HEDGE FUND OVERSIGHT AND TITLE IV: LESS THAN MEETS THE EYE

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INTRODUCTION

The financial crisis of 2007-2009 shook confidence in our nation's financial markets and illuminated shortcomings in corporate governance and banking and securities regulation.[1] Given this environment, the Dodd-Frank Consumer Protection and Wall Street Reform Act ("Dodd-Frank")[2] was promulgated. On July 21, 2010, President Barack Obama signed Dodd-Frank into law,[3] and while its changes were to become effective one year later, the compliance date for many provisions has been postponed.[4] As of July 2, 2012, 221 Dodd-Frank rulemaking requirement deadlines have passed, which represents nearly fifty-five percent of the 398 total rulemaking requirements under Dodd-Frank, and seventy-nine percent of the 280 rulemaking requirements with specified deadlines. Of the 221 passed deadlines, 140, or sixty-three percent, have been missed and 81, or thirty-seven percent, have been met with finalized rules.[5] That aside, the primary purposes of Dodd-Frank are "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices."[6] Spanning over 2,300 pages, Dodd-Frank is the most comprehensive financial regulatory reform in the United States since the Great Depression and affects nearly all aspects of the domestic financial

[1] Wulf A. Kaal, Hedge Fund Regulation via Basel III, 44 Vand. J. Transnat'l L. 389, 391–92 (2011).

[2] Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act Title IV, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

[3] Id.

[4] Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (June 22, 2011), http://www.sec.gov/news/press/2011/2011-133.htm. With respect to registration of investment advisers under Title IV, i.e., those advisers who would have previously relied on §203(b)(3) of the Investment Advisers Act, compliance with registration was extended until March 30, 2012.

[5] Dodd-Frank Progress Report, Davis Polk & Wardwell LLP 2 (July 2, 2012), http://www.davispolk.com/files/Publication/8bc2b1c4-c800-45b1-8324-0381454f6ceb/Presentation/PublicationAttachment/b9462d4e-0be9-4eee-9829-0455bca61e9a/July2012_Dodd.Frank.Progress.Report.pdf.

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

services industry.[7]

The hedge fund industry was not immune from scrutiny. Due in large part to the fact that many individuals and institutions invest a significant amount of assets in private funds, such as hedge funds and private equity funds, Dodd-Frank purports to reign in this sector of the financial services industry. This is primarily because prior to the passage of Dodd-Frank, advisers who managed assets in private funds were subject to little regulatory oversight.[8] This lack of oversight has led critics to blame hedge funds for their role in the crisis, causing hedge funds and their managers to become scapegoats for the problems affecting many aspects of financial markets.[9] While debate over the most appropriate form of hedge fund regulation is far ranging, Congress sought to raise standards and regulations for private funds with the passage of Dodd-Frank.[10] In effect, these new standards fill the regulatory gap that previously existed by extending the registration requirements under the Investment Advisers Act of 1940 ("Advisers Act").[11] Specifically, under Dodd-Frank, Congress enacted the Private Fund Investment Advisers Registration Act of 2010 ("Title IV").[12] Title IV generally expands the reporting requirements of private advisers. As such, Title IV requires those advisers who fall within the definition of "investment advisers"[13] to register with the United States Securities and Exchange Commission (the "Commission").[14]

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7 Erich T. Schwartz, Charles F. Walker, & Colin D. Forbes, *The Dodd-Frank Act: Commentary and Insights* SKADDEN, ARPS, SLATE, MEAGHER, & FLOM LLP & AFFILIATES (Jul. 12, 2010), http://www.skadden.com/cimages/sitefile/skadden_insights_special_edition_dodd-frank_act1.pdf.

8 Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4.

9 Kaal, *supra* note 1, at 392-4.

10 *See generally* STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 111TH CONG., BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

11 Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4. "The law also provides the Commission with the ability to require the limited number of advisers to private funds that will not have to register, to file reports about their business activities" with the Commission.

12 15 U.S.C.A. §80b-20.

13 Investment Advisers Act of 1940, §203(b)(3) (1940) (defines investment advisers who need not be registered).

14 Kaal, *supra* note 1, at 400.

By requiring hedge fund and private equity advisers to register with the Commission as investment advisers, Title IV effectively seeks to end the "shadow" financial system.[15] Many have claimed that a disruption in the shadow banking system was a key component of the subprime mortgage crisis, helping to substantially accelerate the ensuing financial crisis. Private funds, including hedge funds, are one component of the shadow banking system. Under Title IV, these advisers will now be required to provide information about their trades and portfolios necessary to assess systemic risk.[16] This data will then be shared with the systemic risk regulator, and the Commission will report to Congress annually on "how it uses this data to protect investors and market integrity."[17] Furthermore, Dodd-Frank "reallocated regulatory responsibility for certain mid-sized investment advisers to the state securities authorities."[18] This shifting of oversight burden was done in acknowledgement of the Commission's limited examination resources, while taking into consideration the new reporting responsibilities for private fund advisers.[19]

The purpose of this Note is to analyze the implications of Title IV under Dodd-Frank. Specifically, this Note will address whether subjecting advisers to "private funds" (including hedge funds, private equity funds, and other types of pooled investment vehicles excluded from the definition of "investment company" under the Investment Company Act of 1940 ("Company Act"), as amended) to the registration and reporting requirements of the Advisers Act will have any substantial effects from a regulatory standpoint. An in-depth analysis of the repeal of the broad "private adviser" exemption and the narrower exemptions it was replaced with will be explored in greater detail in an effort to determine whether Title IV will have any meaningful and substantial impact on hedge fund advisers who previously enjoyed the broad exemption from registration.

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15 STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, *supra* note 10. "Shadow" in terms of the fact that hedge funds were viewed as financial institutions operating behind the scenes, in the shadows, and outside of the purview of the Commission.

16 *Id.*

17 *Id.*

18 Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4.

19 *Id*.

This Note argues that, although Title IV has been touted by many as sweeping regulation of the hedge fund industry that will ultimately expand federal and state government's oversight of hedge funds and other private funds,[20] there is a lot less to Title IV than meets the eye. Particularly troubling is the "family office" exemption, which has potentially created a significant loophole that encompasses a large fraction of the industry's assets.[21] When coupled with the other newly created exemptions, the breadth and reach of Title IV quickly dissipates. Because many private fund advisers previously chose to register with the Commission, although not required to do so, and, in light of the limited resources of the Commission, Title IV begins to look less revolutionary than originally hoped, offering little by way of protection for the investing public and increased transparency.

This Note begins in Part I with an overview of the Commission's regulatory landscape as it stands today, beginning with the Advisers Act and Company Act. Part II introduces Title IV and the rule's newly created exemptions. Part III examines whether the venture capital fund adviser and family office exemptions contained within Title IV begin to swallow the rule. This section also includes a discussion of how some hedge fund managers have recently restructured their funds, ultimately affording themselves the opportunity to avoid the Commission's oversight. Part IV proposes a critical analysis of the implications Title IV may have on the hedge fund industry, both for advisers required to register and those able to avail themselves of one of the new exemptions. While hedge funds have been maligned as key contributors to the financial crisis of 2007-2009, Dodd-Frank's Title IV does little in the way of regulating the hedge fund industry, as many savvy investment advisers may be able to avail themselves of one of the newly created exemptions. As the compliance date of Title IV has now passed, it remains uncertain whether Title IV's amendments will be effective in limiting systemic risk posed by the hedge fund industry.

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[20] *Dodd-Frank Act: The Impact on Hedge Funds and Private Placements*, SECURITIES LAW PRACTICE CENTER (Sept. 20, 2011), http://seclawcenter.pli.edu/2010/07/14/dodd-frank-act-the-impact-on-hedge-funds-and-private-funds.

