Volume 69

2016

Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency

Cary Martin Shelby
DePaul University, cmart120@depaul.edu

Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency

*Cary Martin Shelby**

ABSTRACT

Academics have frequently noted that the term "public" is one of the most undertheorized concepts under our federal securities laws. It has never been sufficiently defined by Congress, and issuers must instead rely on various indicators of publicness gleaned from an extensive patchwork of rules and exemptions. A prevalent indicator of publicness includes the status of investors, where investment companies that broadly offer investments to the general public, such as mutual funds and money-market funds, are required to register under a complex web of federal legislation. Relatedly, private investment companies such as hedge funds and private equity funds, which restrict offerings to elite investors, are typically considered private and are thus exempt from federal regulation. Other historical indicators include advertising, size of pool, and number of investors/clients. However, these historical indicators of publicness did not capture the increasing effect that private funds were having on the general public, such as systemic risk, retailization, and participation in the shadow banking industry. Congress responded by expanding indicators of publicness through the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which created new registration requirements for private funds irrespective of the status of such underlying investors.

Nevertheless, this article argues that Congress has improperly focused on ancillary laws, such as the Investment Advisers Act of 1940 and the Com-

* Assistant Professor, DePaul University College of Law; William H. Hastie Fellow, University of Wisconsin Law School (May 2012); J.D., Northwestern University School of Law (May 2006). First and foremost, I would like to thank my mentor, Professor Terry Smith from DePaul University College of Law for his invaluable support in developing my research over the duration of this project. I would also like to thank Victoria Shannon Sahani from Washington and Lee University School of Law, who provided detailed and thoughtful feedback to initial drafts of this article. Professors Kristin Johnson from Seton Hall University School of Law, Steven Ramirez from Loyola University School of Law, and Olufunmilayo "Funmi" B. Arewa from University of California, Irvine School of Law, provided unique insights which greatly enhanced the analysis herein. In addition, participants from the following conferences provided invaluable commentary to presentations related to this piece: Law and Society 2015 Annual Meeting in Seattle, WA, National Business Law Scholars Conference at Seton Hall University School of Law, and 9th Annual Lutie Lytle Black Women Law Faculty Writing Workshop at Vanderbilt Law School. Last but not least, I would like to extend special thanks to my research assistant, Maura Mitchell, for her superior contributions to this project. Of course, all errors are my own.

modity Exchange Act of 1936, to integrate evolving notions of publicness in the regulation of investment companies. Congress should instead focus on the Investment Company Act of 1940 (1940 Act), which is the primary legislation tailored to the industry. In focusing on these ancillary laws, Congress has complicated the patchwork of regulation that applies to these entities. This improper focus has also resulted in under-inclusive and over-inclusive indicators of publicness under the 1940 Act, further compromising investor protection in these burgeoning markets. An alternative framework should: (1) integrate emerging indicators of publicness under the 1940 Act; (2) conduct a wholesale review of the 1940 Act; and (3) monitor other strategies that could invoke public concerns such as hedge fund activism, third-party litigation funding, and investment in distressed economies such as Detroit, Puerto Rico, and Greece. This article builds on the current literature which has largely focused on the incoherency of publicness in the context of the Securities Act of 1933 and the Securities Exchange Act of 1934. This article is the first to assess whether emerging notions of publicness have been properly incorporated under the 1940 Act.

Table of Contents

I. INTRODUCTION

REGISTERED investment companies (RICs),[1] such as mutual funds and money-market funds, are a dominating force in the American and global economy. Such entities collectively manage over $18.2 trillion for over 90 million individuals in the United States.[2] Households often depend on these vehicles as a predominant saving mechanism to support education, retirement, and several other categories of expenses. For instance, mutual funds managed 55% of the total assets within 401(k) plans toward the end of 2014, making RICs a vital component of retirement accounts across the nation.[3] As background, RICs are typically managed by an entity adviser that solicits and pools investor capital into a single fund.[4] The adviser then invests the fund's assets into a variety of equity, debt, or cash instruments, with the hopes of earning a return to pass along to its underlying investors.[5] Investors often prefer RICs because they provide immediate access to a diverse portfolio of investments, as well as to the expertise of the adviser.[6] While the term "public" has not been specifically defined under the federal securities laws,[7] RICs are subject to a complex web of federal legislation because they are available for investment by the general public (also known as "retail investors").[8] In particular, RICs must register under the Investment Company Act of 1940 (1940 Act), which is the primary legislation governing the industry.[9] It includes detailed disclosure mandates, restrictions on risky investments, governance requirements, and several other directives that extend beyond the "truth in securities"[10] framework mandated by the inaugural Securities Act of 1933 (Securities Act) and Securi-

1. For purposes of this article, RICs encompass all investment companies that are required to register under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq*. (2012) [hereinafter 1940 Act].

2. Investment Company Institute, 2015 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry 6 (55th ed. 2015), http://www.icifactbook.org/fb_ch1.html [https://perma.cc/E9C3-85K8].

3. *Id.* at 161.

4. Thomas P. Lemke et al., Regulation of Investment Companies § 1.01 (2015) [hereinafter Lemke, Investment Companies] (providing an overview of investment company structure).

5. *Id.*

6. *Id.*

7. *See* discussion *infra* Part II.C.1 (discussing legislative origins of the term "public").

8. *See* discussion *infra* Part II (summarizing various federal mandates that apply to investment company structures).

9. 1940 Act, 15 U.S.C. § 80a-8 (2012).

10. *The Laws That Govern the Securities Industry*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/about/laws.shtml [https://perma.cc/CVM4-5QUE].

ties Exchange Act of 1934 (Exchange Act).[11]

In contrast, private investment companies (Private Funds), which include hedge funds and private equity funds, are generally exempt from the complex web of regulation applicable to RICs.[12] Private Funds evade regulation by restricting investors to institutional investors and high net-worth individuals.[13] Such investors are deemed to have the resources adequate to protect themselves without the need for federal safeguards.[14] In spite of this exclusivity, Private Fund industries have grown exponentially in recent decades since institutional investors such as pension plans, insurance companies, and endowments are increasingly relying on these vehicles to manage risk and earn returns.[15] As of April 2015, hedge funds managed a total of $3.125 trillion in the United States,[16] while private equity funds managed $1.5 trillion.[17] In spite of reports that hedge funds are not consistently beating the markets in recent years,[18] the industry is likely to continue to grow, particularly since these vehicles have access to innovative strategies and instruments that are not available to their registered counterparts.[19] One study predicted that hedge funds will manage a

11. *See* discussion *infra* Part II.A (providing detailed explanation of specific restrictions and mandates provided under the 1940 Act).

12. For purposes of this article, Private Funds include all investment companies that are exempt from regulation under the 1940 Act.

13. These elite investors are legally defined as "accredited investors" and "qualified purchasers" under the Securities Act and 1940 Act, respectively. *See infra* notes 141–142, 151–162 and accompanying text for specific definitions.

14. *See infra* notes 141–142, 151–162 and accompanying text.

15. Quinnipiac Univ. Alt. Inv. Institute & Conn. Hedge Fund Ass'n, Institutional Investor Survey Fall 2014 10, http://www.quinnipiac.edu/prebuilt/pdf/institutes/alternative_investments/2014_Institutional_Investor_Survey.pdf [https://perma.cc/47TG-UZZS] (concluding that institutional investors will increase allocations to private funds in coming years); *see also* discussion *infra* Part IV.A (discussing how increasing life expectancy and ballooning deficits are forcing pension plans to seek creative mechanisms for earning returns). *But see* James B. Stewart, *Hedge Funds lose Calpers, and More*, N.Y. Times (Sept. 27, 2014), at B1 (reporting that Calpers, the California Public Employees' Retirement System, terminated its $4.5 billion hedge fund allocation to "reduce complexity and costs") (internal quotations omitted).

16. *Hedge Fund AUM at $3.13 trillion as Allocations Continue into April*, Evestment (Apr. 2015), https://www.evestment.com/resources/research-reports/2015-research-reports/global-hedge-fund-asset-flows-report—april-2015 [https://perma.cc/N36Y-SWX8].

17. Arleen Jacobius, *Big private equity managers ruling the roost*, Pensions & Investments (Apr. 6, 2015), http://www.pionline.com/article/20150406/PRINT/304069998/big-private-equity-managers-ruling-the-roost [https://perma.cc/C8VP-A3TR].

18. Simon Lack, The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True 1 (2012) (arguing that on average, hedge funds have not been able to exceed the risk-free rate of return provided by government issued treasury bills). *But see* Thomas Schneeweis & Hossein B. Kazemi, *An Academic Response to the 'Hedge Fund Mirage'* 1 (Sept. 30, 2012), http://ssrn.com/abstract=2228851 [https://perma.cc/P4HA-Y939] (providing a direct critique of the methodologies employed by the author of *Hedge Fund Mirage*: "The author of 'Hedge Fund Mirage' does not have the net profits to hedge funds but such data is required before true comparisons between net profit to investor and net profit to hedge fund manager can be made[ ] . . .").

19. *See generally* Cary Martin Shelby, *Privileged Access to Financial Innovation*, 47 Loy. U. Chi. L.J. 315, 346–60 (2015) [hereinafter Shelby, *Privileged Access Article*] (providing in-depth analysis of strategies and instruments that RICs cannot access due to stringent restrictions under the 1940 Act).

total of $5.8 trillion in 2018.[20] Pension plans are primary drivers of this growth, even though the underlying beneficiaries of such plans are comprised of retail investors. In 2014 for example, the Pennsylvania Public School Employees' Retirement System allocated 10.5% of its plan assets into hedge funds, the Public School and Education Employee Retirement Systems of Missouri 13.7%, and the Texas County & District Retirement System 25%.[21]

The exponential growth of these industries is occurring in the midst of a rapidly evolving regulatory landscape for investment company structures, the effects of which have not been sufficiently investigated. More specifically, Congress drastically altered historical "indicators of publicness"[22] under the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[23] Although academics have frequently noted that the term public is one of the most under-theorized concepts under our federal securities laws,[24] common indicators of publicness have arisen through an extensive patchwork of rules and exemptions. As briefly discussed above, a prevalent indicator of publicness includes the *status of investors*. Investment companies that restrict offerings to elite investors are considered private and are thus exempt from federal regulation.[25] An additional indicator includes *advertising*, where investment companies that broadly solicit investments from the general public, such as mutual funds and money-market funds, are required to register under a complex web of federal legislation.[26] Additional indicators include *size of the pool* and *number of investors/clients*.[27]

However, these original indicators of publicness did not appropriately

---

20. Halah Touryalai, *Everybody Loves Hedge Funds, Assets Hit Record $3 Trillion*, FORBES.COM (June 25, 2014, 1:03 PM), http://www.forbes.com/sites/halahtouryalai/2014/06/25/everybody-loves-hedge-funds-assets-hit-record-3-trillion/ [https://perma.cc/F7GC-6HJU].

21. Christine Williamson, *Big public pension funds' hedge fund portfolios outperform their indexes*, PENSIONS & INVESTMENTS (Dec. 22, 2014), http://www.pionline.com/article/20141222/PRINT/312229982/big-public-pension-funds-hedge-fund-portfolios-outperform-their-indexes [https://perma.cc/J22X-RGFT].

22. For purposes of this article, "indicators of publicness" refer to the characteristics that have been legally identified under federal securities laws as significant factors in assessing the publicness of an issuer, an investment adviser, or a securities offering.

23. *See* discussion *infra* Part III.B (summarizing new regulatory framework for Private Funds under the Dodd-Frank Act).

24. *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation after the JOBS Act*, 101 GEO. L.J. 337, 339 (2013) ("[T]he public-private divide has long been an entirely under theorized aspect of securities regulation.").

25. *See* discussion *infra* Part II.C (explaining how the "status of investors" became a prominent indicator of publicness under federal securities laws).

26. *See* discussion *infra* Part II.C.1 (examining the evolution of "advertising" as an indicator of publicness under the Securities Act, and the recently passed JOBS Act).

27. *See* discussion *infra* Part II (providing basic descriptions of the various exemptions and exclusions that incorporate "size of pool" and "number of investors/clients" as prominent indicators of publicness).

account for evolving "notions of publicness"[28] such as systemic risk, participation in the shadow banking industry, and the retailization of Private Funds.[29] With respect to systemic risk, Private Funds were increasingly creating systemic risk through their power to incur unlimited leverage and trade in exotic derivatives.[30] Information related to a Private Fund's interconnectedness, substitutability, complexity, and global activities could possibly provide meaningful information regarding systemic risk, but these categories of activities were not historically monitored under federal securities laws.[31] Comparable activities were historically created by banking institutions and monitored by accompanying bank regulators, making it difficult for Congress to seamlessly integrate Private Funds into the federal securities laws rubric.[32] Other concerns expressed by congressional and SEC reports include the participation of Private Funds in the shadow banking industry, as Private Funds are increasingly engaged in the creation and distribution of credit without being subject to regulatory oversight.[33] Retailization, which generally encompasses the indirect exposure of Private Funds to retail investors through pension plans and other institutional investors, was also expressed as a major concern by regulators.[34] As pension plans continued to invest in these private industries, regulators queried whether underlying retail investors were sufficiently protected.[35]

Congress eventually responded to these evolving notions of publicness by creating new registration requirements for Private Funds under the Dodd-Frank Act.[36] Under this legislation, certain Private Funds must register under the Investment Advisers Act of 1940 (Advisers Act).[37] Over-the-counter (OTC) derivatives, which are frequently traded by Private Funds, must now be traded through clearinghouses registered under the Commodity Exchange Act of 1936 (Commodity Exchange Act).[38] The Dodd-Frank Act also provides the SEC with the power to collect and

28. As used in this article, "notions of publicness" generally refers to financial innovations that have impacted the ways in which regulators should treat publicness under the federal securities laws.

29. *See* discussion *infra* Part III.A (explaining how these emerging notions of publicness impacted Congress's decision to regulate Private Funds under the Dodd-Frank Act).

30. *See* discussion *infra* Part III.A.

31. *See* discussion *infra* Part V.A (summarizing proposed definitions of these terms, provided by the FRB and IOSCO in a joint consultation study completed on March 4, 2015).

32. *See, e.g.*, *Mission*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, http://www.federalreserve.gov/aboutthefed/mission.htm [https://perma.cc/RBC6-G2JU] (The Federal Reserve's mission includes the following: "supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers [and] maintaining the stability of the financial system and containing systemic risk that may arise in financial markets . . . .").

33. *See supra* note 29.

34. *See supra* note 29.

35. *See supra* note 29.

36. *See* discussion *infra* Part III.B (summarizing the new regulatory framework for Private Funds under the Dodd-Frank Act).

37. *See* discussion *infra* Part III.1.

