causes of systemic risk echo Heed's other 'sources of contagion,' particularly the payment system and the lack of information concerning the assets that institutions hold.

Although the SEC does not define the terms 'interconnectedness,' 'liquidity,' or 'market concentration,' the commonly-

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including activities of leveraged private equity vehicles." IA 3145, *supra* note 79, at 12-13.

[133] Specifically, proposed item 1b on Form PF requires: "basic information about the fund's borrowings, including a breakdown of the fund's borrowing based on whether the creditor is a U.S. financial institution, foreign financial institution or non-financial institution as well as the identity of, and amount owed to, each creditor to which the fund owed an amount equal to or greater than 5 percent of the fund's net asset value as of the reporting date." *Id.* at 44-45.

[134] Schwarcz, *supra* note 113, at 218-19.

[135] *Id.* at 219.

[136] *Id.* at 218.

[137] *Id.* at 219.

[138] IA 3145, *supra* note 79, at 79.

accepted definitions of these terms show that PE funds do not pose systemic risk because they are not interconnected, do not offer liquid investments, and are not concentrated in any one market. Interconnectedness generally refers to institutions' connections to lenders, borrowers, prime brokers, and counterparties for derivatives positions. Except to the limited extent to which PE funds use leverage, PE funds are not interconnected with other funds because they do not hold derivatives positions; they do not have counterparty exposure arising from, for example, swaps or securities lending activities; they do not rely on short-term credit for their operations; they do not lend to financial system participants; and they neither rely on prime brokers nor are they otherwise operationally linked to other financial institutions."[139]

Compared to hedge funds, which generally *do* rely on counterparties and prime brokers in their operation, PE funds are much less likely to pose a systemic risk.[140]

Liquidity generally refers to how quickly certain assets can be converted into cash.[141] Generally, institutions that offer highly liquid investments, such as banks, pose more systemic risk because they are more susceptible to runs during times of financial distress. However, liquidity is not a systemic risk concern for PE funds because they require long-term capital commitments and do not offer

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[139] PEGCC Comment letter, *supra* note 13, at 12.

[140] Indeed the example of LTCM shows just how systemically significant the use of counterparties by hedge funds may be: "Had Long-Term Capital been suddenly put into default, its [derivatives] counterparties would have immediately 'closed out' their positions. If counterparties would have been able to close-out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms had rushed to close-out hundreds of billions of dollars in transactions simultaneously, they would have been unable to liquidate collateral or establish offsetting positions at the previously-existing prices. Markets would have moved sharply and losses would have been exaggerated . . . ." Schwarcz, *supra* note 1113, at 201 (quoting William J. McDonough, President, Fed. Reserve Bank of N.Y., Statement Before the United States House of Representatives Committee on Banking and Financial Services (Oct. 1, 1998), *in* FED. RES. BULL., Dec. 1998, *available at* http://newyorkfed.org/newsevents/speeches/1998/mcd981001.html)

[141] An example of a liquid asset is a demand deposit account, whereas a 30-year mortgage is an example of an illiquid asset.

their investors withdrawal rights.[142] Nor do PE funds "rely on short-term financing that could dry up," meaning that a lender's liquidity shortage will not affect the operations of a PE fund.[143]

Finally, market concentration refers to the extent to which a given institution is concentrated within a given industry or geographic region. The failure of such an industry or geographic region would signal a near-certain failure of an institution that is concentrated in such an industry or geographic industry. Yet again, however, this is not generally a concern for PE funds: PE funds use a wide array of investment strategies, and even while "private equity firms and/or private equity funds have a particular geographic or sector focus . . . equity funds in the aggregate are diversified geographically and across multiple industries, and thus lack concentrated exposure in any single region or sector."[144]

IV. Conclusion

The urgency behind mitigating systemic risk appears based, at least in part, on speculation and mere assumptions about the causes of recent systemic failures. Policymakers' immediate experience with the consequences of systemic risks and systemic failures may render their impulse to act understandable, but it does not automatically justify policies predicated on the bare assertion that they will address the maladies that have befallen the financial system.[145]

This statement seems to resonate with the heightened focus on regulating private equity funds following the systemic failures of the Great Recession. Indeed, much of the focus on private equity in the aftermath of the crisis in the Dodd-Frank Act and in proposed bills is on preventing rather nebulous systemic risks that may be associated with PE funds. As this note shows, private equity funds do

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[142] "Private equity funds typically do not allow their investors to withdraw from the fund, except in extremely limited circumstances (such as a change in law that makes it illegal for such investor to continue to hold its interest in the fund), and in any event the fund is not forced to sell assets to effect such withdrawal." PEGCC Comment letter, *supra* note 13, at 7.
[143] *Id.* at 11.
[144] *Id.* at 15.
[145] Anita K. Krug, *Financial Regulatory Reform and Private Funds* 4 (Berkeley Center for Law, Business and the Economy, Working Paper, 2009), *available at papers.ssrn.com/sol3/papers.cfm?abstract_id=1682623.*

not pose systemic risk that would justify their heightened regulation in the Dodd-Frank Act.

There are minimal differences between private equity funds and venture capital funds, and that these differences center on venture capital funds' investment in early stage companies rather than later-stage companies. Providing an exemption for venture capital funds from regulation under the Dodd-Frank Act but not for PE funds is incongruous in light of these minimal differences. There are, however, differences between hedge funds and PE funds, including hedge funds' use of leverage, counterparties, and investment in liquid securities. These differences have in the past caused the Commission to focus regulation on hedge funds and to exempt private equity funds. Failing to recognize the existence of these differences today has led to overly broad regulation that tries to protect investors whom the securities laws view as able to protect themselves, and to prevent the rise of systemic risk in investment vehicles that do not use systemically risky mechanisms.

The links, or channels of contagion, by which one institution's failure spreads to other institutions are simply not present for PE funds. At the fund level, PE funds do not use leverage or counterparties, do not offer liquid securities, and do not concentrate their investments in a given industry or geographic sector. Some PE-backed companies do use leverage to finance their growth, just as companies not backed by PE funds use leverage to finance their growth. The Commission has not proffered any reason why systemic risk regulation should focus on equity holders in the former companies, but not the latter companies. And where any systemic risk may lie with lenders that over-exposed to PE-backed companies, this note shows that it is more efficient and sensible to direct regulation on the lenders to prevent this overexposure and the resultant systemic risk. Thus, the Dodd-Frank Act imposes regulation that does not achieve its intended purpose. For this reason, the Commission's rules that try to reduce systemic risk in private equity funds are superfluous and unjustifiably burdensome because their costs exceed their benefits.