[21] Stephen Brown, Anthony Lynch, & Antti Petajisto, *Hedge Funds after Dodd-Frank*, N.Y.U. LEONARD N. STERN SCHOOL OF BUSINESS (July 19, 2010), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.

I. THE COMMISSION'S PREVIOUS ATTEMPTS TO REGULATE PRIVATE FUND INVESTMEN ADVISERS

A. The 1940 Acts: The Investment Adviser and Investment Company Acts

In response to the stock market crash of 1929 and the Great Depression that then followed, Congress enacted the Securities Act of 1933.[22] The primary objectives of the 1933 Act, often referred to as the "Truth in Securities" law, "were to require that investors receive financial and other significant information concerning securities being offered for public sale," while prohibiting "deceit, misrepresentations, and other fraud in the sale of securities."[23] To further promote investor confidence in the markets during a tumultuous time, Congress passed the Advisers Act and the Company Act. The Advisers Act regulates investment advisers, firms and sole practitioners, requiring those who receive compensation for advising others about securities investments to register with the Commission and conform to certain regulations designed to protect investors.[24] There are exceptions to registration, such as the recently overturned Section 203(b)(3). Alternatively, the Company Act regulates both the organization of companies, such as "mutual funds, that engage in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public," as well as what these companies may ultimately invest in.[25] In regulating the individual funds, the Commission seeks to minimize conflicts of interest.[26]

[22] Congress also enacted the Securities Exchange Act of 1934 at this time. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N. (July 30, 2012), http://www.sec.gov/about/whatwedo.shtml.

[23] *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N. (June 27, 2012), *http*://www.sec.gov/about/laws.shtml#secact1933.

[24] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N. (July 30, 2012), http://www.sec.gov/about/whatwedo.shtml.

[25] *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N. (June 27, 2012), *http*://www.sec.gov/about/laws.shtml#secact1933.

[26] *Id.*

As mentioned, Section 203(b)(3) of the Advisers Act,[27] commonly known as the "private adviser" exemption,[28] exempted any adviser from registration as an investment adviser provided that adviser had: "(i) fewer than fifteen clients in the preceding twelve months;[29] (ii) did not hold itself out to the public as an investment adviser; and (iii) did not act as an investment adviser to a registered investment company or a company that had elected to be a business development company."[30] Advisers specifically exempt under section 203(b)(3) were not subject to reporting or recordkeeping requirements under the Advisers Act, and as such, were not subject to examination by the Commission's staff.[31]

In addition to the "private adviser" exemption under the Advisers Act, the Company Act[32] further insulated certain private funds from the Commission's oversight. Private funds, which include hedge funds, private equity funds, and other types of pooled investment vehicles, are excluded from the definition of "investment company" under the Company Act.[33] This specific exemption is found in both section 3(c)(1) and/or section 3(c)(7) of the Company Act.[34] Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues and has 100

27 15 U.S.C. § 80b-3(b)(3) (2012).

28 *Id.*

29 *See* Implications of the Growth of Hedge Funds, Staff Report to the U.S. SEC. & EXCH. COMM'N (Sept. 29, 2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf.

30 *Clients & Friends Memo: Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, CADWALADER, WICKERSHAM, & TAFT LLP (July 20, 2010), http://www.cadwalader.com/assets/client_friend/072010_DF5.pdf.

31 15 U.S.C. § 80b-3(b)(3) (2012). Under section 204(a) of the Advisers Act, the Commission has the authority to require an investment adviser to maintain records and provide reports, as well as the authority to examine such adviser's records, unless the adviser is "specifically exempted" from the requirement to register pursuant to section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on other sections of the Advisers Act (such as sections 203(l) or 203(m)) are not "specifically exempted" from the requirement to register pursuant to section 203(b), and thus the Commission has authority under section 204(a) of the Advisers Act to require those advisers to maintain records and provide reports and has authority to examine such advisers' records.

32 15 U.S.C. § 80a-3(a)(1)(A) (2012) (the term "investment company means any issuer which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities."). While the Advisers Act seeks to regulate the individual investment adviser, the Company Act regulates the individual fund.

33 15 U.S.C. § 80a-3(a)(1)(A)-(C) (2012).

34 15 U.S.C. § 80b-2(a)(29) (2012). This section will now be amended to include in the Advisers Act § 202(a)(29), which defines the term "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Company Act of 1940. . . but for section 3(c)(1) or 3(c)(7) of that Act." 15 U.S.C. § 80b-2(a)(29) (2012).

or fewer beneficial owners of its outstanding securities.[35] A fund relying on section 3(c)(7) cannot publicly offer the securities it issues and generally must limit the owners of its outstanding securities to "qualified purchasers."[36] Unlike the Advisers Act, the Company Act has not changed as a result of Title IV or any other provisions within Dodd-Frank.

B. *The Rise of Hedge Funds*

During the first decade of this century, the United States saw rapid growth in hedge funds, "fueled primarily by the increased interest of institutional investors such as pension plans, endowments and foundations seeking to diversify their portfolios with investments in vehicles that feature absolute return strategies."[37] Triggered largely by this growth in hedge fund assets, the Commission staff conducted a study of hedge funds and their advisers in 2003.[38] The United States Commission Staff Report estimated that between "6,000 to 7,000 hedge funds operat[ed] in the United States, managing approximately $600 to $650 billion in assets."[39] The report predicted that in the five to ten years that followed, hedge fund assets would exceed $1 trillion.[40] While the true size of the hedge fund sector has long been controversial, and statistical sources differ regarding the precise measure of the total number of hedge fund assets under management, analysts appear to agree that the hedge fund sector has surpassed the $1 trillion prediction. Conservative estimates have valued the industry at $1 trillion,[41] while others value assets in single manager hedge funds at an all-time high of $3.34 trillion.[42] Nonetheless, it is undisputed that the hedge fund

[35] Investment Company Act of 1940, §3(c)(1) (2012).

[36] *Id*. at §3(c)(7).

[37] Implications of the Growth of Hedge Funds, *supra* note 29.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.* Sources differ on what a precise measure of the total number of hedge funds and their respective assets under management are. Most agree that the baseline for assets under management in hedge funds in the United States is $1 trillion, however some have predicted that number may in fact be as high as $2.5 trillion in assets under management in the global hedge fund industry. Tony Griffiths, *17th Biannual Assets Under Administration Survey: Part One Single Managers*, HFMWEEK.COM (Nov. 2011), http://www.citco.com/sites/default/files/downloads/HFM%20Week%20SMF%20AUA%20Survey%20-%20November%202011.pdf.

[42] Griffiths, *supra* note 41 (data is for the six months from May 1, 2011 to Oct. 31,

industry has continued to see net inflows, even in the wake of the financial crisis.[43]

Rapid growth in the hedge fund industry and the associated increased role hedge funds began to play in the financial markets, along with the inherent risk associated with return strategies they employ, ultimately led to an increase in the Commission's number of enforcement cases for malfeasance by hedge fund advisers.[44] Upon conclusion of the hedge fund study in 2003, the Commission recognized that most hedge funds enjoyed a nearly complete lack of transparency, as exemplified by the Commission's "limited ability to obtain basic information about hedge funds."[45] Ultimately, the Commission concluded that hedge fund advisers should be required to register under the Advisers Act.[46]

C. The Look-Through Rule

Most advisers relied on the "de minimis" exemption from registration available for investment advisers with fourteen or fewer clients. Under the Commission rules, each individual fund counted as one client. This meant that for purposes of the "de minimis" exemption, a fund with fourteen or more underlying investors was still eligible for the exemption, because those individual investors (for purposes of the rule) were counted as just one client.[47] However, given the Commission's recognition of the rise in hedge funds, and the potential implications of such an increase,, the Commission adopted a rule

2011 and represents a three percent increase from the prior six-month period); *see also*, Cassell Bryan-Low, *Hedge Funds Look to Rebound, Inward Flows Are Seen Topping Outward Flows for First Time Since 2007*, WALL ST. J. (Mar. 16, 2010), http://online.wsj.com/article/SB10001424052748704588404575123580718646568.htl ("Industry assets stood at $1.6 trillion at the end of 2009, up from $1.4 trillion in 2008, though below the 2007 peak of $1.9 trillion, according to Chicago data tracker Hedge Fund Research Inc.").