38. *See* discussion *infra* Part III.2.

analyze confidential and proprietary information from certain Private Funds and disclose such data to the Financial Stability Oversight Council (FSOC), which is a new entity designated to monitor systemically relevant entities.[39] Nevertheless, this article argues that Congress has improperly focused on ancillary laws, such as the Advisers Act and Commodity Exchange Act, to integrate evolving notions of publicness in the regulation of investment companies, as opposed to the 1940 Act, which is the primary legislation tailored to the industry. Since these evolving notions of publicness have been integrated into ancillary laws, or addressed through additional layers of regulation, Congress has effectively expanded and complicated the patchwork of regulation that applies to these entities. Defining the contours of publicness for investment company structures is now an arduous task that involves mapping out a long list of ancillary exemptions and trying to predict the extent to which FSOC may deem a Private Fund systemically harmful. Thus, there is no clear concept of publicness from a theoretical, regulatory, or practical perspective.

This article builds on the current literature on this topic, which has largely focused on the incoherency of publicness in the context of the Securities Act and the Exchange Act.[40] For instance, Professors Donald Langevoort and Robert Thompson have examined evolving notions of publicness with respect to the offering of securities in their oft-cited article *"Publicness" in Contemporary Securities Regulation after the JOBS Act*.[41] They similarly evaluated Congress's response to these innovations under the Jumpstart Our Business Startups Act of 2012 (JOBS Act) in light of the inconsistent treatment of publicness under federal securities laws.[42] The Securities Act, for example, focuses on the status of investors in determining publicness while the Exchange Act focuses on the size of the entity as well as number of shareholders of record.[43] In comparison, this article is the first to assess whether emerging notions of publicness have been properly incorporated under the 1940 Act. In assessing the resulting harm, this article is also distinct in its focus on investor protection. Congress's improper focus on ancillary legislation has resulted in

39. *See* discussion *infra* Part III.3.

40. *See, e.g.*, Langevoort & Thompson, *supra* note 24 (analyzing evolving assessment of publicness under the JOBS Act of 2012); *see also* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013); A.C. Pritchard, *Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1001 (2013) ("[T]he resulting mismatch between the public-private dividing lines under [the Securities and Exchange Acts] means that the transition from private to public will inevitably be awkward, abrupt, and fraught with problems for issuers, investors, and regulators."); Onnig H. Dombalagian, *Principles for Publicness*, 67 FLA. L. REV. 649, 653 (2015) ("This Article proposes reframing the regulation of public companies under U.S. federal securities law around three well-worn regulatory principles: (1) suitability, (2) efficiency, and (3) representativeness"); Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 137 (2011) ("[T]he failure of the fiduciaries of public corporations to understand their 'publicness' . . . accounts for many of the recent scandals.").

41. Langevoort & Thompson, *supra* note 24, at 340.

42. *Id.*

43. *Id.*

under-inclusive and over-inclusive indicators of publicness under the 1940 Act, which could further compromise investor protection in these burgeoning markets.

With respect to the reliance on under-inclusive indicators, such as *status of investors*, for example, it is possible that a systemically harmful Private Fund could evade regulation under the 1940 Act, while the SEC and FSOC is engaged in the opaque process of aggregating and analyzing proprietary data from this same fund. Consider, for example, the Texas County & District Retirement System, which has allocated 25% of its assets into hedge funds.[44] The underlying beneficiaries of this pension plan include retail investors among the 255,000 county and district employees in Texas.[45] If this pension inadvertently invests with a hedge fund that is later deemed systemically harmful, the pensions of these underlying retail investors could be adversely affected. Given the growing reports that hedge funds cannot sufficiently beat the markets, which could induce advisers to pursue even riskier strategies, refining the regulation of these industries is of the utmost importance.[46] Mandating tailored registration under the 1940 Act could preemptively deter investor exposure to systemically harmful entities by subjecting such funds to standardized valuations, mandatory disclosure, and various other protections. However, as will be further discussed below, a wholesale review of the 1940 Act would be a necessary endeavor as many of the rigorous provisions of this law could unduly compromise capital formation.

Over-inclusive indicators do not permit regulators to make nuanced distinctions amongst the heterogeneous nature of the fund industry. Individual retail investors are restricted from directly accessing the more innovative strategies of Private Funds, some of which may not pose a systemic threat to the economy. RICs are automatically subject to the stringent capital restrictions under the 1940 Act and are therefore limited in accessing innovative products such as derivatives, illiquid instruments, distressed securities, and other exotic instruments.[47] The potential harms of these innovations have been well-documented by researchers across disciplines.[48] Given these harms, this article does not advocate unfettered

44. Williamson, *supra* note 21.

45. *Who We Serve*, TEX. CTY. & DIST. RET. SYS., https://www.tcdrs.org/AboutUs/Pages/WhoWeServe.aspx [https://perma.cc/JHJ9-57HY].

46. LACK, *supra* note 18.

47. *See generally* LEMKE, INVESTMENT COMPANIES, *supra* note 4, § 8 (providing detailed description of regulatory framework underlying mutual fund capital restrictions, which includes applicable 1940 Act provisions, as well as corresponding rules and cases).

48. *See generally* BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 15, http://www.berkshirehathaway.com/2002ar/2002ar.pdf [https://perma.cc/A4ZK-TZZK] (Warren Buffet's firm famously stated that "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."); Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011) (generally arguing that the deregulation of OTC derivatives under the Commodities Futures Modernization Act of 2000 was a major contributor to the Great Recession); Larry Swedroe, *It's time to regulate financial instruments*, CBS MONEYWATCH (Apr. 12, 2012, 8:21 AM), http://www.cbsnews.com/news/its-time-to-regulate-financial-instruments/ [https://perma.cc/CC85-

access to these instruments by retail investors. However, the current public-private divide, which gives elite investors unfettered access while retail investors have no direct access, is not sufficiently nuanced to accommodate the growing intricacies of the markets. This inequitable access is more likely to have an adverse impact on retail investors during times of economic distress, when hedge funds can rely on their increased freedoms to engage in short-trading and other innovative strategies to protect investors from these declining prices.[49] As retail investors are the most vulnerable class of investors during times of economic distress, the disparities created by this divide have become more problematic.[50]

An alternative framework should first integrate evolving indicators of publicness under the 1940 Act. For example, to the extent regulators can agree on appropriate systemic risk indicators, such as interconnectedness, substitutability, complexity, or global activities, such indicators could be integrated into existing 1940 Act exemptions. To the extent that additional funds are required to register under the 1940 Act as a result of these new indicators, a wholesale review of the law is a necessary endeavor, as many of the provisions may unduly restrict capital formation. For example, the existing restrictions on leverage and derivatives would likely need to be retooled, as well as the complete bar against conflict of interest transactions. These archaic restrictions may have played a role in Congress's decision to avoid the 1940 Act in the new regulation of Private Funds. Relatedly, many of these archaic restrictions may unduly restrict retail investors from directly accessing innovative strategies. Long-term steps include consistently monitoring other strategies that could invoke public concerns such as hedge fund activism, third-party litigation funding, and investment in distressed economies such as Detroit, Puerto Rico, and Greece. These emerging strategies fall outside the purview of systemic risk, but they could similarly have a latent impact on the general public. For example, investment in distressed economies could create scenarios where Private Funds have a direct impact over the public policies produced by these governments.[51]

In summary, Part II provides a description of the patchwork regulation that applies to investment companies. It begins with a brief roadmap of the 1940 Act, which is the primary legislation that regulates investment company structures, and proceeds with an overview of the ancillary laws such as the Securities Act, Exchange Act, Advisers Act, and Commodity Exchange Act. It concludes by explaining how the assessment of publicness is the primary driver of the accompanying exemptions of these laws.

BWE2] (querying whether innovative products should be freely accessible to the general public given harms revealed during Great Recession).

49. Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 Berkeley Bus. L.J. 240, 244 (2009) (generally arguing that hedge fund flexibilities allow such advisers to consistently outperform the broader markets).

50. *See* discussion *infra* Part IV.B.

51. *See* discussion *infra* Part V.B.

Part III highlights the ways in which Private Funds started to invoke public concerns through the creation of systemic risk, their participation in the shadow banking industry, and the retailization of the industry. Congress responded through the passage of the Dodd-Frank Act, which amended ancillary laws as a means of incorporating these emerging notions of publicness. Part IV explores the resulting harms of this ancillary law focus, some of which include over-inclusive and under-inclusive indicators of publicness under the 1940 Act. Part V proposes an alternative framework that includes the following tasks: (1) integrate emerging indicators of publicness under the 1940 Act; (2) conduct a wholesale review of 1940 Act; and (3) monitor other possible indicators of publicness. Part VI concludes.

II. PATCHWORK REGULATION OF INVESTMENT COMPANY INDUSTRY

Investment companies are subject to an intricate patchwork of regulation under the following pieces of federal legislation: the 1940 Act, the Securities Act, the Exchange Act, the Advisers Act, and the Commodity Exchange Act. This Part begins with a broad overview of the 1940 Act, which is the primary legislation that is directly tailored to the unique investor protection issues that accompany investment company structures. The 1940 Act includes detailed disclosure mandates, capital restrictions, anti-fraud provisions, governance requirements, and several other directives that extend beyond the inaugural legislation provided under the Securities and Exchange Acts. This Part proceeds by briefly summarizing the ancillary laws that apply to these entities.

Part II.C then examines the origins of common indicators of publicness, which largely derive from the private-offering exemption under the Securities Act as well as accompanying SEC and Supreme Court interpretations. The remaining federal securities laws similarly incorporate indicators of publicness within numerous exemptions and exclusions. In determining these investment company exemptions, regulators attempt to define "publicness" as they do not seek to regulate activities that would not have an adverse impact on the public in terms of investor protection, capital formation, and market integrity. This Part concludes by outlining these common exemptions that Private Funds frequently rely on, which include common indicators of publicness such as *status of investors*, *number of investors/clients*, *size of pool*, and *advertising*.

A. Primary Legislation: 1940 Act

Investment company vehicles share many of the same structural characteristics that have compelled the need for tailored regulation under the 1940 Act. Investment companies[52] are usually organized as corporations

52. 1940 Act, 15 U.S.C. § 80a-3 (defining investment companies as "any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily,

that are overseen by a board of directors.[53] Investment advisers are often considered the "brain" of such entities as they create the fund and manage its assets.[54] The adviser's unique investment strategy comprises a variety of financial instruments, predominantly stocks, bonds, and cash instruments.[55] The adviser then solicits investments from a number of individuals and institutions, and invests the resulting pool of capital pursuant to the predetermined strategy.[56] Many investors prefer investment companies over investing directly in the markets because advisers provide expertise and immediate access to diversification across a range of financial instruments.[57] In exchange for providing this service to investors, advisers receive a fee calculated as a percentage of the total assets of the underlying pool.[58]

Several investor protection concerns naturally arise from the unique relationship between advisers and investors. First, there is an inherent conflict of interest between these parties since advisers seek to earn the highest possible fees from managing investment companies. Investors on the other hand seek to pay the lowest possible fees as those fees get subtracted from any capital gains earned by the pool. Excessive fees could essentially gouge into any gains allocated to investors, thereby significantly compromising the protection of investor capital.[59] Second, advisers may not voluntarily disclose material information regarding the content of the pool or the pool's distinct structural features. Advisers may have incentive to perpetuate these information asymmetries for a number of reasons, which can include a desire to keep the pool's strategy proprietary from competing advisers and regulators, or an effort to conceal the adviser's fraudulent activities. Inadequate disclosures make it difficult for investors to optimize their decisions on how best to allocate their limited capital.[60] Third, since investment companies attract a significant portion of the national savings from the general public, the trading activities of

---

in the business of investing, reinvesting, or trading in securities; . . . or . . . is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis").

53. DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 252 (1992) [hereinafter PROTECTING INVESTORS STUDY], https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf [https://perma.cc/7ZU7-T9A6].

54. U.S. SEC. & EXCH. COMM'N, MUTUAL FUNDS: A GUIDE FOR INVESTORS 6 (2010) [hereinafter MUTUAL FUND GUIDE], http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [https://perma.cc/5E33-L2YR]; *see also* discussion *infra* Part II.B (summarizing the separate regulatory framework that applies to such advisers under the Investment Advisers Act of 1940).

55. MUTUAL FUND GUIDE, *supra* note 54, at 7.

56. *Id.* at 6–7.

57. *Mutual Funds Can Help Lower Investing Risks*, VANGUARD.COM, https://investor.vanguard.com/mutual-funds [https://perma.cc/4MYN-L8DT].

58. MUTUAL FUND GUIDE, *supra* note 54, at 14.

59. PROTECTING INVESTORS STUDY, *supra* note 53, at 255–56.

60. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 24 (3d ed. 2010).

such vehicles could have a vital effect on capital formation in the broader economy.[61]

In addition to the unique conflicts of interest between advisers and investors, many fraudulent abuses were uncovered in the 1920s and 1930s, when the investment company industry "suffered from a number of conspicuous abuses, including self-dealing, inordinately complex capital structures, self-perpetuating managements, and excessive fees."[62] Congress sanctioned a study in 1936, where the SEC investigated and confirmed the pervasive occurrence of these abuses (1936 Study).[63] A member of the SEC's staff aptly summarized the findings of this 1936 Study as follows:

> The [1936 Study], and the subsequent Congressional hearings, found that, to an alarming extent, investment companies were being organized and operated to benefit the interests of their affiliates rather than the interests of their shareholders. The highly liquid nature of fund assets made them easy targets for embezzlement by affiliates, who often viewed them as a source of private capital. Transactions between investment companies and their affiliates, which were expressly permitted to allow investment companies to participate in the business dealings of affiliated financial firms, often resulted in improper transactions. Underwriters found it convenient to dump into the portfolios of affiliated funds securities that they found to be unmarketable.[64]

Between 1929 and 1936, the SEC estimated that "investment company shareholders lost 40 percent of their investments."[65]

In response to the abuses discovered in the 1936 Study, Congress passed the 1940 Act, which is frequently viewed by commentators as being the most complex legislation under our rubric of federal securities laws.[66] In addition to mandating supplemental disclosure obligations for investment companies, beyond the disclosures mandated under the inaugural Securities Act and Exchange Act,[67] this law also limits the total amount of leverage that such funds may utilize.[68] The law implements

61. 1940 Act, 15 U.S.C. § 80a-1(a)–(b) (declaring that underlying activities of investment company structures have a direct impact on the national public interest).

62. Richard M. Phillips & Robert G. Bagnall, *The Investment Company Act of 1940: A Time For Reassessment*, *in* 22nd Annual Institute on Securities Regulation 593, 596 (Practising Law Institute Corporate Law and Practice Course Handbook Series No. 713, 1990).

63. Paul F. Roye, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Remarks at the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference (June 14, 2001) (transcript *available at* https://www.sec.gov/news/speech/spch500.htm) [https://perma.cc/32EF-MJ4W].

64. *Id.*

65. *Id.*

66. *Id.* ("[T]he great securities law scholar, Louis Loss, described the '40 Act as the most complex of the federal securities laws.").

67. Lemke, Investment Companies, *supra* note 4 § 5.02 (summarizing the extensive disclosure requirements that apply to registered investment companies).