43 Tony Griffiths, *Assets hit all-time high*, HFMWEEK.COM (May 25, 2011), http://www.hfmweek.com/news/1666632/assets-hit-alltime-high.thtml (quoting William Keunen, global director of Citco Fund Services, the industry's largest administration firm).

44 Implications of the Growth of Hedge Funds, *supra* note 29; s*ee also*, William K. Sjostrom Jr., *A Brief History of Hedge Fund Adviser Registration and Its Consequences for Private Equity and Venture Capital Advisers*, HARV. BUS. L. REV. ONLINE (2011), *available at* http://www.hblr.org/wp-content/uploads/2011/02/Sjostrom_Online_Article3.pdf.

45 Implications of the Growth of Hedge Funds, *supra* note 29.

46 Sjostrom, *supra* note 44.

47 Implications of the Growth of Hedge Funds, *supra* note 29.

requiring investment advisers of hedge funds to "look-through" the fund and count as clients the fund's individual investors for purposes of the fifteen-client threshold.[48] As a result, most hedge fund advisers were no longer able to rely on the "private adviser" exemption, thereby forcing them to register with the Commission.[49] The "look-through" rule, narrowly approved by a 3-2 vote on December 2, 2004, went into effect on February 1, 2006, but was short-lived.[50] In June 2006, a federal appeals court held, in *Goldstein v. S.E.C.*,[51] that the rule exceeded the Commission's rule-making authority and was thus invalid.[52] Once again, hedge fund advisers were able to rely on the "private adviser" exemption from registration. This was the first of many attempts by regulatory authorities to increase hedge fund transparency. Shortly after the decision in *Goldstein*, Congressman Barney Frank (D-MA)[53] introduced a bill giving the Commission express authority to adopt a "look-through" rule.[54] However, this attempt at hedge fund regulation also proved futile, as the bill stalled out in committee.[55] A similar bill introduced the following year was likewise unsuccessful.[56]

D. Title IV

In the wake of the financial crisis, Congressional desire to require hedge funds to register under the Advisers Act was revived; as a result, Dodd-Frank included a hedge fund adviser registration provision.[57] In contrast to prior attempts at regulation, instead of adopting, or authorizing the Commission to adopt, a "look-through" rule, Title IV

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[48] Sjostrom, *supra* note 44.

[49] *Id. See also*, SEC Adopts Requirements that Hedge Fund Advisers Register Under Investment Advisers Act, LOWENSTEIN SANDLER PC (Nov. 2004), http://www.lowenstein.com/files/Publication/c5a19f0d-0888-4684-898b-2c4333d55da1/Presentation/PublicationAttachment/2ac29b9e-3a52-46a9-8297-579862798ab5/Investment%20Management%2011-04.pdf.

[50] *Id*. *See also*, *Investment Management Group Alert: Court Vacates SEC Rule Requiring Hedge Funds to Register*, LOWENSTEIN SANDLER PC (June 2006), http://www.lowenstein.com/files/Publication/1955a703-3138-4e7b-8b1b-017df55c616c/Presentation/PublicationAttachment/1e35596c-aac4-4964-8e40-0204bf32344f/Investment%20Management%2006-06.pdf.

[51] *Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873 (D.C. Cir. 2006).

[52] Sjostrom, *supra* note 44.

[53] The most recent legislation's namesake, along with Senator Chris Dodd (D-CT).

[54] Sjostrom, *supra* note 44.

[55] *Id.*

[56] *Id*.

[57] *Id*.

completely eliminated the "private adviser" exemption from the Advisers Act.[58] Specifically, Title IV repealed section 203(b)(3) of the Advisers Act. The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to "private funds," who had previously been considered exempt from registration, to register under the Advisers Act.[59]

By promulgating Title IV under Dodd-Frank, Congress adopted changes to the Advisers Act, with the intent of increasing the probability that managers of private funds, including hedge funds, private equity funds, and other types of pooled investment vehicles, would be required to register with the Commission as investment advisers.[60] Commission Chairman Mary L. Shapiro stated, "[t]hese rules will fill a key gap in the regulatory landscape. . .[i]n particular, our proposal will give the Commission, and the public, insight into hedge fund and other private fund managers who previously conducted their work under the radar and outside the vision of regulators."[61] By eliminating the "private adviser" exemption, Title IV seeks to fulfill one of the key provisos of Dodd Frank's "overarching mandate to limit systemic risk."[62] Title IV aims to bring hedge funds under the purview of the Financial Stability Oversight Council,[63] which maintains the authority to call upon financial services firms on a case-by-case basis to

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58 *Id*.

59 *Rules Implementing Amendments to the Investment Advisers Act of 1940*, 17 C.F.R., pt. 275, Rel. No. IA-3221, 15 U.S.C. § 80b, http://www.sec.gov/rules/final/2011/ia-3221.pdf.

60 Susan Alker, *Dodd-Frank Changes the Game for Hedge Funds and PE Funds*, LENDING LAW REPORT (Aug. 13, 2010), http://www.lendinglawreport.com/2010/08/articles/regulation/doddfrank-changes-the-game-for-hedge-funds-and-pe-funds/ (while it has been covered as "hedge fund registration" requirements, in actuality "the amendments primarily affect the status of the fund managers, rather than the funds themselves.").

61 Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4.

62 *Dodd Frank Changes Next to Nothing*, REUTERS (Sept. 7, 2010), http://www.hedgefundmarketing.org/dodd-frank-changes-nothing.

63 *Hedge Funds and Dodd-Frank Reform*, MANAGED FUNDS ASS'N (last visited Feb. 18, 2012), https://www.managedfunds.org/issues-policy/issues/hedge-funds-and-dodd-frank-reform. The Council was created to monitor and maintain the stability of the United States financial system and to facilitate coordination and information sharing among regulatory agencies. Additionally, the Council consists of 10 voting members and five nonvoting members, bringing together the expertise of federal financial regulators, state regulators, and an insurance expert appointed by the President. *Financial Stability Oversight Council*, U.S. DEPT. OF TREASURY (last visited Feb. 18, 2012), http://www.treasury.gov/initiatives/fsoc/Pages/default.aspx.

either: (i) "increase the frequency and detail of its reporting," or (ii) "firm up its capital reserves."[64]

II. THE PRIVATE FUND INVESTMENT ADVISERS REGISTRATION ACT OF 2010

A. Registration Requirements

Title IV will now require those advisers who are no longer permitted to avail themselves of the "private adviser" exemption, and do not qualify for one of the newly created "narrower" exemptions, to register with the Commission under the Advisers Act. Accordingly, these advisers will be required to maintain records and any other information that the Commission deems "necessary and appropriate to avoid systemic risk."[65] "Risk-related information includes trading and investment positions, trading practices, the amount of assets under management, the use of leverage, including off-balance sheet leverage, counterparty credit risk exposure, valuation policies, and side letters."[66] Dodd-Frank also requires registered investment advisers to "adopt both a written code of ethics that complies with federal securities laws" and "written policies to prevent insider trading."[67] Lastly, "registered investment advisers are required to maintain financial and other business-related books and records, which facilitates inspections" by the Commission.[68] The Commission implemented a "transitional exemption period so that private advisers, including hedge fund and private equity fund advisers" not previously required to register, "[did] not have to do so until March 30, 2012."[69]

Another significant change under Title IV will come in the form of increased state supervision, as the Act raised the assets under management "threshold for federal regulation of investment advisers."[70] Previously, non-exempt investment advisers that managed more than $25 million in assets had the option of registering with the Commission,

[64] *Dodd Frank Changes Next to Nothing*, *supra* note 62.

[65] Kaal, *supra* note 1, at 418.

[66] *Id.*

[67] *Id.* (citing Dodd-Frank Act, §404, 124 Stat. at 1571-73) (requiring investment advisers to make disclosures to the Commission to protect investors and the "integrity of the markets.").

[68] Kaal, *supra* note 1, at 418.

[69] Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4.

[70] STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, *supra* note 10.

instead of with the state in which they had their primary place of business.[71] However, under Title IV, investment advisers who manage between $25 million and $100 million in assets, known as "mid-sized" investment advisers, will now be required to register with the state, as opposed to the Commission.[72] This will significantly increase the number of advisers under state supervision. The Commission claimed that this would "allow [it] to focus its resources on newly registered hedge funds."[73] As discussed in greater detail below, private fund advisers with less than $150 million in assets under management will also be exempt from registration with the Commission, along with the other four classes of exempt investment advisers.[74]

B. Key Exemptions

While Dodd-Frank removed the broad "private adviser" exemption, it simultaneously created five new, narrow exemptions from registration under the Advisers Act.[75] The narrow exemptions from registration under Title IV are: "(i) commodity trading advisers ("CTAs") registered with the Commodity Futures Trading Commission (CFTC) and that provide advice to a private fund" (so long as the advice provided is not predominantly securities-related); (ii) "advisers to small business investment companies that are licensees under the Small Business Investment Act,"[76] who have received notices to proceed to qualify as a small business investment company, or certain other affiliated person; and (iii) foreign private advisers.[77] The foreign private adviser exemption has only very limited application and applies to money managers who: (i) have "no place of business in the United States"; (ii) have fewer than fifteen clients in the United States (either directly or through a private fund managed by the investment adviser);

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[71] Investment Management Practice, *Dodd-Frank Changes to Investment Adviser Regulation*, MONTGOMERY MCCRACKEN (Oct. 18, 2010), http://www.mmwr.com/home/publications/default.aspx?d=2889.

[72] *Id.* (for investment advisers who would have to register in 15 or more individual states, they may have the option to register with the Commission even though their AUM is greater than $100 million).

[73] STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, *supra* note 10.

[74] Kaal, *supra* note 1, at 400.

[75] Investment Management Practice, *supra* note 71.

[76] *Id.*

[77] Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(30) (providing an exemption for certain foreign private advisers who meet criteria set forth in the section).

(iii) have assets under management attributable to clients in the United States of less than $25 million; and (iv) do not generally hold themselves out in the United States as investment advisers and are not an investment adviser to a registered investment company or business development company.[78] Additionally, this exclusion can be used for offshore hedge fund managers.[79]

Two additional narrow exemptions under Title IV are available for: (i) venture capital fund advisers,[80] and (ii) family offices.[81] Skeptical industry professionals have scrutinized these two exemptions, leaving many wondering if the two will effectively swallow the rule.[82] A valid argument may be made that the exception does in fact swallow the rule, leaving a lot less to Title IV than meets the eye. "Particularly troubling is the family office exemption, which has the potential to turn into a loophole that encompasses a large fraction of the industry."[83]

III. TWO TROUBLING LOOPHOLES – THE VENTURE CAPITAL FUND ADVISERS AND FAMILY OFFICE EXEMPTIONS

A. Venture Capital Fund Advisers

Under Section 203(1)-1, the Commission approved a new definition of "venture capital fund," designed to clearly and legally distinguish such vehicles from other types of private funds, such as hedge funds and private equity funds.[84] The rule also seeks to address Congressional concerns regarding the potential for systemic risk.[85]

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[78] *Id*. *See also*, Press Release, U.S. SEC. & EXCH. COMM'N, *supra* note 4.

[79] *Clients & Friends Memo: Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, CADWALADER, WICKERSHAM, & TAFT LLP (July 20, 2010), http://www.cadwalader.com/assets/client_friend/072010_DF5.pdf.

[80] Investment Advisers Act of 1940, 15 U.S.C.A. 80b-3(k)(3) (exempting advisers solely to "venture capital funds," as defined; advisers to "venture capital funds" are exempt from *full* registration (emphasis added), however, "venture capital funds" may still be subjected to reporting and recordkeeping by the Commission).

[81] Investment Management Practice, *supra* note 71.

[82] *See* Kaal, *supra* note 1, at 419 (citing 156 CONG. REC. S5915 (daily ed. July 15, 2010) (statement of Sen. Jack Reed)(expressing concern for the "carve-outs" in the Dodd-Frank bill for venture capital)); *see also* 156 Cong. Rec. S5239 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski) (outlining concerns with several of the exemptions).

[83] Brown, Lynch, & Petajisto, *supra* note 21.

[84] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77190 (proposed Dec. 10, 2010), to be codified at 17 C.F.R. pt. 275.

[85] *Id.*

However, the opportunity for overlap is greater than one might anticipate.

In summary, the rule defines a 'venture capital fund' as a private fund that: (i) holds no more than twenty percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings); (ii) "does not borrow or otherwise incur leverage, other than short-term borrowing; (iii) "does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Company Act and has not elected to be treated as a business development company. . .[86]

In defining a venture capital fund to "include a fund that invests a portion of its capital in investments that would not otherwise satisfy all elements of the rule (the 'non-qualifying basket')," the Commission sought to balance its desire to differentiate between a venture capital fund and other types of private funds, with competing considerations of managers who wanted greater flexibility to exercise investment discretion.[87] "While the definition limits the amount of non-qualifying investments, it allows the adviser to choose how to allocate those investments."[88]

While "setting the level for non-qualifying investments at a sufficiently low threshold would preclude advisers of other types of private funds from relying on the venture capital exemption," setting the threshold too high may allow for the inclusion of many advisers to other types of private funds.[89] In setting this level, however, the Commission did not "receive specific empirical analysis regarding the venture capital industry as a whole" that might assist in determining "the appropriate size of the basket."[90]

This is troubling because by including a twenty percent basket, firms may employ hybrid strategies and still fall under the "narrow"

86 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. IA-3222, 17 CFR pt. 275 (2011). ("Qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund).

87 *Id.*

88 *Id.*

89 *Id.*

90 *Id.*

Title IV exemptions for venture capital fund advisers. If the purported purpose of Title IV is to fill a regulatory gap and limit systemic risk by increasing regulatory oversight, this opportunity to create a hybrid strategy may be one significant way to skirt the regulatory requirements of Title IV. This twenty percent basket of non-qualifying assets may have significant systemic market risk, given the size of the overall fund. Said percentage of the market will be unregulated and may also allow other private investors to take advantage of the exemption. One such investment adviser who employs a hybrid strategy is Michael Stark of Crosslink Capital Inc., who manages $2.15 billion in assets.[91] Stark attempts to profit from a hybrid strategy of providing venture funding for private companies and hedge fund investments to profit from public ones.[92] Such a business model allows "the firm to double its bets when it perceives good opportunities."[93]

B. Family Offices

In recognition of Dodd-Frank's repeal of the "private adviser" exemption, upon which many family offices previously relied, section 202(a)(11)(G) explicitly exempts family offices from the definition of investment advisers who may be subject to the Advisers Act.[94] A "family office" is defined as any company,[95] "including its directors, partners, trustees, and employees acting within the scope of their employment," that: (i) "has no clients other than 'family clients'"; (ii) is wholly owned and controlled[96] (directly or indirectly) by "family members"; and (iii) "does not hold itself out to the public as an

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91 Kambiz Foroohar, *A VC Who Runs a Hedge Fund: Michael Stark's Crosslink Capital is Unleashing its Unusual Combination of Venture Funding and Stock Picking to Profit from Technology Hits*, BLOOMBERG MARKETS, Nov. 2011, at 98.