68. 1940 Act, 15 U.S.C. § 80a-18 (providing specific restrictions on the capital structure implemented by registered funds).

direct limits on loans from banks[69] and provides that registered funds must be appropriately "covered"[70] before engaging in derivative transactions. Congress designed these capital restrictions to protect investor capital from excessive risk-taking. As a result, investment companies that must register under the 1940 Act are significantly restricted in the kinds of strategies that they can offer to investors.[71]

Specific governance requirements are likewise an integral component of this law. Certain conflict of interest transactions between the fund and its fiduciaries are completely prohibited,[72] and a percentage of board directors must be deemed independent.[73] The board is largely viewed as being the "watchdog" of the adviser, to ensure that the adviser is not exploiting its position for personal gain.[74] In addition, advisers must calculate the fund's performance data, as well as its valuations, in a standardized format so that investors can easily compare a large range of funds.[75] The law further mandates that investment company advisers treat shareholders equally and fairly, and it relatedly prohibits advisers from creating inordinately complex structures.[76] The process through which advisers can advertise and promote funds is also tightly regulated under the 1940 Act.[77]

B. Ancillary Legislation

Although the 1940 Act directly targets the potential market failures within the investment company industry, such vehicles are subject to additional layers of regulation under the federal laws discussed below. Scholars suggest that this patchwork of regulation results from a variety of factors: administrative inefficiencies,[78] historical accident,[79] and the bifurcated regulation of the financial industry,[80] to name a few. Most notably, the SEC has primary jurisdiction over securities and other related

---

69. *Id.* § 80a-18(f)(1) (specifying that registered funds must have 300% asset coverage for any indebtedness incurred from third-party banks).

70. Lemke, Investment Companies, *supra* note 4 § 8.06(2)(b)(ii); *see also* Shelby, *Privileged Access Article*, *supra* note 19, at 346–50 (outlining various mechanisms for appropriately "covering" derivative transactions).

71. Shelby, *Privileged Access Article*, *supra* note 19, at 346.

72. 1940 Act, 15 U.S.C. § 80a-17(a).

73. *Id.* § 80a-10(a).

74. Protecting Investors Study, *supra* note 53, at 253.

75. Lemke, Investment Companies, *supra* note 4, § 9.

76. *Id.* § 2.04(2).

77. *Id.*

78. *See, e.g.*, Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 Rutgers L.J. 681, 683 (suggesting that the SEC regulated private investment companies through an extensive patchwork of exemptions instead of undergoing a much-needed wholesale review of the 1940 Act).

79. Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 Wash. U. L.Q. 319, 338 (1999) ("[L]argely as a result of historical accident, our financial system is built upon a heterogeneous collection of regulatory structures, each with a surprising degree of political resilience within its own traditional sphere of authority.").

80. Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. Cin. L. Rev. 537, 538 (2009).

instruments, while the CFTC has regulatory jurisdiction over futures and other derivative instruments.[81] Since investment companies often trade in both instruments, they must either register or seek exemptions under laws overseen by each of these administrative agencies. This section consequently provides a brief summary of the ancillary laws that apply to investment companies, namely the Advisers Act, the Securities Act, the Exchange Act, and the Commodity Exchange Act.

1. Advisers Act

While the 1940 Act directly regulates investment company entities, federal law includes additional regulatory obligations for the underlying advisers of such pools.[82] These advisers can serve in their individual capacities or through formally organized business associations. The Advisers Act defines "investment advisers" as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ."[83] Investment advisers serve a variety of clients in this capacity, including individual investors, mutual funds, pension plans, corporations, endowments, and trusts.[84] Advisers that must register under the Advisers Act are commonly referred to as "Registered Investment Advisers" (RIAs). The RIA industry has also expanded in recent years as the industry has collectively tripled its assets in the past decade.[85] In 2015, a total of 11,473 RIAs served approximately 29.7 million clients and collectively managed $66.7 trillion in regulatory assets under management.[86]

Commentators have frequently noted that the Advisers Act is the least restrictive among the federal securities laws and of "considerably less consequence [than the 1940 Act], originally providing little more than a pro forma registration requirement for personal investment advisers with fifteen or more clients, and antifraud provisions."[87] Nevertheless, advisers regularly manage numerous unrelated client accounts and funds, and such clients will likely find information related to general management activities material. Characteristics of the particular adviser, such as past

---

81. *See generally id.* (discussing the roles of both the SEC and CFTC, and the Treasury Department's Blueprint for combining them into a single regulatory body).

82. Investment Advisers Act of 1940, 15 U.S.C. § 80b-3 (2012) [hereinafter Advisers Act].

83. *Id.* § 80b-2(a)(11).

84. INV. ADVISER ASS'N & NAT'L REGULATORY SERVS., 2015 EVOLUTION REVOLUTION: A PROFILE OF THE INVESTMENT ADVISER PROFESSION 2, https://www.investmentadviser.org/eweb/docs/Publications_News/EVREV/evolution_revolution_2015.pdf [https://perma.cc/S42M-SFCD].

85. Christopher Condon, *The Rise of the Registered Investment Adviser*, BLOOMBERG BUSINESSWEEK, (March 3, 2011, 4:00 PM), http://www.bloomberg.com/bw/magazine/content/11_11/b4219041484091.htm [https://perma.cc/29SZ-YHXF].

86. INV. ADVISER ASS'N & NAT'L REGULATORY SERVS., *supra* note 84, at 7.

87. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 222 (3d ed. 2003); *see also* Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L.J. 627 (2008) ("[W]hen compared to its companion statute, the Investment Company Act of 1940, the Advisers Act places relatively few substantive burdens on entities that fall within its registration requirements.") (internal citations omitted).

criminal history (if any), prior or existing lawsuits, and the professional and educational background of individual portfolio managers, are also relevant to investors.[88] Given the necessity of trust between investors and advisers, investors benefit greatly from heightened fiduciary duties that apply to advisers who manage their assets.[89]

RIAs are automatically subject to the various registration and fiduciary requirements under the Advisers Act, unless there is an available exclusion or exemption.[90] More specifically, RIAs have a general fiduciary obligation to act in the best interests of their clients in dispensing accompanying investment advice.[91] In exchange, clients pay RIAs a fixed fee, which is typically one to two percent of the client assets the RIA manages.[92] This fixed fee is distinguishable from the commission stockbrokers receive, which amounts to a percentage of each particular sale.[93] Stockbrokers are also subject to lower fiduciary standards where they are only obligated to offer products that are suitable for prospective clients.[94] Some commentators have attributed the growth of the RIA industry to these heightened fiduciary obligations, coupled with the freedom to advise without being hampered by the pressures of commissions.[95] RIA clients are further protected by the disclosure requirements provided under the Advisers Act. RIAs must disclose material information relating to their business practices, fees, disciplinary history, certain conflicts of interest, and other material information related to their advisory business.[96] RIAs must also create and maintain compliance programs to prevent violations of the Advisers Act, and the SEC has the power to inspect RIAs randomly to ensure compliance with these various provisions.[97]

2. *Securities and Exchange Acts*

The Securities and Exchange Acts comprise the inaugural legislation passed by Congress in response to the massive stock market frauds and related losses that occurred during the Great Depression.[98] These laws were among the first to regulate public offerings, and the Securities Act—widely known as the "truth in securities" law—boasts the underlying principle of providing investors with material information about the ini-

---

88. Advisers Act, 15 U.S.C. § 80b-3(c)(1)(A)–(H) (RIAs must disclose comparable information under this provision.).

89. *See SEC Fiduciary Standard*, INV. ADVISER ASS'N, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=KI_Fiduciarydty [https://perma.cc/E8QG-A4LN].

90. Advisers Act, 15 U.S.C. § 80b-3.

91. INV. ADVISER ASS'N, *supra* note 89.

92. Condon, *supra* note 85.

93. *Stockbroker*, INVESTOPEDIA, http://www.investopedia.com/terms/s/stockbroker.asp [https://perma.cc/HQR2-L3BQ] (defining stockbrokers as "[a]n agent that charges a fee or commission for executing buy and sell orders submitted by an investor").

94. Condon, *supra* note 85.

95. *Id.*

96. Advisers Act, 15 U.S.C. § 80b-3(c)(1)(A)–(H).

97. *Id.* § 80b-3(k)(1).

98. *What We Do*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml [https://perma.cc/AS27-QX2J].

tial issuance of securities.[99] With the disclosure of this information, investors are better equipped to optimize their decisions on how best to allocate their limited capital. For the sake of clarity, regulators do not determine the quality of a particular offering under these laws; instead they equip investors with the necessary information to make such determinations on their own.[100] Issuers who fail to disclose such material information, either purposely or inadvertently, can be exposed to substantial civil liabilities under various provisions of the Securities Act.[101]

This obligation to provide material information hinges on the legal definition of security, which includes a long list of financial instruments as well as the catch-all "investment contract."[102] Congress included this catch-all term to capture issuers who tried to evade the Act's arduous registration requirements by simply renaming their offered securities.[103] Investment contracts include investment schemes where investors are called to invest money in a common enterprise, and are led to expect profits, solely from the efforts of others.[104] With respect to investment company structures, investors in these vehicles receive an ownership interest in the underlying vehicle in exchange for their investment of capital.[105] Investors then receive a pro rata share of the pool's profits.[106] As such, investment companies must register under the Securities Act,[107] unless an available exclusion or exemption applies to its underlying ownership interests offered to investors.[108] Once investment companies offer ownership interest to the general public, they must complete a detailed prospectus document that is publicly available on the SEC's website.[109] They are also subject to civil liability for material misstatements and omissions that appear on the registration statement.[110]

The Exchange Act was passed in 1934, shortly after the adoption of the Securities Act. While the Securities Act primarily regulates the flow of information related to the initial issuance of securities, the Exchange Act regulates the disclosure of information related to securities traded on the secondary markets.[111] Broadly prohibiting fraud in connection with the sale of securities is also an integral component of this legislation.[112] Issu-

---

99. *Id.*

100. Marianne M. Jennings, *The Efficacy of Merit Preview of Common Stock Offerings: Do Regulators Know More Than the Market?*, 7 BYU J. PUB. L. 211, 212 (1993).

101. Securities Act, 15 U.S.C. §§ 77k, 771, 77q (2012); Exchange Act, 15 U.S.C. §§ 78j, 78ff (2012).

102. Securities Act, 15 U.S.C. § 77b(a)(1).

103. Reves v. Ernst & Young, 494 U.S. 56, 60–61 (1990).

104. SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946).

105. *Investment Companies*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/mfinvco.htm [https://perma.cc/MGC8-HWCP].

106. *Id.*

107. *Id.*

108. *See* Securities Act, 15 U.S.C. § 77c.

109. *See id.* §§ 77j, 77a; U.S. SEC. & EXCH. COMM'N, *supra* note 105.

110. Securities Act, 15 U.S.C. §§ 77k, 77*l*, 77q; Exchange Act, 15 U.S.C. §§ 78j, 78ff (2012).

111. U.S. SEC. & EXCH. COMM'N, *supra* note 98.

112. *See* Exchange Act, 15 U.S.C. §§ 78j, 78ff.

ers that fall within the definition of "public company" must comply with the periodic disclosure requirements under the Exchange Act.[113] The definition of public company under the Exchange Act includes the following three categories of issuers: (1) issuers that have securities listed on an exchange;[114] (2) issuers with "total assets" exceeding $10 million and classes of equity securities held by at least 2,000 persons (or 500 persons who are not accredited investors);[115] and (3) any issuer that files a registration statement under the Securities Act.[116] Investment company structures could potentially fall under any of these categories due to their size, number of holders, or registration status under the Securities Act. As a result, investment companies must file the periodic reports mandated under the Exchange Act unless an available exclusion or exemption applies to the underlying entity.[117]

3. Commodity Exchange Act

To the extent that investment company advisers trade in futures or other derivatives on behalf of an underlying pool, they may also be subject to registration requirements under the Commodity Exchange Act.[118] As briefly discussed above, securities are regulated by the SEC, while futures and other derivatives are regulated by the CFTC.[119] Securities typically encompass financial instruments that represent an ownership interest in a particular company.[120] In contrast, derivatives encompass financial instruments "whose price[s] [are] dependent upon or derived from one or more underlying assets."[121] Such "underlying assets" can include commodities, securities, currencies, indexes, and other such instruments. Agricultural futures are a well-known example of derivatives as they are contracts whose value depends on price fluctuations in underlying commodities, such as corn, wheat, and soybeans.[122] Hedgers rely on derivatives to ensure a fixed price on a particular instrument, while spec-

---

113. *See id.* § 78l; U.S. SEC. & EXCH. COMM'N, *supra* note 98.
114. Exchange Act, 15 U.S.C. § 78*l*(a).
115. *Id.* § 78*l*(g).
116. *Id.* § 78*l*(l).
117. *Id.* § 78*l*(g).
118. Commodity Exchange Act, 7 U.S.C. § 6 (2012).
119. The CFTC's mission includes the following initiatives:

> [P]olice[ ] the derivatives markets for various abuses and work[ ] to ensure the protection of customer funds. Further, the agency seeks to lower the risk of the futures and swaps markets to the economy and the public.
>
> To fulfill these roles, the Commission oversees designated contract markets, swap execution facilities, derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators and other intermediaries.

Mission & Responsibilities, U.S. COMMODITY FUTURES COMM'N, http://www.cftc.gov/About/MissionResponsibilities/index.htm [https://perma.cc/W882-L2FJ].