92 *Id*.

93 *Id*.

94 Family Offices, Investment Advisers Act, 17 C.F.R. pt. 275 (2011); *see* Dodd-Frank Act § 409.

95 "Company" for purposes of rule 202 means "a corporation, a partnership, an association, a joint-stock company, a trust or any organized group of persons, whether incorporated or not; or any receiver, trustee in a case under Title 11, or similar official, or any liquidating agent for any of the foregoing, in his capacity as such." 15 U.S.C. §80b-2(a)(5) (2010).

96 "Control" for purposes of rule 202 means "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company." 17 C.F.R. §275.202(a)(11)(G)-1(d)(1).

investment adviser."[97] The Commission concluded that ownership and control by family members ensures that the family is in a position to protect its interest, and is therefore less likely to need the protections of the federal securities laws.[98]

Therefore, the relief granted in Section 202(a)(11)(G) is premised on two separate grounds. First, "the family adviser [is not] within the intent of the 'investment adviser' definition under the Advisers Act."[99] Second, the "primary purpose of regulation under the Advisers Act. . . is to protect the public from fraudulent and unscrupulous asset managers."[100] Moreover, the "family office" exemption was included based on the philosophy that the Commission "should not be involved in policing financial disputes among family members or regulating people managing their own money."[101]

The family office rule purports to narrowly circumscribe the class of relatives who are permissible "family clients" or owner-controllers of the family office.[102] "Family clients" include any: (i) "family member or, subject to certain conditions, former family member;" (ii) "charitable foundation, charitable organization or charitable trust established and funded exclusively by one or more family members or former family members;" (iii) "trust or estate existing for the sole current benefit of one or more family clients;" (iv) "entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients;"[103] or (v) "key employee or, subject to

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[97] 17 C.F.R. §275.202(a)(11)(G)-1(b) (holding itself out to the public as an investment adviser suggests that the family office is seeking to enter into typical advisory relationships with non-family clients, and thus is inconsistent with the adoption of this rule.)

[98] Family Offices, Investment Advisers Act, 17 C.F.R. pt. 275 (2011).

[99] Lawrence D. Frishman & Anastasia T. Rokas, *SEC Proposes Rule Defining "Family Office" Exclusion From Definition of Investment Adviser*, SKADDEN, ARPS, SLATE, MEAGHER, & FLOM LLP & AFFILIATES (Oct. 27, 2010), http://www.skadden.com/Index.cfm?contentID=51&itemID=2271.

[100] *Id.*

[101] Sarah N. Lynch, *Senator Shelby says Soros hypocrite for reforms dodge*, THOMSON REUTERS (July 28, 2011, 9:47 AM), http://in.reuters.com/article/2011/07/28/idINIndia-58490620110728.

[102] Frishman & Rokas, *supra* note 99 (for example, the proposed family office rule excludes from the class of permissible relatives aunts, uncles, cousins and stepparents, and their spouses and siblings).

[103] *Id.* (Any such entity that is a pooled investment vehicle must be excepted from the definition of "investment company" under the Investment Company Act of 1940, 15 U.S.C. §§80a-1 to -64 (the 'Investment Company Act' (internal citations omitted))

certain conditions, former key employee."“[104]

The key concept in the family client definition is the term "family members,"[105] which will include "all lineal descendants of a common ancestor (who may be living or deceased) as well as current and former spouses or spousal equivalents of those descendants, provided that the "ancestor is no more than ten generations removed from the youngest generation of family members."[106] Under this construction, "the family office will be able to choose the common ancestor and may change [the] designation over time such that the family office clientele is able to shift over time along with the family members served by the family office."[107] "To prevent families from choosing an extremely remote ancestor, which could allow commercial advisory businesses to rely on the rule, [the Commission] impos[ed] a ten-generation limit between the oldest and youngest generation of family members."[108] The term also encompasses all children by adoption, current and former stepchildren, foster children, and persons who were minors when another family member became their legal guardian.[109] The adopted definition of "family member"[110] is far broader than the Commission initially

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[104] Family Offices, Investment Advisers Act, 17 C.F.R. §275.202(a)(11)(G)-1(b). "If a person that is not a family client becomes a client of the family office as a result of [an] involuntary transfer from a family member or key employee" (i.e. a bequest to a friend, of assets in a family office-advised private fund) that person will be deemed a family client for purposes of the rule for only one year following the involuntary transfer. This transition period permits the family office to orderly transition that client's assets to another investment adviser or otherwise restructure its activities to comply with the Advisers Act (via registration).

[105] 17 C.F.R. §275.202(a)(11)(G)-1(d)(4)(i).

[106] Family Offices, Investment Advisers Act, 17 CFR pt. 275, (2011). In proposed rule 202(a)(11)(G)-1(d)(2)(vi), and (d)(4) the Commission proposed permitting former family members to retain any investments held through the family office at the time they became a former family member, but to limit them from making any new investments through the family offices.

[107] Family Offices, Investment Advisers Act 17 CFR pt. 275, 9–10 (2011).

[108] *Id*. (quoting Comment Letter of the American Bar Association, Section of Business Law and Section of Real Property, Trust and Estate Law (Nov. 18, 2010)).

[109] 17 C.F.R. §275.202(a)(11)(G)-1(d)(6).

[110] Family Offices, Investment Advisers Act 17 CFR pt. 275 (2011)(to be codified at 17 C.F.R. §275.202(a)(11)(G)-1(d)(5)). Proposed rule 202(a)(11)(G)-1(d)(5) defined the term "family member" by reference to the "founder: or the family office, and generally to include the founder's spouse (or spousal equivalent), their parents, their lineal descendants, and their siblings and their lineal descendants. Family Offices, Investment Advisers Act Release No. IA-3220, 17 C.F.R. pt. 275 (June 22, 2011)(now codified at 17 C.F.R. §275.202(a)(11)(G)-1(d)(5)).

proposed. Such a limit will arguably serve to restrict the "scope of persons considered family members while accommodating the typical number of generations served by most family offices."[111]

Other permitted "family clients" include "any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization," all funded exclusively by one or more other family clients.[112] In an effort to accommodate estate planning and charitable giving plans, the Commission included certain family trusts established for testamentary and charitable purposes as "family clients."[113] Irrevocable trusts "in which one or more other family clients are the only current beneficiary,"[114] "revocable trusts of which one or more family client is the sole grantor,"[115] and an estate of a "family member, former family member, key employee or. . . former key employee," will also be treated as "family clients."[116]

Finally, the Commission included "key employees" among the list of permissible family clients to whom the family office is permitted to provide investment advice.[117] "Key employees" for purposes of the rule include any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee), who is: (i) an

[111] *Id.* at 9-10.

[112] Family Offices, Investment Advisers Act 17 C.F.R. pt. 275 (2011) (to be codified at 17 C.F.R. §275.202(a)(11)(G)-1(d)(4)(v); proposed rule 202(a)(11)(G)-1(d)(2)(iii) included requirement that charities be established and funded "by family members," however in its final form, the Commission changed that requirement to "by family clients" as family charities are often established and funded by family trusts, corporations or estates, and not exclusively family members.

[113] *Id.*

[114] *Id.* The rule also permits the family office to advise irrevocable trusts funded exclusively by one or more other family clients in which only current beneficiaries, in addition to other family clients, are non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations.

[115] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4)(ix) (2011). Accordingly, a revocable trust may be advised by a family office relying on the rule regardless of whether the beneficiaries of the trust are family members.

[116] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4)(vi) (2011). For former key employees, the advice is subject to the condition contained in rule 202(a)(11)(G)-1(d)(4)(iv). This effectively permits a family office to advise the executor of a family member's estate even if that estate will be distributed to (and thus be for the benefit of) non-family members.

[117] *Id.*

executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office,[118] or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions), who, in connection with his or her regular functions or duties, participates in the investment activities of the family office.[119]

"To qualify for key employee status, the individual must have been performing such functions and duties…for at least 12 months."[120] "In addition to receiving direct advice from the family office, key employees (because they are 'family clients') may indirectly receive investment advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities."[121]

IV. HOW WILL TITLE IV AFFECT THE HEDGE FUND INDUSTRY?

A. Potential Implications of the Family Office Exemption on Private Fund Investment Advisers.

Title IV's family office exemption may create a significant regulatory loophole in a number of ways. First, in defining what constitutes a "family office" the Commission included a broad definition of "family member" that not only signals a certain level of leniency, but also a relatively expansive limit. Additionally, section 202(a)(11)(G)-1, makes no reference to which individual the common ancestor is, nor does it specify that it always has to remain the same

118 17 C.F.R. §275.202(a)(11)(G)-1(d)(8) (2011) "Affiliated family office" is defined as "a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office." The rationale is that those key employees qualifying as knowledgeable employees of an affiliated family office, should be in a position to protect themselves in receiving investment advice from a family office excluded from registration under the Advisers Act. Family Offices, Investment Advisers Act Release No. IA-3220, 17 CFR pt. 275, (June 22, 2011)(to be codified at 17 C.F.R. §275.202(a)(11)(G)-1(d)(1)).

119 17 C.F.R. §275.202(a)(11)(G)-1(d)(8) (2011).

120 Frishman and Rokas, *supra* note 99.

121 Family Offices, Investment Advisers Act, 17 C.F.R. pt. 275, 23–24 (2011).

common ancestor.[122] This effectively allows the family office to serve later generations that would otherwise extend beyond the ten-generation limit by simply re-designating the family office's common ancestor.[123] Also, ten generations is far-reaching and this too presents the possibility for an additional loophole. It may be safe to suspect that most Americans are completely unaware of who their ancestors are ten generations back. At that level of generality, it may very well be that a large group could point to a single, common ancestor. This expansive generational-limit, coupled with the re-designation allowance, may avow the family office exemption to swallow the rule.

Second, hedge funds may restructure their funds by returning assets from outside investors who would not qualify as a "family client." Arguably in anticipation of the implementation of Title IV and the associated registration with the Commission, several prominent hedge fund managers have already begun to do so, thus availing themselves of the "family office" exemption. For example, George Soros, hedge fund manager at Soros Fund Management LLC, announced that he would end hedge fund management for clients who are not family members.[124] As a result, Soros will return $1 billion to these external, non-familial investors. In effect, he is "kicking out long-time investors," which will allow him to remain exempt under Title IV.[125] In forfeiting $1 billion to avoid regulation, Soros Fund Management's Quantum Group of Funds will still retain $25 billion in internal, familial assets under management.[126] If the purported purpose of Title IV is to increase transparency and monitor systemic risk, does the $25 billion pose any less of a risk simply because it is classified as a "family office"? In that context, $1 billion forfeited in exchange for $25 billion of assets under management outside the regulatory oversight of

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122 *Id*.

123 *Id*. at 10.

124 Lonely Conservative, *George Soros Dumping Hedge Funds to Avoid Dodd-Frank Rules*, LONELYCONSERVATIVE.COM (July 26, 2011), http://lonelyconservative.com/2011/07/george-soros-dumping-hedge-funds-to-avoid-dodd-frank-rules/.

125 Duff McDonald, *Why George Soros should be regulated, even now*, CNN MONEY (July 27, 2011, 3:16 PM), http://finance.fortune.cnn.com/2011/07/27/why-george-soros-should-be-regulated-even-now/.

126 Lonely Conservative, *supra* note 124; *see also* Bess Levin, *George Soros Returning All Outside Investor Money, Keeping It In The Fam*, DEALBREAKER (July 26, 2011), http://dealbreaker.com/2011/07/george-soros-returning-all-outside-investor-money-keeping-it-in-the-fam/.

the Commission may be a small sacrifice to make.

Influential Republican Senator Richard Shelby publicly scolded Soros for evading the new hedge fund regulations he had once publicly backed.[127] Soros is a staunch Democratic Party supporter who had testified before Congress in 2008, stating that "[t]he entire regulatory framework needs to be reconsidered, and hedge funds need to be regulated within that framework."[128] When pressed by lawmakers, "Soros said he believed some hedge funds pose systemic risk and should be required to report additional information to regulators."[129] Congress seemed to agree with Soros's sentiments when they promulgated Title IV and thereby called for increased transparency in the hedge fund industry in an effort to monitor systemic risk.

That said, "don't be surprised to see his fellow Wall Street financiers follow suit. They'll use their. . .legal muscle to sidestep Dodd-Frank. . ."[130] Soros has been joined by a "growing list of fund managers who have recently revamped their businesses in the face of" Title IV.[131] In March of 2011, prominent investor and influential hedge fund manager, Carl C. Icahn, announced that he also had plans to discontinue the management of money for outsiders.[132] In a letter to investors, Icahn cited "a reluctance to be responsible to investors should another financial crisis erupt;" however, similar to Soros, he will continue to manage a "family office."[133] Icahn will return nearly a quarter of the overall assets he manages, which comprise roughly $1.76 billion of the $7 billion currently managed by Icahn Capital.[134] Fellow hedge fund manager Stanley Druckenmiller of Duquesne Capital Management will also create a "family office," where he will continue to oversee nearly $12 billion.[135] With the passing of Title IV's

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127 Lynch, *supra* note 101.

128 *Id.*

129 *Id.*

130 *Id.*

131 *Id.*

132 Katie Benner, *Carl Icahn closes hedge fund to outside investors*, CNN MONEY (Mar. 8, 2011, 12:10 PM), http://finance.fortune.cnn.com/2011/03/08/carl-icahn-calls-it-quits/.

133 Azam Ahmed & Michael J. De La Merced, *Icahn to Return Outside Money in Hedge Fund*, N.Y. TIMES DEALBOOK (Mar. 8, 2011, 8:34 PM), http://dealbook.nytimes.com/2011/03/08/icahn-to-retun-outside-money-in-hedge-fund/; *see also* Benner *supra* note 132.

134 *Id*.

135 Katherine Burton, *Billionaire Stanley Druckenmiller to shut down Duquesne hedge*

compliance date, this trend has only continued. In September of 2012, William Collins, manager of Brencourt Advisors LLC, a multistrategy hedge fund with $300 million in assets under management, announced that he too would be returning money to outside investors. [136] While Brencourt Advisors had previously managed more than $2 billion, Collins has decided to convert his firm into a family office in 2013.[137]

Third, "family advisers that fail to satisfy the conditions of the proposed rule may still seek an exemptive order" from the Commission, thereby skirting registration requirements.[138] It is unclear on which grounds the Commission will grant these exemptive orders. However, the Commission has "expressly recognized the privacy concerns of family advisers."[139] Additionally, the Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved.[140] The allowance of exemptive orders to protect the privacy of the family involved, if applied too loosely, also has the potential to swallow the rule.