120. *Security*, INVESTOPEDIA, http://www.investopedia.com/terms/s/security.asp [https://perma.cc/RAC8-A3LR].
121. *Derivative*, INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp [https://perma.cc/BKC5-7M22].
122. *See id.*

ulators use such contracts to bet on predicted price fluctuations.[123]

Investment company advisers that utilize trading strategies in both securities and derivatives markets must comply with the layers of regulation imposed under each of these frameworks unless there is an available exemption or exclusion. More specifically, if investment company advisers fall within the definition of "commodity pool operator" (CPO) or "commodity trading adviser" (CTA), then they must automatically register with the CFTC.[124] CPOs generally include any "individual or organization which operates a commodity pool and solicits funds for that commodity pool."[125] A "commodity pool" is defined as "an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts or commodity options, retail off-exchange forex contracts or swaps, or to invest in another commodity pool."[126] Thus, investment company advisers that invest fund assets into the derivative instruments provided above could fall under the definition of CPO, and the law would identify the underlying fund as a commodity pool. Relatedly, CTAs include "an individual or organization which, for compensation or profit, advises others . . . as to the value of or the advisability of buying or selling futures contracts, commodity options, retail off-exchange forex contracts or swaps."[127] Hence, investment company advisers that invest fund assets into derivative instruments could concurrently fall under the definitions of CPO and CTA. Registered CPOs and CTAs must comply with the intricate system of rules and regulations specifically prescribed by the Commodity Exchange Act, which includes additional disclosure obligations, filing fees, recordkeeping requirements, and many other mandates.[128]

RICs previously relied on the exclusion provided under CFTC Rule 4.5 to avoid duplicative regulation by the CFTC, since the SEC already had extensive oversight over these entities under the 1940 Act, Advisers Act, Securities Act, and Exchange Act, as discussed herein.[129] Mandating comparable regulation under the Commodity Exchange Act would likely result in excessive and unnecessary compliance costs, which inevitably get passed down to underlying investors. Other regulated entities such as pension plans and insurance companies similarly relied on CFTC Rule 4.5 to avoid redundant regulation.[130] In 2012 however, pursuant to its ex-

123. Michael Durbin, All About Derivatives 4-5 (2006).
124. *CPO/CTA Registration Requirements Under Dodd-Frank*, Sidley Austin LLP: News & Insights (Sept. 14, 2010), http://www.sidley.com/news/cpocta-registration-requirements-under-dodd-frank-09-07-2010 [https://perma.cc/AK2L-HV5A].
125. *Commodity Pool Operators*, Nat'l Futures Ass'n, https://www.nfa.futures.org/NFA-compliance/NFA-commodity-pool-operators/index.HTML [https://perma.cc/95XD-BWA7].
126. *Id.*
127. *Commodity Trading Advisors*, Nat'l Futures Ass'n, https://www.nfa.futures.org/NFA-compliance/NFA-commodity-trading-advisors/index.HTML [https://perma.cc/4T3Z-CP7U].
128. *See id.*; Nat'l Futures Ass'n, *supra* note 125.
129. *See* 17 C.F.R. § 4.5 (2016).
130. *See id.*

panded authority granted under the Dodd-Frank Act, the CFTC amended Rule 4.5 to add a requirement that entities relying on this exemption limit derivatives trading activities that do not constitute bona fide hedging trades to "a de minimis level of the fund's total assets."[131] This amendment forced hundreds of RICs to register with the CFTC, in spite of the unified resistance amongst numerous industry participants.[132] The CFTC quickly responded to this opposition by passing harmonization rules in 2012, which seek to resolve "conflict, inconsistency, and duplication with SEC-administered disclosure, reporting and recordkeeping by RICs."[133] The specific registration requirements for RICs under the Commodity Exchange Act will likely evolve over time as the SEC and CFTC continuously update the application of these harmonization rules to newly registered RICs.

C. Indicators of Publicness Embedded in Exemptions

Congress has not provided a definition of public in any of the federal securities laws enumerated above. The term first appeared in the private offering exemption under the Securities Act, where Congress carved out offerings from regulation that did not invoke a public concern.[134] This exclusion is supported by the notion that regulators should not oversee activities that would not have an adverse impact on the public in terms of investor protection, capital formation, and market integrity. The SEC, as well as the Supreme Court, have subsequently attempted to provide clarification to this term through a series of releases, cases, and rules. Accordingly, this section begins by briefly delineating these various interpretations of the term *public*.

Congress followed suit, incorporating indicators of publicness into the numerous exemptions and exclusions under each of the federal securities laws. With respect to investment companies, these laws attach to different components of an investment company structure, which complicates the process of identifying common indicators of publicness. The Securities Act, for example, examines publicness in terms of the ownership interests offered to investment company investors. In contrast, the Exchange Act

131. Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252-01, 11,252, 11,283 (Feb. 24, 2012) (to be codified at 17 C.F.R. pts. 4, 145, 147); Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 17,328-01, 17,328 (Mar. 26, 2012) (to be codified at 17 C.F.R. pts. 4, 145, 147) (correcting 77 Fed. Reg. at 11,252-01, 11,283); Tom Watterson, *Attention Mutual Funds–Potential Relief for CPO and CTA Regulation in the 2014 CFTC Reauthorization Act*, Reed Smith LLP: The Swap Report (Aug. 29, 2014), http://www.theswapreport.com/2014/08/articles/cpo-cta-registration/attention-mutual-fund-spotential-relief-for-cpo-and-cta-regulation-in-the-2014-cftc-reauthorization-act/ [https://perma.cc/GW4N-LPLR].

132. *History of Rule 4.5*, Inv. Co. Inst. (Apr. 17, 2012) https://www.ici.org/pdf/12_commod_inv_hist_rule4.5.pdf [https://perma.cc/4ZNB-YCRL].

133. Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 Fed. Reg. 52,308-01, 58,308–09, 52,312 (Aug. 22, 2013) (to be codified at 17 C.F.R. pt. 4).

134. *See* 15 U.S.C. § 77d(a)(2) (2012).

examines the publicness of the overall investment company entity. The Advisers Act and the Commodity Exchange Act, on the other hand, examine the publicness of the advisers charged with managing such pools. In spite of these varying perspectives of publicness, common indicators arise with respect to these exemptions. Such indicators reference the following characteristics: *status of investors*, *size of pool*, *number of investors/clients*, and *advertising*. This section concludes by highlighting the common exemptions that incorporate these common indicators of publicness.

1. Original Indicators of Publicness

In passing the foundational Securities Act, Congress specifically noted that the laws were not intended to cover transactions "where the public benefits are too remote."[135] The logic behind this exclusion is readily apparent, as the federal laws should only apply to activities that have a significant impact on the collective public. To the extent that an offering solely affects a finite number of investors and has no lasting impact on the government or other unsuspecting third parties, then the law should indeed exclude such offerings from regulation. Section 4(2) of the Securities Act codifies the original wishes of Congress, as the private offering exemption specifically carves out any transaction not involving a public offering.[136] The challenge has been defining publicness: Congress failed to provide a precise definition in this inaugural legislation. This possibly resulted from this legislation's hurried passage.[137] Supporters sought to capitalize on the strong political support that resulted from the Great Depression.[138]

The SEC initially undertook the task of defining public offerings when it provided additional guidance in a 1935 SEC Release. This release included an evaluation of the following countervailing factors in defining public offerings: "(1) [t]he number of offerees and their relationship to each other and to the issuer[,] . . . (2) [t]he number of units offered[,] . . . (3) [t]he size of the offering," and "(4) [t]he manner of offering."[139] Issuers wishing to structure private offerings would have to weigh each of these factors to determine whether securities offerings were public.[140] With respect to the first factor, evaluating the relationship of offerees to the issuer implies that access to information creates a boundary of publicness related to the status of investors. More specifically, investors who have access to material information related to the issuer are better able to

135. H.R. Rep. No. 73-85, at 5 (1933).
136. 15 U.S.C. § 77d(a)(2).
137. Seligman, *supra* note 87, at 52 ("[President] Roosevelt was determined to draft and quickly submit to Congress a securities bill that could be voted on while he still enjoyed the extraordinary political support generated by the bank crisis.").
138. *Id.*
139. Letter of General Counsel, Securities Act Release No. 285, 1935 WL 27785 (Jan. 24, 1935).
140. *Id.*

protect themselves, decreasing the need for federal protection. In applying the second and third factors, evaluating the number of units offered as well as the size of the offering implies that the likeliness of publicness increases with the overall size of a particular offering. Larger funds tend to have a greater impact on the general public due to their trading volume, intermediary relationships, and the high number of investors that are dependent upon the underlying returns. In applying the last factor, which evaluates the manner of the offerings, publicness is implied when issuers engage in advertising that reaches a large number of offerees.

The Supreme Court famously narrowed the focus of publicness in *SEC v. Ralston Purina Co*.[141] In this case, the Court held that an offering to those who can "fend for themselves" is a transaction "not involving any public offering."[142] The *status of investors* seemed to be the primary focus of the Court in outlining the contours of publicness. The Court reasoned that if the offerees have access to the same type of information that would be available in a registration statement, then they do not need the protections guaranteed under the federal securities laws. Executive employees of the issuer, for example, would be a category of investors who could appropriately fend for themselves given their direct and immediate access to material information related to the issuer.[143] With respect to evaluating the size of the offering, as well as the number of offerees, the Court seemed to imply that these factors were not as relevant.[144] An offering to a single investor, who could not appropriately fend for himself or herself, could still constitute a public offering. Even still, the Court did not directly address the extent to which the "manner of the offering" constituted publicness and issuers were not entirely clear as to the level of sophistication required to rely on this holding.

In 1982, to mitigate the uncertainty of publicness, the SEC promulgated Regulation D, a safe harbor providing an alternative framework for ensuring compliance with Section 4(2).[145] Among the rules included within this regulation are Rules 504, 505, and 506, through each of which the SEC intended to provide clear standards for constructing private offerings.[146] The bright-line standards incorporated into each rule directly correlate to the original indicators of publicness provided under the 1935 SEC Release. Issuers must comply with specific restrictions on aggregate offering price, number and status of purchasers, and advertising in order to rely on each of these rules.[147] With respect to the *status of investors*, Regulation D coined the new term "accredited investor," which provides

141. 346 U.S. 119, 120 (1953).
142. *Id.* at 125 (internal quotations omitted).
143. *Id.* at 125–26.
144. *Id.* at 125.
145. James R. Tanenbaum & Anna T. Pinedo, *The Law: Legal and Regulatory Framework*, *in* PIPEs: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 80 (Steven Dresner & E. Kurt Kim eds., 2d ed. 2006); *see* Regulation D, 17 C.F.R. §§ 230.501–230.508 (2016).
146. *See* 17 C.F.R. §§ 230.501–230.508.
147. *Id.*

a clear definition of investors who can adequately fend for themselves.[148] Individuals who earn over $200,000 per year, as well as a variety of institutions, are included in this definition.[149] Regulation D also provided a foundational definition of the term *advertising* and integrated varying degrees of restrictions under Rules 504, 505, and 506.[150]

Rule 506 is the most common exemption relied upon by Private Funds, as it allows issuers to raise an unlimited amount of capital—i.e., it places no restrictions on aggregate offering price—if purchasers are limited to accredited investors.[151] Rule 506 issuers cannot accept more than thirty-five retail investors, and such retail investors must be deemed "sophisticated" as defined under Regulation D.[152] In comparison, Rule 504 issuers can raise capital from an unlimited number of unsophisticated retail investors, but the aggregate offering price is $1 million.[153] Investment companies previously had to sacrifice the power to *advertise* in order to rely on Rule 506, but this historic indicator of publicness has been partially eradicated with the passage of the JOBS Act.[154] Under the JOBS Act, issuers that rely on Rule 506 are now permitted to advertise such private offerings broadly, but retail investors still have limited access to Private Funds.[155]

2. *1940 Act Exemptions*

The most common exemption provided under the 1940 Act similarly focuses on the *status of investors* in outlining the contours of publicness. Section 3(c)(7) was passed under the National Securities Markets Improvement Act of 1996, which sought "to amend the [1940 Act] to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation."[156] Under this exemption, funds that restrict offerings to "qualified purchasers" are considered private and can thus offer interests to such investors without having to comply with the rigors of the 1940 Act.[157] Qualified purchasers are similar to accredited investors, but are subject to higher net-worth re-

148. 17 C.F.R. § 230.501(a).

149. *Id.* Pursuant to authority granted under the Dodd-Frank Act, the SEC staff recently published a report that provides a number of recommendations to revise the "accredited investor" definition. U.S. Sec. & Exch. Comm'n, Report on the Review of the Definition of "Accredited Investor" 90, (Dec. 18, 2015), http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf [https://perma.cc/AAL8-SMGV] (noting that one such recommendation suggests that the income and net-worth thresholds be updated to adjust for inflation).

150. 17 C.F.R. § 230.502(c).

151. *See* Tanenbaum & Pinedo, *supra* note 145, at 81; 17 C.F.R. § 230.506.

152. *Id.*

153. *Id.* § 230.504.

154. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (2012).

155. *Id.*

156. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996).

157. 15 U.S.C. § 80a-3(c)(7) (2012).

quirements.[158] They include institutions that own at least $5,000,000 in investments as well as any natural person who owns not less than $5,000,000 in investments.[159] With these higher net-worth requirements, Congress likely viewed this exemption as being the perfect solution to facilitate capital formation in the industry without compromising investor protection for this subset of investors. Given that entities could easily comply with this exemption's requirements, the exemption could have contributed to the massive growth of the Private Fund industry. Once a fund restricts investors to qualified purchasers, it can raise an unlimited amount of capital from an unlimited number of such investors.[160]

Section 3(c)(1) is another common exemption provided under the 1940 Act, but it instead focuses on the *number of investors* in measuring the contours of publicness.[161] Under this provision, if a fund restricts its number of investors to 100 beneficial owners, then it is exempt from the arduous registration requirements prescribed under the 1940 Act.[162] A fund that relies on Section 3(c)(1) must also restrict its offerings to accredited investors and cannot "propose to make a public offering of its securities."[163] This emphasis on *number of investors* is consistent with Congress's belief that smaller pools, with a limited number of investors, are private in nature because they will likely have a minimal impact on the general public.[164] As stated in the congressional hearings related to the passage of the 1940 Act:

> A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.[165]

As such, smaller funds relying on the 3(c)(1) exemption may participate in the same investment activities as their registered counterparts.[166] However, section 3(c)(1) is not quite as popular as section 3(c)(7) within the Private Fund industry given this stringent limit on the number of investors.[167]

158. *Id.* § 80a-2(a)(51)(A)(i).
159. *Id.* §§ 80a-2(a)(51)(A)(i), (ii).
160. *Id.* § 80a-3(c)(7)(A). Private Funds that rely on this provision must still restrict their number of investors to 2,000 in order to avoid the registration requirements under the Exchange Act. *Id.* § 78*l*(g).
161. 1940 Act, 15 U.S.C. § 80a-3(c)(1).
162. *Id.*
163. *Id.*
164. PROTECTING INVESTORS STUDY, *supra* note 53, at 105–06.
165. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the S. Comm. on Banking & Currency*, 76th Cong. 179 (1940).
166. *Id.*
167. Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L L. & BUS. 703, 704 (2001).

3. *Ancillary Law Exemptions*

Unlike the Securities Act, which focuses on *status of investors* to evaluate whether offerings are public, the Exchange Act focuses on the *size of the entity* as well as the *number of investors* in examining the contours of publicness. Professors Langevoort and Thompson have recently noted the inconsistent treatment of publicness under the Securities Act and Exchange Act, which is not necessarily supported theoretically.[168] Nevertheless, these inconsistent indicators appear under Section 12(g) of the Exchange Act, which excludes issuers from the Act's periodic disclosure requirements if "total assets" do not exceed $10 million and classes of equity securities are not held by 500 or more investors.[169] Private Funds frequently relied on this provision to evade regulation by restricting the total number of investors to 499.[170] The JOBS Act, however, has since made it easier to exclude Private Funds from Section 12(g) by increasing the triggering threshold of investors to 2,000 persons, or 500 persons or more who are not "accredited investors."[171]

With respect to the Advisers Act, a common indicator of publicness previously included the *number of clients* managed by an adviser, which was incorporated under the now defunct Section 203(b)(3) of the Advisers Act.[172] This provision exempted advisers from regulation if they advised fewer than fifteen clients and did not hold themselves out to the public as RIAs or act as advisers to RICs. In applying this provision, each individual fund managed by an adviser was counted as a single client, irrespective of the total number of investors within such fund. Thus, if an adviser managed a single fund which had 100 underlying investors, the adviser could still rely on Rule 203(b)(3) without violating the fifteen client threshold.[173] However, the Dodd-Frank Act recently repealed Section 203(b)(3) in an attempt to capture the large number of Private Fund advisers that were evading regulation under the federal securities laws.[174]

With respect to the Commodity Exchange Act, common indicators of publicness similarly include *status of investors*. For example, the most common exemption provided under the now defunct CFTC Rule

168. *Langevoort & Thompson Article*, *supra* note 24, at 339.