B. Is it all Smoke and Mirrors? What are the Real Implications?

While Title IV requires all eligible private fund advisers to register with the Commission, "maintain extensive records about their investment and business practices and provide this information to the SEC, hire a chief compliance officer to design and monitor a compliance program, and be subject to periodic SEC examinations and inspections,"[141] one may wonder what difference this will make. While unregistered hedge funds are not required to make any disclosures, they are still subject to common law fraud standards. Additionally, the Commission adopted an antifraud rule (following the invalidity of the

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fund, WASH. POST (Aug. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/08/20/AR2010082006322_2.html.

136 Kelly Bit, *Brencourt Advisors to Return Capital to Outside Investors*, BLOOMBERG (Sept. 27, 2012), http://www.bloomberg.com/news/print/2012-09-27/brencourt-advisors-to-return-capital-to-outside-investors.html.

137 *Id.*

138 Frishman & Rokas, *supra* note 99.

139 *Id.*

140 Family Offices, Investment Advisers Act, 17 C.F.R. pt. 275, 5 (2011) (quoting S. Conf. Rep. No. 111-176, at 75 (2010)).

141 Brown, Lynch, & Petajisto, *supra* note 21.

aforementioned registration rule) for all investment advisers.[142] Rule 206(4)-8(a)(1) prohibits investment advisers, including those advising hedge funds, from making

> any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made. . .to any investor or prospective investor. . .or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle.[143]

Even those hedge fund advisers who previously met the "private adviser" exemption under the Advisers Act typically provided potential "hedge fund investors with a private placement memorandum that disclos[ed] information about the investment strategies the hedge fund [was] permitted to use and an overview of how the hedge fund operat[ed]."[144] Additionally, hedge fund investors generally received some "ongoing performance information, risk analyses and portfolio profiles from their hedge fund advisers."[145] "Although not required, most hedge funds retain an auditor to conduct an annual independent audit."[146] This begs the question of how significant the changes will be, especially considering the fact that many hedge fund advisers previously offered information to their clients for the purported purpose of increasing transparency.

Furthermore, and perhaps most noteworthy, is the fact that prior to the passage of Dodd-Frank, the "majority of hedge funds based in the United States" voluntarily registered with the Commission.[147] Specifically, as of 2009, "almost 55 percent of the more than 2,000 United States-based hedge fund firms" were registered with the Commission.[148] "The registered universe of hedge funds represents

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142 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 17 C.F.R. pt. 275 (2007).

143 Investment Advisers Act of 1940, §206(4)-8(a)(1), 15 U.S.C. §80b (2006).

144 Implications of the Growth of Hedge Funds, Staff Report to the U.S. SEC. & EXCH. COMM'N (Sept. 29, 2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf.

145 *Id.*

146 *Id.*

147 Jeff Benjamin, *Bleeding assets, hedge funds register with SEC*, INVESTMENT NEWS (Feb. 2, 2009, 2:35 PM), http://www.investmentnews.com/article/20090202/REG/902029987.

148 *Id.*

seventy-one percent of United States-based hedge fund assets."[149] Kenneth Heinz, president of Hedge Fund Research, Inc. stated in 2009, that the rationale for registering with the Commission was difficult to determine.[150] "It's tough to speculate on exactly why these firms are registering beyond that they certainly feel it is beneficial to be able to show clients they are registered."[151] One primary reason for this may be the successful, albeit short-lived, passage of the 2006 hedge fund regulation. Although *Goldstein v. S.E.C.* overturned the rule that required hedge fund managers to register as investment advisers, many hedge funds never de-registered. While Title IV has been touted as sweeping regulation of the hedge fund industry, it seems that there may be less to Title IV than meets the eye, in light of the fact that a large majority of United States-based hedge fund firms and their assets optionally registered already.

While the burden for oversight of "mid-sized" investment advisers will shift from the Commission to the state, added responsibility for larger investment advisers, coupled with reduction in workforce at the Commission, raises reasonable concerns about how the Commission can effectively regulate those investment advisers with assets under management in excess of $150 million.[152] "The Commission lacks the resources necessary to conduct frequent, comprehensive hedge fund adviser examinations."[153] Taken a step further, the Commission may not have the resources to evaluate the data it receives involving dynamic hedging strategies and trades.[154] This highlights the fact that although the purpose of Title IV is to monitor systemic risk through increased transparency, the Commission and state agencies may not have the necessary resources to effectively examine those who are registered, thus leaving less to Title IV than meets the eye.

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149 *Id.*

150 *Id.*

151 *Id.*

152 Registration Under the Advisers Act of Certain Hedge Fund Advisers, 17 C.F.R. pts. 275 & 279 (2005) (dissent of Commissioners Cynthia A. Glassman & Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers).

153 *Id.*

154 Kaal, *supra* note 1, at 428 (*citing* 156 Cong. Rec. S5902 (daily ed. July 15, 2010) (statement of Sen. Richard Shelby)("criticizing the Dodd-Frank Act for creating an even larger bureaucracy and questioning its ability to make the correct decisions")); *see also*, 156 Cong. Rec. S5885 (statement of Sen. Ted Kaufman)(raising the concern that agencies may not have the resources to properly carry out all of their obligations under Dodd-Frank).

Elisse Walter, the Democratic Securities and Exchange Commission Commissioner voiced concern over this increased responsibility. Commissioner Walter "pointed to a study the Commission released in January" 2011, which showed that the average fund manager can expect to be examined once every eleven years under the existing system.[155] Walter stated, "the SEC is not, and unless significant changes are made, cannot fulfill its examination mandate with respect to investment advisers."[156]

Indeed, when Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, testified before the Committee on Financial Services on the Investment Adviser Oversight Act of 2012, he echoed Commissioner Walter's concerns. Ketchum highlighted the Commission's findings that "only 8 percent of registered investment advisers were examined in 2011 and approximately 38 percent of advisers registered with the [Commission] have never been examined."[157] Ketchum further estimated that regulators examine the average Commission-registered investment adviser "only once every 10 to 13 years," a more pessimistic estimate than Walter's eleven-year estimate.[158] Additionally, he stated that the frequency of Commission "examinations of investment advisers has decreased 50 percent since 2004."[159] According to the Commission's January 2011 study, the entity "will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."[160] If securities regulators are unable to examine newly registered investment advisers, how will the investing public be protected?

Ketchum correctly concluded that currently the Commission lacks the requisite resources to effectively regulate these additional industry

[155] Ronald D. Orol, *SEC delays hedge-fund registration rule: Republican commissioners reject reporting requirement for some VC funds*, MARKETWATCH (June 22, 2011, 4:25 PM), http://www.marketwatch.com/Story/story/print?guid=F939CF70-9CD1-11E0-8019-002128049AD6.

[156] *Id.*

[157] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony Before the Committee on Financial Services, U.S. House of Representatives (June 6, 2012), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P126815.