169. 15 U.S.C. § 78*l*(g) (2012).

170. *See* U.S. SEC. & EXCH. COMM'N, *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission* 13 (2003) [hereinafter SEC STAFF REPORT], http://www.sec.gov/news/studies/hedgefunds0903.pdf [https://perma.cc/87VY-RCV7].

171. 15 U.S.C. § 78*l*(g).

172. SEC STAFF REPORT, *supra* note 170, at 21. It should also be noted that, under the Advisers Act, Private Fund advisers are prohibited from charging performance fees (which are calculated as a percentage of investment profits generated by a particular fund), unless they restrict investments to "qualified clients." 17 C.F.R. § 275.205-3(d) (2016). This class of investors includes a "natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser[.]" *Id.* As a result, most Private Fund advisers also limit investors to qualified clients so that they can freely charge performance fees to such investors.

173. SEC STAFF REPORT, *supra* note 170, at 21.

174. See *infra* Part III.B.1 for further explanation of the implications of this change.

4.13(a)(4) was similar to Section 3(c)(7) under the 1940 Act in that it relied on the status of investors as the primary proxy for publicness.[175] Under this exemption, if Private Funds restricted investments to "qualified eligible purchasers" then they were exempt from regulation.[176] These investors encompass several categories of high-net-worth individual and institutional investors, including qualified purchasers as defined under the 1940 Act.[177] However, this exemption was recently repealed by the CFTC under authority granted pursuant to the Dodd-Frank Act given Congress's expressed desire to further regulate the derivatives markets.[178] Private Funds that restrict offerings to qualified eligible purchasers can still rely on CFTC Rule 4.7, which provides such funds relief from certain reporting and disclosure requirements mandated under the Commodity Exchange Act.[179] Private Funds can also rely on CFTC rule 4.13(a)(3), which exempts funds that trade de minimis levels of futures instruments.[180]

III. CONGRESSIONAL RESPONSE TO EVOLVING NOTIONS OF PUBLICNESS

Since the passage of the federal securities laws, regulators have consistently altered indicators of publicness to accommodate financial innovation and to support capital formation. For instance, the SEC promulgated Regulation D under the Securities Act to create bright-line standards of publicness, which led to a significant expansion of private offerings.[181] Issuers were no longer forced to rely on the unpredictable indicators of publicness provided under previous Supreme Court opinions and SEC releases. Similarly, the Section 3(c)(1) and 3(c)(7) exemptions provided under the 1940 Act made it easier for Private Funds to evade this legislation's incredibly restrictive mandates. Private Funds relying on these exemptions would often pursue innovative strategies that were largely unavailable to their registered counterparts. A large number of elite investors took advantage of this increased access to financial innovation as they frequently sought creative mechanisms for diversifying returns and managing risk. As a result, the Private Fund industry has grown substantially in recent decades.

---

175. Jeffrey D. Collins & Diana W. Lo, *CFTC Repeals Rule 4.13(a)(4) Exemption from Registration and Amends Rule 4.13(a)(3)*, FOLEY HOAG LLP: THE FOLEY ADVISOR (Apr. 19, 2012), http://www.foleyhoag.com/publications/alerts-and-updates/2012/april/cftc-repeals-rule-4-13a4-exemption-from-registration-and-amends-rule-4-13a3 [https://perma.cc/R2QV-MSDZ].

176. *Id.*

177. 17 C.F.R. § 4.7(a)(2) (2016).

178. Collins & Lo, *supra* note 175.

179. 17 C.F.R. § 4.7(b).

180. 17 C.F.R. § 4.13(a)(3) (2016).

181. Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole* 35 DEL. J. CORP. L. 151, 173–79 (2010) (examining extent to which private placement industry has grown in response to Regulation D).

However, with the exponential growth of Private Funds, regulators grew increasingly concerned with the abilities of such entities adversely to affect the general public. This Part thus examines how the expansion of the Private Fund industry invoked public concerns such as systemic risk, retailization, and shadow banking. It continues by outlining Congress's response to these concerns under the Dodd-Frank Act, which has since expanded indicators of publicness in the Private Fund industry. This law incorporates these expansions under the Advisers Act and Commodity Exchange Act, instead of focusing on the industry's core regulation under the 1940 Act. Part III concludes by exploring the investor protection harms that have resulted from this inadequate focus on ancillary laws, which include over-inclusive and under-inclusive indicators of publicness under the 1940 Act.

A. Private Funds Invoke "Public" Concerns

As of April 2015, hedge funds managed a total of $3.125 trillion in the United States,[182] while private equity funds managed $1.5 trillion.[183] One study predicted that hedge funds will manage a total of $5.8 trillion in 2018.[184] In spite of reports that hedge funds have not consistently beat the markets in recent years, the industry is likely to continue its exponential growth particularly since it has access to innovative strategies and instruments that are not available to its registered counterparts. Institutional investors such as pension plans, endowments, and insurance companies are increasingly investing in private funds and a 2015 study administered by J.P. Morgan found that 94% of such investors plan to maintain or increase hedge fund investments in the coming years.[185] Such investors are generally attracted to the diversification opportunities afforded by Private Funds, as well as their unique abilities to earn returns in declining markets.

This rapid growth has been accompanied by new regulatory concerns that Private Funds are perhaps engaging in activities that could imply greater degrees of publicness. Most importantly, Private Funds are not constrained by the capital restrictions provided under Section 18 of the 1940 Act, which requires that registered funds maintain at least 300% asset coverage for any leveraged transaction, and that advisers be sufficiently "covered" before trading in derivatives.[186] These flexibilities create a risk that a particular fund could default on a debt obligation with an investment bank counterparty, thereby exposing such bank to the risk of failure. To the extent that a fund, or series of funds, has relationships with several counterparties, such correlated defaults could expose the broader

182. Evestment, *supra* note 16.
183. Jacobius, *supra* note 17.
184. Touryalai, *supra* note 20.
185. *Capital Introduction Group Institutional Investor Survey – 2015*, J.P. Morgan 60 (2015), https://www.managedfunds.org/wp-content/uploads/2015/02/JPM-Capital-Introduction-Group-2015-Institutional-Investor-Survey.pdf [https://perma.cc/YB4A-J3NZ].
186. Shelby, *Privileged Access Article*, *supra* note 19, at 347.

economy to a financial calamity.[187] This phenomenon falls under the category of systemic risk, which generally refers to "the possibility that an event at the company level could trigger severe instability or collapse an entire industry or economy."[188]

One of the earliest incidents that shed light on these emerging systemic risk concerns occurred in 1998 with the near failure of Long-Term-Capital Management (LTCM), a large hedge fund organized by the top talent in the industry. The organizers of LTCM included two Nobel Prize winners who were highly successful in the fund's first years of operation—they initially raised billions of dollars from investors.[189] However, an unanticipated "flight to quality" on a global scale caused unanticipated shifts in the markets, leading to massive losses of the fund's portfolio.[190] LTCM's resulting losses were so severe, and its leverage so exceedingly high, that it was set to default on over $1 trillion in debt to a number of prominent investment banks. If these defaults would have actually occurred, the resulting losses to the investment banks would have single-handedly crippled the economy. The Federal Reserve orchestrated a private deal amongst LTCM's counterparties to prevent the default of these obligations. The near-failure of LTCM created a political backlash against the industry because it highlighted the possibility that private entities could have a significant, adverse impact on the general public.[191] This of course challenged the private-public divide as losses incurred by a private entity should theoretically be constrained to such entity, as opposed to reaching unsuspecting third parties.

Relatedly, hedge funds became active participants in the "shadow banking" industry,[192] which refers to a network of "financial intermediaries involved in facilitating the creation of credit across the

---

187. Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony for the House Oversight Committee on Hedge Funds*, 3–4 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217 [https://perma.cc/GF5M-7BUH]; Luis A. Aguilar, *Speech by SEC Comm'r: Hedge Fund Regulation on the Horizon - Don't Shoot the Messenger*, U.S. SEC. & EXCH. COMM'N (June 18, 2009), https://www.sec.gov/news/speech/ 2009/spch061809laa.htm [https://perma.cc/2Z9L-4FQ4]; Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 163–64 (2011).

188. *Systemic Risk*, INVESTOPEDIA, http://www.investopedia.com/terms/s/systemic-risk.asp [https://perma.cc/V7L6-CZPB].

189. Stephanie Yang, *The Epic Story of How a 'Genius' Hedge Fund Almost Caused a Global Financial Meltdown*, BUSINESS INSIDER (July 10, 2014), http://www.businessinsider.com/the-fall-of-long-term-capital-management-2014-7 [https://perma.cc/4YRC-T9PJ].

190. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12 (1999).

191. *Id.* at 13–14, 29.

192. Karin Matussek, *Hedge Funds Are Shadow Banks in Need of Regulation, Bafin Says*, BLOOMBERG BUSINESS (May 13, 2012), http://www.bloomberg.com/news/articles/2012-05-13/hedge-funds-are-shadow-banks-in-need-of-regulation-bafin-says [https://perma.cc/3TTG-3JCB]. *But see The Role of Credit Hedge Funds in the Financial System: Asset Managers, Not Shadow Banks*, ALT. INV. MGMT. ASS'N 3 (Mar. 2012), http://www.aima.org/en/document-summary/index.cfm/docid/129E55F5-AF6C-471F-B30DA4A33B40A8EB [https://perma.cc/G6MU-JVGF] (arguing that the hedge fund industry is a part of the asset management sector, as opposed to shadow banking, and further arguing that "hedge funds generally do not engage directly in credit transformation").

global financial system, but whose members are not subject to regulatory oversight."[193] While credit was historically created and managed by large banking institutions subject to prudential regulation, innovative financial instruments such as credit default obligations (CDOs), credit default swaps (CDS), and other exotic derivatives, created a mechanism for Private Funds to participate directly in such credit markets.[194] These instruments essentially gave banks the power to repackage and sell debt to a variety of market participants, which led to a robust credit market that evaded regulation under the federal securities laws.[195] Given that hedge funds have flexibility to trade unlimited derivatives, they are active participants in these markets. Some have estimated that "hedge funds were responsible for over one-third of [credit derivative] contracts sold through 2006" and "55% of all trading volume [in the plain vanilla credit derivative industry]."[196]

Hedge funds, and other private entities, provided the necessary liquidity to fuel the growth of these markets, which expanded the availability of credit to market participants across the globe.[197] This unprecedented growth, however, precipitated the financial crisis of 2007–2010 (Great Recession), as the rampant speculation in these instruments, coupled with the lack of regulatory oversight, eventually led to massive defaults that crippled the global economy.[198] Although the investment banks that created these instruments have been identified as the major culprit in facilitating the crisis, the ongoing presence of Private Funds in facilitating the demand of such instruments created unique regulatory concerns.[199] For example, numerous commentators have queried whether Magnetar, a massive Chicago based hedge fund, helped to resuscitate the housing bubble through its speculative trading activities in complex mortgage-backed securities.[200] In late 2005, just as the housing market was beginning to deflate, Magnetar brokered deals with several banks to invest in

193. *Shadow Banking System*, INVESTOPEDIA, http://www.investopedia.com/terms/s/shadow-banking-system.asp [https://perma.cc/6ZXF-CWGT].

194. *See generally* FIN. CRISIS INQUIRY COMM'N, THE FIN. CRISIS INQUIRY REP. 27–38 (2011), https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/52MG-UQ6S] (discussing the shadow banking system and its role in the 2008 financial crisis).

195. *Id.* at 27. Prior to the Dodd-Frank Act, credit derivatives were not subject to regulatory oversight by the CFTC. *See id.* at 48.

196. DAVID P. STOWELL, INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY 234 (2d ed. 2013).

197. CATE REAVIS, THE GLOBAL FINANCIAL CRISIS OF 2008: THE ROLE OF GREED, FEAR, AND OLIGARCHS 6–7 (2012), https://mitsloan.mit.edu/LearningEdge/CaseDocs/09-093%20The%20Financial%20Crisis%20of%202008.rev.pdf [https://perma.cc/MQ2B-GK87].

198. *Id.*

199. *E.g.*, James Richards, *Repeal of Glass-Steagall Caused the Financial Crisis*, US-NEWS (Aug. 27, 2012), http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis [https://perma.cc/8ZWR-6BR9].

200. Stephen Gandel, *Even Housing Bears Bought Big Homes Before the Crash*, FORTUNE (Apr. 1, 2013), http://fortune.com/2013/04/01/even-housing-bears-bought-big-homes-before-the-crash/ [https://perma.cc/7LKF-6WH6]; Jesse Eisinger and Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA

the riskiest portion of various CDOs. Some estimates have found that Magnetar controlled up to half of the total volume of these toxic investments. Because Magnetar protected itself from these toxic assets through its simultaneous investment in CDS instruments, Magnetar earned record profits when the housing bubble eventually burst.[201]

The participation of Private Funds in these toxic markets leads to provocative questions about whether the underlying activities of such entities can appropriately be classified as private. On the one hand, these vehicles are not available for direct investment by retail investors, which shields the general public from the heightened risk associated with investing in these kinds of risky instruments. Furthermore, in analyzing the performance of Private Funds on a micro level, many were able to shield their elite investors from excessive losses. If not, one could still argue that any excessive losses were constrained to such elite investors and did not spill over to the general marketplace (which is inapposite to the scenario resulting from the near-failure of LTCM). And in some cases, such as in the Magnetar example provided above, hedge funds were able to earn a sizable return for their underlying investors by appropriately hedging against such risky bets. This analysis would be consistent with traditional notions of publicness, which are rooted in determining whether investors can appropriately fend for themselves.

However, if we examine these examples in terms of "public effect" as opposed to status of investors, the assessment of publicness dramatically changes. To the extent that private entities are speculating on toxic instruments that could eventually lead to a crisis, such entities are perhaps—if not in fact—engaged in activities that are more public in nature. The vast participation in these markets by Private Funds could also create perverse incentives that spur the growth of toxic markets, irrespective of the resulting harms to the broader economy. Private Fund advisers could, for example, be incentivized to encourage investment banks to create toxic instruments, through either these advisers' relationships or their bargaining power, so that they can secretly hedge against such trades and earn massive profits.[202] Many alleged that Magnetar engaged in these sorts of activities unbeknownst to its bank counterparties.[203] A range of regulatory solutions have been considered by numerous commentators, such as creating an administrative body to prescreen innovative products before they are traded on the financial markets,[204] or prohibiting the trading of

(Apr. 9, 2010), http://www.propublica.org/article/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble [https://perma.cc/HNG9-EV4G].