[158] *Id.*

[159] *Id.*

[160] *Id.*

professionals.[161] The study further acknowledged that new examination responsibilities provided to the Commission under Dodd-Frank means that an increase in agency examination staff "is unlikely to keep pace with the growth of registered investment advisers."[162] The Commission study estimated that it would need to "double the number of examiners to increase the frequency of examinations even 20 percent."[163] That said, the House Appropriations Committee, after considering the Commission's request for a $1.57 billion budget for fiscal year 2013, allotted $1.37 billion to the Commission for fiscal year 2013, which is $195 million less than President Obama had requested. Although this figure represents a $245 million increase from fiscal year 2012's appropriations, it starves the Commission of "necessary funding to boost oversight of advisers."[164] While Dodd-Frank's shifting of investment advisers to state regulation may result in a short-term decrease in the number of advisers, "there will be an immediate increase in assets under management 'as larger and more complex entities enter the Commission's oversight.'"[165] Further, as Commissioner Walter noted, these advisers are "more likely to be assessed as higher-risk advisers requiring more resources."[166]

The "government's desire to learn more about hedge funds, both to assess systemic risk and to protect investors," must also be weighed against the compliance costs this imposes on funds and then subsequently, investors.[167] While compliance costs will be high, it remains to be seen what substantial benefit this strict reporting requirement will have on hedge fund managers newly registered as investment advisers.[168] Given Commissioner Walter's forecast, it seems that costly registration may result in insignificant benefits resultant from proactively monitoring risk in the overall hedge fund industry. Any solace obtained from the knowledge that a hedge fund or its investment adviser is registered is misplaced by the fact that periodic inspections

161 *Id.*
162 Ketchum, *supra* note 157.
163 *Id.*
164 Melanie Waddell, *SRO Bill May See July Vote; SEC Gets Glint of Hope for Extra Funds*, ADVISORONE (Jun. 14, 2012), http://m.advisorone.com/2012/06/14/sro-bill-may-see-july-vote-sec-gets-glint-of-hope.
165 Ketchum, *supra* note 157 (*internal quotations omitted).*
166 *Id.*
167 Brown, Lynch, & Petajisto, *supra* note 21.
168 *Id.*

are not always foolproof. For example, R. Allen Stanford, a registered investment adviser who was subject to periodic examinations by the Commission, was convicted in June 2012 of swindling more than $7 billion from investors over a twenty-year period.[169] On a larger scale, the Commission inspected financier "Bernard Madoff's operations several times, and eventually required him to register as an investment adviser."[170] Although he too was registered as an investment adviser, the Commission never ascertained that Madoff was running an unprecedented Ponzi scheme estimated to amount to $65 billion.[171]

In addition to federal regulation by the Commission, "mid-sized" and smaller hedge funds will now fall under the purview of state overseers. It is not clear that the states are ready for this responsibility. The Commission "estimates that about 4,000 investment advisers will switch to the states."[172] "Right now, as it is, the states don't have the budget or the manpower to even deal with the advisers that they have. . . You're lucky if the states [examine firms] on a three-year basis."[173] This is particularly troublesome given that "[f]raud is more likely to happen with small managers than big managers."[174] This issue is compounded by the fact that several states, including Connecticut and California, account for a disproportionately portion of the hedge-fund industry. Connecticut expects that the number of investment advisers registered in connection with Dodd-Frank will increase by thirty percent.[175] Critics of the increased state supervision also point to the resultant administrative burden. As opposed to a uniform federal system, each state may conceivably have its own rules and procedures for hedge

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169 Juan A. Lozano, *R. Allen Stanford gets 110 years for role in $7B swindle*, USA TODAY (Jun. 14, 2012), http://www.usatoday.com/money/industries/brokerage/story/2012-06-14/r-allen-stanford-sentenced/55597082/1.

170 Kara Scannell, *States Will Be Hedge-Fund Police*, WALL ST. J. (Aug. 19, 2010), http://online.wsj.com/article/SB10001424052748704557704575437663904234590.html.

171 *Id.; see* Grant McCool & Martha Graybow, *Madoff pleads guilty, is jailed for $65 billion fraud*, REUTERS (Mar. 13, 2009), http://www.reuters.com/article/2009/03/13/us-madoff-idUSTRE52A5JK20090313. *See generally*, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme – Public Version,* U.S. SEC. & EXCH. COMM'N OFFICE OF INVESTIGATIONS (Aug. 1, 2009), http://www.sec.gov/news/studies/2009/oig-509.pdf.

172 *Id.*

173 *Id.* (quoting attorney and hedge fund adviser Bart Mallon, who advises funds previously registered with state authorities).

174 *Id.* (quoting Christopher Wells, head of the hedge-fund practice at the law firm Proskauer Rose L.L.P.).

175 *Id.*

funds to follow.[176]

As illuminated recently within the context of the insurance industry, the lack of uniformity created by state-by-state regulation has the potential for creating a problem wherein the industry lacks perspective of the larger picture. Where "each state is responsible only for its individual jurisdiction, no state can keep tabs on insurance companies that cross state or international boundaries."[177] Proponents for a uniform federal regulator point to the potential for systemic blind spots in the insurance industry that jeopardize the capital markets and national economy.[178] This problem was highlighted by the failure of the American International Group (AIG), a financial holding company comprised of 209 subsidiaries, 71 of which were state-regulated insurance entities.[179] While AIG's demise was brought on by investments initiated by AIG's financial products companies, it caused many to question the state-based system. Not only does it have the potential to create regulatory blind spots, but also, "some insurers have become too complex and too interconnected world-wide for the limited resources of state regulators to handle."[180] These same problems may inevitably carry over to the hedge fund industry's "mid-sized" and smaller investment advisers, overseen by state regulators. Perhaps an even more troubling aspect of the state-versus-federal debate is the fact that many states do not currently have investment adviser laws, registration requirements, or applicable programs in place.[181]

Finally, there is a risk that the information disclosed to the Commission, including trading positions, trading strategies, and dynamic hedging strategies, will not remain confidential. Potential leakage could "undermine trading strategies and the long-term viability of hedge funds."[182] This is concerning because hedge funds often

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[176] Scannell, *supra* note 170.

[177] Congresswoman Melissa Bean (D-IL), Senator Tim Johnson (D-SD), Congressman Ed Royce (R-CA), & Senator John Sununu (R-NH), *Insurance Companies Need a Federal Regulator*, WALL ST. J. (Sept. 23, 2008), http://online.wsj.com/article/SB122212967854565511.html?mod=article-outset-box.

[178] *Id.*

[179] *Id.*; Press Release, National Association of Insurance Commissioners, AIG: Conversation Should Stay Focused on the Facts (Sept. 18, 2008), http://www.naic.org/Releases/2008_docs/AIG_facts.htm.

[180] Bean, Johnson, Royce, & Sununu, *supra* note 177.

[181] Stephen J. Lubben, Professor, Harvey Washington Wiley Chair in Corporate Governance & Business Ethics, Class Lecture on Financial Institutions (Feb. 20, 2012).

[182] Kaal, *supra* note 1, at 427.

provide markets and investors with substantial benefits including enhanced liquidity, market efficiency, and an important risk management tool.[183] Leakage could also affect specific positions in the market, including front running and potentially market-moving positions.[184]

CONCLUSION

With the rulemaking power vested in them by Congress under Title IV of Dodd-Frank, the Commission adopted new rules defining five particular exemptions under the Advisers Act. While Title IV was touted as highly anticipated, long-overdue regulation of the hedge fund industry, there is far less to Title IV than meets the eye. Dodd-Frank removed the broad "private adviser" exemption that many advisers previously relied upon to avoid the regulatory and reporting eye of the Commission, only to replace it with five more "narrow" exemptions. As defined by the Commission, these exemptions begin to swallow the rule. The "family office" exemption, in particular, may create a loophole for the savvy hedge fund adviser. Given that other hedge fund advisers have begun to cast away outside investors in order to meet one of the newly designed exemptions to the Advisers Act, many of the assets the Commission seeks to regulate will essentially remain unregulated.

As the effective date for compliance with Title IV has now passed, one might reasonably wonder whether Title IV will go far enough to achieve Congress's purported goals of increased transparency in an effort to protect investors by monitoring systemic risk. Policy arguments may be made in favor of more strict scrutiny of the hedge fund industry, primarily because investors are demanding more transparency[185] and because private funds used to operate in the shadow of the financial system, outside the regulatory control of the Commission. However, the free-market crowd believes that overall Dodd-Frank has gone too far, "strangling the lifeblood of market capitalism."[186]

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[183] Implications of the Growth of Hedge Funds, *supra* note 29 (hedge funds provide valuable diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets).

[184] Kaal, *supra* note 1, at 427.

[185] Ahmed & De La Merced, *supra* note 133.

[186] McDonald, *supra* note 125.