201. *See* Eisinger & Bernstein, *supra* note 200.

202. *See id.*

203. *Id.*

204. Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets*, 107 Nw. U. L. Rev. 1307 (2013) (proposing that an administrative agency comparable to the FDA prescreen new financial instruments before they enter the markets).

such instruments altogether.[205] Congress likely grappled with comparable questions and solutions in creating the new regulatory framework for OTC derivatives under the Dodd-Frank Act, which will be further discussed below.[206]

The retailization of Private Funds has also strained the private-public divide in the investment company industry.[207] As background, investment companies such as mutual funds and money-market funds are automatically deemed public because they are available for direct investment by retail investors. This is consistent with the deeply embedded notion that members of the general public do not have the resources sufficient to protect themselves from the often riskier strategies employed by hedge funds and other private vehicles. However, since pension plans typically qualify as both accredited investors and qualified purchasers under the Securities Act and 1940 Act, respectively, they frequently invest in the Private Fund industry. This phenomenon challenges traditional notions of publicness as the underlying retail investors of pension plans are indirectly exposed to Private Funds.

This retailization of Private Funds is set to increase in coming years. In 2014 for example, the Pennsylvania Public School Employees' Retirement System allocated 10.5% of its plan assets into hedge funds, the Public School and Education Employee Retirement Systems of Missouri allocated 13.7%, and the Texas County & District Retirement System allocated 25% of its assets into hedge funds.[208] Institutional investors are increasingly seeking Private Fund investments because of the large universe of strategies that are simply unavailable in the registered fund space. Such strategies provide institutional investors with unique diversification and hedging opportunities. As one commentator noted, "public pension funds are expected to be the main driver of growth in the alternatives space going forward."[209]

B. Ancillary Law Focus under Dodd-Frank Act

Congress, as well as the SEC, sanctioned studies to investigate these heightened concerns with respect to the Private Fund industry.[210] These studies did indeed confirm that Private Funds could increase systemic risk

205. James Rickards, *Derivatives Should Be Banned from Financial Markets*, USNews (July 16, 2012), http://www.usnews.com/opinion/blogs/economic-intelligence/2012/07/16/derivatives-should-be-banned-from-financial-markets [https://perma.cc/BMA6-YGKZ].

206. *See* discussion *infra* Part III.B.

207. SEC Staff Report, *supra* note 170, at 80–82.

208. Williamson, *supra* note 21.

209. Tim Ng, *The Role of Hedge Funds in Institutional Portfolios*, Pensions & Invs. (Feb. 3, 2015), http://www.pionline.com/article/20150203/ONLINE/150209962/the-role-of-hedge-funds-in-institutional-portfolios [https://perma.cc/3CQU-8NHR].

210. *See, e.g.*, Cong. Oversight Panel, 111th Cong., Special Report on Regulatory Reform: Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability (Jan. 2009), http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT47018/pdf/CPRT-111JPRT47018.pdf [https://perma.cc/PD37-F99S]; *see also* SEC Staff Report, *supra* note 170.

levels in the broader economy. One study noted that, "[i]f highly leveraged hedge funds are forced to liquidate assets at fire-sale prices, these asset classes may sustain heavy losses. This can lead to further defaults or threaten systemically important institutions not only directly as counterparties or creditors, but also indirectly through asset price adjustments . . . ."[211] While the regulators generally seemed eager to implement some form of regulation over Private Funds, original indicators of publicness embedded in our federal securities laws, such as *status of investors* and *number of investors/clients*, did not sufficiently measure systemic risk. In contrast, information regarding a Private Fund's interconnectedness, substitutability, complexity, and global activities could possibly act as meaningful indicators of systemic risk, but these categories of activities were not historically monitored under federal securities laws.[212] Such activities were typically created by banks and monitored by accompanying banking regulators, making it difficult for Congress seamlessly to integrate Private Funds into the federal securities laws rubric.

In spite of these difficulties, Congress eventually responded to these systemic risk concerns by creating new registration requirements for Private Funds under the Dodd-Frank Act. Its passage effectively demonstrated that historical indicators of publicness, such as status of investors, for example, no longer provided sufficient boundaries in delineating private and public investment companies. Instead of revamping the primary legislation provided under the 1940 Act directly to integrate these evolving notions of publicness, Congress instead focused on the ancillary laws such as the Advisers Act and the Commodity Exchange Act. This section summarizes these new registration requirements, as well as the new power of the SEC to collect confidential and proprietary information from Private Funds, and to report such information to a newly created agency, the Financial Stability and Oversight Council (FSOC).

1. Advisers Act Registration for Private Funds

The Dodd-Frank Act essentially eliminated Section 203(b)(3) of the Advisers Act,[213] which was the most common exemption that Private Fund advisers previously relied on to avoid regulation under the Advisers Act. Congress then incorporated an official definition for Private Funds under the Dodd-Frank Act, which encompasses any issuer that relies on the exemptions provided under Sections 3(c)(1) or 3(c)(7) of the 1940 Act.[214] This definition effectively captured the large number of Private

211. Reint Gropp, *How Important Are Hedge Funds in a Crisis?*, FRBSF ECONOMIC LETTER (Apr. 14, 2014), http://www.frbsf.org/economic-research/publications/economic-letter/2014/april/hedge-fund-risk-measurement-spillover-economic-crisis [https://perma.cc/8LVT-49NF].

212. *See* discussion *infra* Part V.A.

213. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80b-3(b) (2006 & Supp. IV 2010)).

214. § 402, 124 Stat. at 1570 (codified as amended at 15 U.S.C. § 80b-2(a)(29)). Private Funds were previously defined in this article as any investment company that was exempt

Funds that relied on Sections 3(c)(1) and 3(c)(7) of the 1940 Act to avoid the arduous requirements that normally apply to RICs. All such Private Funds must now register under the Advisers Act, unless there is an available exemption. Congress did adopt numerous exemptions from this new registration requirement,[215] one of which includes advisers that only advise Private Funds and have assets under management in the United States of less than $150,000,000.[216] In addition, managed futures funds and other funds that hold a limited amount of securities are excluded from the definition of Private Funds under the Dodd-Frank Act and thus are not required to register.[217] Family offices, venture capital funds, and certain foreign advisers are also exempt from registration.[218]

For the sake of clarity, Private Funds are not required to register under the 1940 Act, in spite of Congress's reference to the 1940 Act exemptions in defining this term. The Advisers Act creates additional disclosure obligations and fiduciary duties for registered advisers, but has a minimal effect on the actual funds managed by advisers. Specific limits on leverage and derivatives trading would only be triggered by mandatory registration under the 1940 Act. This primary legislation would also impose standardized valuation mechanisms, corporate governance requirements, and disclosure mandates, which still do not apply to Private Funds. Overall, Congress did not retool the registration requirements provided under the 1940 Act as a mechanism for incorporating systemic risk measures or controls in the enactment of the Dodd-Frank Act.

The Dodd Frank Act did, however, create a new reporting obligation for Private Funds, which also applies to mid-sized Private Funds that are exempt from Advisers Act registration.[219] Under this new requirement, Private Fund advisers must file a confidential Form PF with the SEC, which includes proprietary information such as use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, and "such other informa-

---

under the 1940 Act. For the remainder of this article, Private Funds refer to investment companies that are exempt under Sections 3(c)(1) or 3(c)(7) of the 1940 Act.

215. §§ 407–410, 124 Stat. at 1574–76 (codified as amended in scattered sections of the U.S. Code).

216. § 408, 124 Stat. 1376, 1575 (codified as amended at 15 U.S.C. § 80b-3(m)(1)). However, these funds are still required to maintain certain records and provide certain reports as the SEC deems necessary or appropriate in the public interest. § 408, 124 Stat. at 1575 (codified as amended at 15 U.S.C. § 80b-3(m)(2)). In addition, private funds with less than $100 million in assets under management must register with applicable state authorities. § 410, 124 Stat. at 1577.

217. § 403, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-3(b)).

218. §§ 409, 124 Stat. at 1575 (codified as amended at 15 U.S.C. § 80b-2(a)(11)(G)) (family offices); 407, 124 Stat. at 1574 (codified as amended at 15 U.S.C. § 80b-3(l)(1)) (venture capital funds); 403, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-3(b)(3)) (foreign advisers).

219. § 404, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-4(b)(3)). Certain mid-sized funds, presumably including certain funds that would be exempt pursuant to Section 408 of the Act (which exempts advisers who have less than $150 million under management), could be subject to these additional reporting requirements if they pose a systemic risk to the economy. § 408, 124 Stat. at 1575 (codified as amended at 15 U.S.C. § 80b-3(m)(1)).

tion . . . the Commission . . . determines is necessary and appropriate [for disclosure] in the public interest and for the protection of investors or for the assessment of systemic risk[.] . . ."[220] These confidential disclosures are likely designed to assist the SEC in identifying the Private Funds that pose a systemic risk to the economy.[221] Investors will not have access to this information because it has been deemed proprietary. Private Fund interest groups successfully lobbied Congress to find that the public disclosure of information related to their underlying strategies would destroy the competitive nature of the industry and subsequently lead to significant investor losses. The SEC is thus required to guarantee the confidentiality of these disclosures and can only reveal this information to Congress or to other regulatory bodies, such as the newly created FSOC, which is designed to oversee institutions that pose a systemic threat to the economy.[222]

2. *Retooling of Commodity Exchange Act*

Under Title VII of the Dodd-Frank Act, Congress also created a new regulatory framework for OTC derivatives.[223] Since Private Funds frequently rely on OTC derivatives in pursuing innovative strategies, this new framework has significantly altered the regulatory framework that applies to these entities.[224] The hallmark feature of Title VII requires that many OTC derivative contracts be centrally cleared through authorized clearinghouses.[225] Such parties must become a member of an authorized clearinghouse or contract with a member of an authorized clearinghouse in order to trade OTC derivatives.[226] Prior to the Dodd-Frank Act, parties trading in OTC derivatives would instead enter into bilateral contracts to effectuate their trading relationships. These contracts were privately negotiated and documented, making the full scope of the industry opaque from a regulatory perspective. Interposing a clearinghouse into this trading relationship standardized the process of these trades, and as illustrated by Professor Kristin Johnson, "[m]igrating the trades within the industry onto a clearinghouse platform thus mitigates risk exposure by increasing the transparency in the industry and maximizing alloca-

220. § 404, 124 Stat, at 1572 (codified as amended at 15 U.S.C. § 80b-4(b)(3)(H)).

221. *See* § 404, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-4(b)(1)(A)).

222. § 404, 124 Stat. at 1573 (codified as amended at 15 U.S.C. § (b)(7)(B)).

223. §§ 701–74, 124 Stat. at 1641–1802 (codified as amended in scattered sections of 7, 12, & 15 U.S.C.).

224. *See id.*

225. *Id.* While the Dodd-Frank Act granted the CFTC primary authority to regulate the OTC derivative market, it granted the SEC exclusive authority to regulate "security-based swaps," which are "swaps based on a single security or loan or a narrow-based group or index of securities (including any interest therein or the value thereof), or events relating to a single issuer or issuers of securities in a narrow-based security index." *Derivatives*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml [https://perma.cc/D4P6-84AW].

226. §§ 711–74, 124 Stat. at 1641–802 (codified as amended in scattered sections of 7, 12, & 15 U.S.C.).

tional efficiency."[227] This clearinghouse mandate also "requir[es] real-time trade reporting . . . [and] allow[s] the regulators to see the volume of contracts trading in the market," which allows regulators "to monitor derivatives trading data and . . . to oversee risk exposures and reduce systemic risk in the derivatives markets."[228]

The Dodd-Frank Act gave authority to the CFTC to retool a number of exemptions provided under the Commodity Exchange Act. Pursuant to this authority, the CFTC eliminated CFTC Rule 4.13(a)(4), which previously exempted Private Funds that restricted investors to "qualified eligible purchasers."[229] As previously discussed, these investors encompass several categories of high-net-worth individual and institutional investors, including qualified purchasers as defined under the 1940 Act.[230] In eliminating this exemption, many Private Funds would thus be required to register under the Commodity Exchange Act and comply with additional layers of regulation, such as additional disclosure obligations, filing fees, and recordkeeping requirements, among others. While some funds do in fact have to register with the CFTC as a result of the repeal of 4.13(a)(4), many instead rely on CFTC Rule 4.7, which provides such funds relief from certain reporting and disclosure requirements mandated under the Commodity Exchange Act.[231] Private Funds can also rely on CFTC Rule 4.13(a)(3), which exempts funds that trade de minimis levels of futures.

3. *FSOC and Possible SIFI Designations*

Under the Dodd-Frank Act, FSOC "is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system."[232] This newly created entity also has the power to designate both "bank entities" and "non-bank entities," such as Private Funds, for example, as "systemically important financial institutions" (SIFIs). In determining whether non-bank entities should be categorized as SIFIs, FSOC analyzes the following characteristics: "(i) [s]ize, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny."[233] The FSOC uses these characteristics to determine whether a non-bank entity is vulnerable to financial distress, and whether an entity's financial distress

---

227. Kristin Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 216 (2013).

228. *Hedge Funds and Dodd-Frank Reform*, MANAGED FUNDS ASS'N, https://www.managedfunds.org/issues-policy/issues/hedge-funds-and-dodd-frank-reform [https://perma.cc/F7J7-2Q4T].

229. FOLEY HOAG LLP, *supra* note 175.

230. *Id.*

231. *See* 17 C.F.R. § 4.7(b) (2016).

232. *Financial Stability Oversight Council*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx [https://perma.cc/U6LM-NNRQ].

233. Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637–21,641 (Apr. 11, 2012) (amending 12 C.F.R. pt. 1310).

would adversely impact the broader economy.[234] Once a non-bank entity is classified as a SIFI, it is then subject to enhanced regulation under the Dodd-Frank Act that would be similar to the prudential regulation typically imposed upon banks.[235] The Federal Reserve Board (FRB) would then supervise and implement this enhanced regulation. Should a SIFI fail, it would enter into a receivership process that would be administered and supervised by the Federal Deposit Insurance Corporation.[236]

FSOC has yet to designate a Private Fund as a SIFI, and the likelihood of FSOC making this kind of designation has declined significantly in recent years.[237] In 2012, FSOC called on the Treasury Department's Office of Financial Research (OFR) to investigate the extent to which Private Funds create systemic risk.[238] While the final report found that hedge funds could in fact amplify and transmit systemic risk through possible reliance on highly leveraged strategies,[239] the industry has consistently disagreed with these findings. In particular, the Managed Fund Association (MFA) has consistently argued that the existing regulation of its investment bank counterparties, as well as the new clearing requirements for OTC derivatives, sufficiently deters excessive leverage.[240] This opposition also found support from the SEC, as the agency has frequently highlighted the distinct differences between Private Funds and investment banks, and has similarly queried whether the FRB has the expertise to regulate the Private Fund industry sufficiently. As a result, FSOC has recently announced that it will instead focus on systemic risk posed by the products and activities of Private Funds, instead of focusing on the underlying entity as a whole.[241]

Even still, the SEC will likely assert a stronger stance as the primary regulator over these emerging issues within the Private Fund industry. As one commentator noted, "FSOC and other regulators now expect the SEC to assume a prudential supervisory role, in addition to exercising its traditional mandate of investor protection."[242] Moreover, international administrators, such as the Financial Stability Board (FSB) and the Inter-

234. *See id.*

235. Andy Winkler, *Primer: FSOC's SIFI Designation Process for Nonbank Financial Companies*, American Action Forum (Sept. 3, 2014), http://americanactionforum.org/research/primer-fsocs-sifi-designation-process-for-nonbank-financial-companies [https://perma.cc/362S-6Q4J].

236. *Id.*

237. *See id.*

238. *See* Asset Mgmt. & Fin. Stability, Office of Fin. Research 1 (Sept. 2013), http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf [https://perma.cc/SH79-TW5N].

239. *See id.* at 9.

240. *See, e.g.*, *MFA Comments on Significantly Systemic Institutions*, Managed Funds Ass'n (Feb. 25, 2011), http://www.managedfunds.org/wp-content/uploads/2011/06/2.25.11-MFA.letter.on_.systemically.significant.institutions.pdf [https://perma.cc/SXF4-8CS4].

241. *Asset Managers: FSOC Stands Down, SEC Stands up*, PriceWaterhouseCoopers 1–2 (Nov. 2014), http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-asset-managers-fsoc-stands-down-sec-stands-up-sifis.pdf [https://perma.cc/JJ96-6TSS].

242. *Id.* at 1.

national Organization of Securities Commissions (IOSCO) have concluded that Private Funds could in fact enhance systemic risk irrespective of the existing regulations over counterparties and OTC derivatives. On March 4, 2015, the FSB and IOSCO published a consultation study (Consultation Study) that noted the following:

> [I]t is still possible for an investment fund to become highly leveraged through derivatives that are not centrally-cleared, particularly if margining practices for the non-centrally cleared derivatives are inadequate. Hence leverage constitutes a central component in the analysis of the counterparty channel, particularly for those funds that are not subject to any restrictions and may build up significant leverage positions (e.g. private funds).[243]

Both domestic and international regulators will likely continue this contested process of measuring and identifying appropriate systemic risk indicators within the investment company industry. As discussed in Part V below, incorporating these final resolutions into the 1940 Act will help to ensure continuity in documenting these evolving notions of publicness.

IV. RESULTING INCOHERENCY AND INVESTOR PROTECTION HARMS

Through the passage of the Dodd-Frank Act, Congress has drastically altered historic indicators of publicness in the investment company industry. Private Funds are now required to register under the Advisers Act and are subject to increased oversight by the CFTC.[244] OTC derivatives must also be cleared through authorized clearinghouses with the hopes of enhancing transparency in the previously opaque industry. Moreover, systemically relevant Private Funds could be subject to additional prudential oversight by the SEC and FSOC, although the full extent of this oversight is still unclear. In spite of these sweeping changes to the industry, the 1940 Act has remained largely untouched.

Since these evolving notions of publicness have been integrated into the ancillary laws that regulate such vehicles, or addressed through additional layers of regulation, Congress has effectively expanded and complicated the patchwork of regulation that applies to these entities. Extending this regulatory patchwork has further complicated the distinction between private and public investment companies. Defining the contours of publicness within the investment company industry is now an arduous task that involves mapping out a long list of ancillary exemptions and trying to predict the extent to which FSOC may deem a Private Fund, or its underlying activities, systemically harmful. Thus, there is no

243. FIN. STABILITY BD. & INT'L ORG. OF SEC. COMM'N, CONSULTATION PAPER: ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 33 (Mar. 4, 2015) [hereinafter CONSULTATION STUDY], http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf [https://perma.cc/5DSU-JPCK].

244. *See* discussion *supra* Part III.B.1.

clear concept of publicness from a practical, theoretical, or regulatory perspective. This Part describes two investor protection harms that have likely resulted from this improper focus on ancillary legislation: (1) under-inclusive indicators of publicness under the 1940 Act, which could effectively exempt systemically relevant investment companies from effective regulation; and (2) over-inclusive indicators of publicness under the 1940 Act, which could restrict retail investors from accessing innovative strategies during times of economic distress.

A. Under-inclusive Indicators under the 1940 Act

In spite of the extensive innovations that have occurred in the investment company industry, with respect to evolving notions of publicness and Congress's accompanying responses, the 1940 Act has remained largely unaltered. The predominant indicator of publicness is still *status of investors* as most Private Funds rely on Section 3(c)(7) in order to maintain exemptions under the 1940 Act. Other indicators such as *number of investors* and *advertising* have been significantly narrowed under the recently passed JOBS Act. Private Funds can now maintain exemptions under the Exchange Act with as many as 2,000 investors, and Private Funds are now permitted to advertise to solicit a larger number of elite investors.[245] As such, Private Funds can simply restrict investments to qualified purchasers to evade significant oversight. This reliance on *status of investors* as the dividing line between public and private is possibly under-inclusive, as it exempts all Private Funds from regulation under the 1940 Act, irrespective of whether such pools pose a systemic threat to the economy.

Congress attempted to resolve this loophole by mandating registration under the Advisers Act, retooling clearing requirements under the Commodity Exchange Act, and creating FSOC to regulate Private Funds that could pose a systemic threat to the economy. But there are several limitations related to these mandates. With respect to Advisers Act registration, this requirement has enhanced transparency in the industry by creating additional disclosure obligations for the underlying advisers of such pools, as well as heightened fiduciary duties. However, this law is limited in its oversight of systemic risk, as it has no required capital restrictions, valuation mechanisms, or governance requirements related to Private Fund entities. With respect to the new clearing requirements for OTC derivatives, it has similarly enhanced transparency within these markets. Yet, mandating clearing could serve to transfer and concentrate systemic risk within clearinghouse entities. Professor Kristin Johnson specifically noted that, "[i]f a clearinghouse member with a large volume of contracts or a series of members whose transaction constitutes a significant volume of contracts should default, the clearinghouse may face insol-

245. *Jumpstart Our Business Startups Act Frequently Asked Questions*, U.S. Sec. & Exch. Comm'n, https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm [https://perma.cc/8ZF3-KKTY].

vency or bankruptcy."[246] With respect to the power granted to FSOC, the council has yet to develop sufficient systemic risk indicators for the industry. FSOC's efforts to produce systemic risk indicators have been widely criticized by the private sector, as well as by the SEC. As a result, the likelihood of FSOC designating a Private Fund as a SIFI has significantly declined. Overall, the obligation to comply with this extended patchwork of regulation has significantly increased compliance costs, without necessarily producing the intended benefits of mitigating systemic risk. These costs inevitably get passed down to the underlying investors, which could further compromise investor protection.

This potential loophole with respect to systemic risk is somewhat troubling given that the Private Fund industry will likely expand in coming years. Institutional investors such as pension plans, endowments, and insurance companies are increasingly investing in Private Funds, which can expose their retail investor constituents to significant losses. Some pension plans, such as CAPLERS, have admittedly divested their hedge fund allocations due to concerns related to excessive complexity and inability to beat the markets.[247] Yet, many pension plans are facing significant challenges that have driven the desire to allocate to innovative strategies. As one commentator noted, "[l]ife for pension funds is getting tough. The race to the bottom in global interest rates has reduced the rate at which funds discount their future liabilities. Life expectancy continues to surge. Deficits have ballooned."[248] A 2015 study administered by J.P. Morgan found that 94% of such investors plan to maintain or increase hedge fund investments in the coming years.[249] In 2014 for example, the Texas County & District Retirement System allocated 25% of its assets into hedge funds.[250] In terms of private-sector pension plans, "[l]arge corporate pension funds have quadrupled the share of their portfolios invested in hedge funds over the past five years, according to an analysis of about 300 firms in the S&P 500 by Wilshire Consulting."[251]

One can certainly argue that institutional investors can sufficiently protect themselves against the risks discussed herein.[252] Institutional inves-

246. Johnson, *supra* note 227, at 226.

247. INSTITUTIONAL INVESTOR SURVEY, *supra* note 15.

248. Christopher Swann, *Why Hedge Funds Still Make Sense for Pension Funds*, N.Y. TIMES (Mar. 10, 2015), http://www.nytimes.com/2015/03/10/business/dealbook/why-hedge-funds-still-make-sense-for-pension-funds.html [https://perma.cc/S4R8-WP4H].

249. *Capital Introduction Group Institutional Investor Survey*, *supra* note 185, at 60.

250. Williamson, *supra* note 21.

251. Timothy W. Martin, *Hedge-Fund Bet Hits Pensions Firms moved portfolios away from stock market to reduce risk, but missed out on rally*, WALL ST. J. (June 16, 2015), http://www.wsj.com/articles/hedge-fund-bet-hits-pensions-1434496049 [https://perma.cc/JK54-HLRW].

252. *See, e.g.*, Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 992 (2006) ("[Hedge fund] [i]nvestors, particularly institutional investors, engage in active due diligence before investing, routinely retain advisory firms to evaluate options for them, and negotiate for more disclosure from hedge funds."); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 713–14 (2000) (arguing that existing anti-fraud protections sufficiently protect hedge fund investors).

tors typically invest significant resources in undergoing due diligence and research with respect to prospective Private Fund investments.[253] Nevertheless, there have been occurrences where the inadvertent mistakes of such investors have adversely impacted their retail investor constituents. For instance, when a prominent hedge fund, Amaranth Advisors, L.P., lost close to $6 billion due to unanticipated fluctuations in natural gas prices, the San Diego County Employees Retirement Association lost its approximately $87 million investment in this fund.[254] Moreover, a systemic risk calamity is typically triggered by a completely random event that may have pervaded the complex calculations implemented by fund managers. And given the numerous reports that hedge funds cannot beat the markets,[255] Private Fund advisers may start pursuing more aggressive strategies that entail higher degrees of risk. To the extent that either FSOC or the SEC identifies a fund as being a systemic threat, that fund should also be subject to tailored regulation under the 1940 Act. Investors of such funds, as well as possible retail constituents, should be entitled to protections against any resulting losses. The 1940 Act could effectively provide enhanced transparency with respect to such funds, mandate standardized valuation mechanisms for exotic instruments, and implement corporate governance mechanisms to closely monitor the underlying strategies of such advisers.

B. Over-inclusive Indicators under the 1940 Act

The reliance on *status of investors* as the predominant indicator of publicness under the 1940 Act is also over-inclusive from an investor protection standpoint. It does not permit regulators to make the nuanced distinctions necessary to address the heterogeneous fund industry. While some Private Funds are not appropriate for investment by retail investors for the reasons discussed in Part IV.A above, others may rely on innovative strategies that could create unique diversification and profit-maximizing opportunities for retail investors without exposing those investors to excessive risks. Since RICs are automatically subject to the stringent capital restrictions under the 1940 Act, they are restricted from accessing innovative products such as derivatives, illiquid instruments, distressed securities, and other exotic instruments. Mutual funds and other RICs primarily rely on equities, bonds, and cash instruments in order to earn returns for investors.

In contrast, Private Funds have unfettered access to a plethora of exotic instruments, illiquid investments, and non-U.S. investment opportunities to assist in maximizing investor returns. Because of these flexibilities, hedge funds are often viewed as the leaders in extracting the benefits of financial innovation, as they attract the best managerial talent

253. Gibson, *supra* note 252, at 713.
254. Jonathan H. Bliley, *Shutting the Door on Pension Fund Investment in Hedge Funds - Protecting Investors That Need Protection*, 3 J. Bus. & Tech. L. 455, 456 (2008).
255. Lack, *supra* note 18.

to take advantage of these broad liberties. They are characterized as having the ability to earn "absolute returns," which means that they seek to guarantee returns irrespective of market performance.[256] Strategies include market neutral, global macro, opportunistic, emerging markets, and distressed securities, to name a few.[257] With respect to private equity and venture capital funds, these vehicles typically invest in an assortment of private companies and investments. These can include start-ups, leveraged buy-outs, mezzanine financing, and distressed companies, among others.[258] Because private fund advisers are not obliged to fulfill daily redemption requests and can even suspend redemptions at their election, they can invest in instruments that are highly illiquid, as investor subscriptions can be locked into private vehicles for an extended period of time.[259]

This inequitable access is more likely to have an adverse impact on retail investors during times of economic distress, where "the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining."[260] During these time periods, hedge funds can often rely on their increased freedoms to engage in short-trading and other innovative strategies to protect investors from these declining prices.[261] On the whole, the hedge fund industry outperformed the mutual fund industry during the Great Recession.[262] More specifically, in 2008, the value of global equities collectively fell forty-two percent while hedge funds worldwide lost a comparatively smaller 19 percent for their investors.[263] Commentators have recently noted that hedge funds have been underperforming the markets in recent years.[264] However, this trend could possibly reverse when our economy enters into a bear market, which appears inevitable given the natural flow of the business cycle. As retail investors are often the most vulnerable class of investors during times of economic distress, resulting in dwindling retirement and savings accounts, an increasing retirement age, and decreasing property values, the potential disparities created by this divide have become more problematic and difficult to justify.

---

256. *See* SEC STAFF REPORT, *supra* note 170, at 33.

257. Dion Friedland, *Synopsis of Hedge Fund Strategies*, MAGNUM FUNDS, http://www.magnum.com/hedgefunds/strategies.asp [https://perma.cc/5RG3-BSA3].

258. THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 13.1 (2015).

259. *Id.* § 4.19.

260. *Bear Market*, INVESTOPEDIA, http://www.investopedia.com/terms/b/bearmarket.asp [https://perma.cc/BE8J-5CGP].

261. *See* Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 244 (2009) (arguing generally that hedge fund flexibilities allow such advisers to consistently outperform the broader markets).

262. *See id.* at 243–44.

263. *Id.*

264. LACK, *supra* note 18.

V. ALTERNATIVE FRAMEWORK: RECALIBRATE THE 1940 ACT

Congress's attempt to incorporate emerging notions of publicness under the ancillary laws discussed herein has served to complicate the already extensive patchwork of regulation that applies to investment companies. This extended patchwork has done little to resolve the systemic risk concerns expressed by Congress and has likely enhanced the investor protection harms discussed in Part IV above. This Part thus proposes an alternative framework that would require the following actions: (1) integrate emerging indicators of publicness under the 1940 Act; (2) conduct a wholesale review of 1940 Act; and (3) monitor other strategies that could invoke public concerns such as hedge fund activism, third-party litigation funding, and investment in distressed economies such as Detroit, Puerto Rico, and Greece. On the whole, recalibrating the 1940 Act to account for these emerging notions of publicness could help regulators resolve the over-inclusive and under-inclusive effects resulting from the archaic reliance on *status of investors*.

A. Integration and Wholesale Review

Congress has effectively identified systemic risk as being the preeminent concern in regulating evolving notions of publicness in the investment company industry. As such, this section focuses on systemic risk as the emerging indicator that should be incorporated under the 1940 Act. In order to effectuate this goal, regulators must first agree on specific indicators and measures for systemic risk. This will continue to be a difficult endeavor given the recent challenges faced by FSOC in addressing this issue. Determining ideal indicators is largely outside the scope of this article as this will entail further study and analysis by a range of experts. Even still, a suggested starting point could be the Consultation Study published by the FSB and IOSCO on March 4, 2015. This Consultation Study was sanctioned by G20 leaders during the Cannes Summit in November 2011, and provides suggested indicators of systemic risk for investment company structures, coupled with possible measures.[265]

Potential indicators for determining whether investment companies create or transmit systemic risk include the following characteristics: size, interconnectedness, substitutability, complexity, and global activities.[266] With respect to size, the Consultation Study noted that, "[t]he importance of a single entity for the stability of the financial system generally increases with the scale of financial activity that the entity undertakes"; suggested measures include net assets under management and gross national exposure.[267] In terms of interconnectedness, systemic risk is likely heightened when the activities of investment companies are inextricably linked

---

265. Consultation Study, *supra* note 243, at 1.
266. *Id.* at 6.
267. *Id.* at 6, 38.

with various counterparties. Hence, the failure of a particular fund could have a ripple effect on the performance of its investment bank counterparties. Suggested measures include balance sheet financial leverage, as well as the ratio of collateral posted by a fund relative to its NAV.[268]

Substitutability relates to the ease through which other financial entities can provide comparable products in the event of a fund's failure. This indicator captures funds whose failure would decimate niche markets.[269] A possible measure would compare a fund's daily trading volume of a particular asset, to the overall trading volume in the markets. In terms of complexity, "the more complex a financial entity, the more difficult, costly and time-consuming it will be to resolve the failing institution."[270] Complexity can be measured by a number of factors, including volume of non-centrally cleared derivatives, liquidity profile, and reliance on algorithmic trading strategies.[271] Lastly, "[t]he greater the global reach of a financial entity, the more widespread the spill-over effects from its failure."[272] Examining the number of jurisdictions in which a fund invests, sells its interests, or has counterparties can provide appropriate measures for global activities.[273]

Since indicators of publicness are embedded in the exemptions and exclusions of federal securities laws, systemic risk indicators should similarly be integrated under 1940 Act exemptions. With Section 3(c)(7) being the most popular amongst Private Funds, Congress could rely on this exemption as a starting point for accommodating these changes. The primary constraint under Section 3(c)(7) entails restricting investors to qualified purchasers. To the extent regulators agree on appropriate systemic risk measures, they can then add such additional restrictions to this provision. A basic example related to interconnectedness could read as follows: "*Private Funds relying on Section 3(c)(7) shall have a ratio of collateral posted relative to its NAV that does not exceed x%.*" An alternative approach would be to develop varying degrees of publicness similar to Regulation D under the Securities Act. Regulators would effectively develop a series of exemptions, incorporating multiple indicators of publicness, which would give regulators more flexibility to tailor varying degrees of restrictions. This approach may be better suited to accommodate the heterogeneous nature of the fund industry.

Creating new exemptions in this manner would necessitate a wholesale review of the 1940 Act. Many aspects of this law unduly restrict capital formation and are not closely tailored to the innovative products offered by Private Funds. For instance, the valuation mechanisms provided under the 1940 Act may be wholly inadequate for valuing certain complex de-

268. *Id.* at 6, 40.
269. *Id.* at 6.
270. *Id.*
271. *Id.* at 42–43.
272. *Id.* at 6.
273. *Id.* at 44–45.

rivatives. Regulators would have to consider developing standardized valuation mechanisms for these instruments, which could further enhance investor protection in these niche markets. Other restrictions related to conflict of interest transactions, as well as mandated daily redemptions, would not match the practicalities of the Private Fund industry. Furthermore, many of the provisions under the 1940 Act are simply archaic and would likely need to be updated to address the inequities between retail and elite investors discussed in Part IV.B above. The stringent capital restrictions provided under Section 18 of the 1940 Act have made it difficult for mutual funds and other RICs to pursue innovative strategies that could protect investors in declining markets. Former SEC Commissioner Professor Roberta S. Karmel has similarly suggested that the SEC undertake wholesale review of the 1940 Act to accommodate innovations in the investment company industry. She specifically stated that, "[i]nstead of trying to reform the [1940 Act] . . . to accommodate hedge funds and private equity funds, the SEC exempted them for many years[.] . . ."[274]

By and large, reconciling publicness under the 1940 Act would provide more clarity as to the distinction between private and public funds. It would ensure that funds that do in fact invoke these emerging notions of publicness are sufficiently regulated, thereby enhancing protection for such underlying investors. Focusing on the 1940 Act would also reconcile over-inclusive indicators that possibly exclude average investors from accessing strategies that could protect them in declining markets. This alternative framework is consistent with the SEC's expressed desire to take greater responsibility over the regulation of Private Funds. Given the recent failures of FSOC in undertaking this task, this alternative framework provides a useful starting point for the SEC to carry out the Congressional mandates expressed under the Dodd-Frank Act.

B. Monitor Other Possible Indicators of Publicness

Systemic risk has been flagged by regulators as the preeminent focus in regulating evolving notions of publicness. This focus largely derives from the Great Recession, where the failure of large investment banks had a ripple effect across the global economy. However, other innovations within the fund industry that fall outside the purview of systemic risk could also have a latent impact on the general public. Fund investments have grown increasingly creative, particularly since the industry has grown highly saturated in recent years. Advisers are constantly exploring innovative mechanisms for earning returns and protecting their portfolios against risk. Specific strategies that warrant further investigation entail hedge fund activism, third-party litigation funding, and investment in distressed economies.

Hedge fund activists, for example, typically invest in public companies that they deem undervalued. These activists purchase large stakes in

274. Karmel, *supra* note 78, at 700.

these companies so that they can perhaps correct perceived mismanagements to improve each company's value and thereby enhance their underlying investments.[275] Initiatives at eBay, Family Dollar, and PepsiCo provide popular examples of such activist campaigns.[276] Determining whether these strategies are actually good for public companies is subject to much debate. On the one hand, supporters have applauded hedge fund activists who utilize their role as large institutional shareholders to implement much needed changes that corporate boards have been unwilling to implement for a variety of reasons. Many reports have recently established that hedge fund activists do in fact collectively add value to companies, and that the market responds quite well to the participation of hedge funds in corporate governance.[277] Conversely, critics have accused hedge fund activists of "destroy[ing] companies by pushing them to load up with debt, lay off employees, slash research and development, and pump up short-term dividends and profits."[278] And any such failure would adversely affect the value of the underlying shareholders of such companies, many of which include retail investors. This article does not attempt to resolve this ongoing debate. It does, however, flag this strategy as one that could invoke heightened public concerns, particularly since hedge funds currently besiege public companies on a daily basis.[279]

Third-party litigation funding is an industry "composed of institutional investors who invest in litigation by providing finance in return for an ownership stake in a legal claim and a contingency in the recovery."[280] Hedge funds have been increasingly employing this investment strategy, particularly with respect to commercial litigation. Critics have alleged that this strategy could compromise attorney-client privilege and perhaps "encourage frivolous lawsuits while discouraging settlement."[281] In contrast, it can serve as a mechanism to connect legal services to individuals who may not otherwise have the means to secure legal representation.[282] In addition to these policy debates, many researchers are also concerned that the growth of this industry could encourage the securitization of lawsuits where advisers simply repackage their litigation finance contracts

---

275. Bill George & Jay W. Lorsch, *How to Outsmart Activist Investors* HARV. BUS. REV. (May 2014), https://hbr.org/2014/05/how-to-outsmart-activist-investors [https://perma.cc/75NX-PMY9].

276. Frank Partnoy, *The Surprising Market Response to Activist Hedge Funds*, WALL ST. J. (Apr. 22, 2015), http://www.wsj.com/articles/the-surprising-market-response-to-activist-hedge-funds-1429743683 [https://perma.cc/623K-DLDS].

277. *See, e.g.*, Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 3–5 (2009), http://ssrn.com/abstract=1551953 [https://perma.cc/NEM9-BRTW] ("[E]vidence generally supports the view that hedge fund activism creates value for shareholders by effectively influencing the governance, capital structure decisions, and operating performance of target firms.").

278. Partnoy, *supra* note 276.

279. *See id*.

280. Maya Steinitz, *Whose Claim is this Anyway? Third-Party Funding Litigation*, http://ssrn.com/abstract=1586053 (Aug. 2, 2010) (full article at 95 MINN. L. REV. 1268 (2011)).

281. Jason Lyon, *Revolution in Progress: Third-Party Funding of American Revolution* 58 UCLA L. REV. 571, 576 (2010).

282. *Id.*

into financial products that can be resold to a larger number of investors. Repackaging contracts in this manner would likely transform these instruments into asset-backed securities, triggering regulation under the Dodd-Frank Act. Professor Victoria Shannon Sahani has further suggested that the underlying litigation funding contract be subject to regulation under the Dodd-Frank Act or other securities laws, given the latent risks associated with securitization.[283] She has similarly noted that these underlying contracts are subject to minimal regulation and has suggested a number of regulatory reforms in a series of articles.[284] Given the potential effect that such contracts can have on the general public, either through securitization or other policy concerns expressed herein, regulators should at least begin the process of compiling a regulatory framework in the coming years.

Hedge funds are also frequent purchasers of debt issued by distressed economies, such as Detroit, Puerto Rico, and Greece.[285] The participation of hedge funds in these debt markets has engendered a spectrum of debates, the resolution of which is largely outside the scope of this article. However, the common thread revealed by these debates is that these private entities now have a direct impact over public policies produced by these governments. In some cases, this impact yields positive results, as hedge funds can infuse much-needed capital into cash-strapped governments that are facing dire budget deficits, thereby reducing the likelihood of bankruptcy.[286] In other cases, this impact can yield negative results, such as mandating stringent repayment measures that force governments to encourage austerity measures that disproportionately affect marginalized populations.[287] For example, municipal debtholders in Puerto Rico administered an economic report that advocated cuts to public education

---

283. Victoria Shannon Sahani, *Third-Party Litigation Funding and the Dodd-Frank Act*, 16 TENN. J. BUS. L. 15, 19 (2014).

284. Victoria Shannon Sahani, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 861, 861–62 (2015) ("This Article proposes harmonizing the regulatory framework for third-party litigation funding in the United States by identifying the three categories of interactions—transactional, procedural, and ethical—that make up third-party litigation funding, and suggesting avenues for regulation within those three categories."); Victoria Shannon Sahani, *Judging Third-Party Funding*, 63 UCLA L. REV. 388, 391 (2016) (The Article "provid[es] guidance to federal judges on how to interpret the existing Federal Rules of Civil Procedure to address third-party funding . . . and suggests rule revisions to the Advisory Committee for future consideration.").

285. Tom Hals, *Detroit Draws Attention from Hedge Fund Investors Looking to Profit Off City's Debt, Possible Bankruptcy*, REUTERS (May 8, 2013), http://www.huffingtonpost.com/2013/05/08/detroit-investors-hedge-funds-bankruptcy-debt_n_3234577.html [https://perma.cc/5K2F-ZHCG]; Matt Wirz, *Big Hedge Funds Roll Dice on Puerto Rico Debt*, WALL ST. J. (April 9, 2014), http://www.wsj.com/articles/SB10001424052702303873604579491992862363698 [https://perma.cc/H96H-G6Z7]; Michelle Celarier, *Hedge Funds Show Little Fear Buying Greek Debt*, N.Y. POST (July 6, 2015), http://nypost.com/2015/07/06/hedge-funds-show-little-fear-buying-greek-debt [https://perma.cc/C2P5-KP9D].

286. Tim Fernholz, *How Hedge Funds Can Help Detroit Avoid Bankruptcy*, QUARTZ (June 14, 2013), http://qz.com/94613/how-hedge-funds-can-help-detroit-avoid-bankruptcy [https://perma.cc/MRG8-UDBR].

287. *See Hedge funds Want Puerto Rico to Close Schools*, CNNMONEY (Aug. 4, 2015), http://money.cnn.com/2015/08/04/investing/puerto-rico-hedge-funds-close-schools/ [https://perma.cc/6SGW-YXXL].

and enhanced mechanisms for collecting taxes.[288] Protestors have even accused hedge fund investors of "going after schools, cutting teachers and other kinds of austerity measures in their voracious, rapacious desire to recoup all profits at any cost[.] . . ."[289] Hedge fund lobbyists could likewise be incentivized to push for self-serving legislation, such as favorable tax treatment, perhaps at the expense of their government counterparties, who represent the general public. Given the potential for hedge funds to influence the public policies effectuated by governments, regulators should investigate the extent to which these scenarios warrant additional oversight.

VI. CONCLUSION

The investment company industry has rapidly evolved since the passage of the federal securities laws. Regulators have made crucial efforts to accommodate these innovations in the face of budget constraints, intense public scrutiny, and political roadblocks such as jurisdictional battles amongst agencies and bureaucratic inefficiencies. In reconciling these challenges, regulators must often produce responsive regulation within a very short time frame and are severely limited in taking action proactively to resolve ineffective regulations. These challenges have likely contributed to the growing complexities of the regulatory framework that applies to investment company structures. For instance, Congress hurriedly passed the Dodd-Frank Act in response to a monumental financial crisis that crippled the global economy. The time constraint likely influenced Congress's decision, at least from a political perspective, to focus simply on using ancillary laws to regulate Private Funds in light of evolving notions of publicness. Revamping the primary legislation provided under the 1940 Act would have required significantly more resources, which might not have been readily available during the passage of the Dodd-Frank Act.

Nevertheless, reconciling publicness under the 1940 Act would provide a clearer distinction between private and public funds. It would also ensure that emerging notions of publicness, such as systemic risk, are sufficiently regulated under the federal securities laws. In a similar vein, focusing on the 1940 Act would help to reconcile the over-inclusive indicators that have excluded average investors from accessing strategies that could protect them in declining markets. This arduous task of revamping the 1940 Act will likely become necessary given the industry's penchant for never-ending innovation. Strategies such as hedge fund activism, third-party litigation funding, and distressed municipal debt have similarly placed stress on the public-private divide. Regulators should

288. Jessica Dinapoli, *Protestors Target Hedge Fund Holding Puerto Rico Debt*, Reuters (July 30, 2015), http://www.reuters.com/article/2015/07/30/usa-puertorico-protest-idUSL1N10A2JH20150730 [https://perma.cc/6AYN-LSSH].

289. *Id.* (internal quotations and citation omitted).

constantly monitor emerging notions of publicness, as advisers will continuously explore creative mechanisms for beating the markets.