# CHAPTER 6

# Revisiting Title IV: Why Mandatory SEC Registration for Hedge-Fund Advisers Is Not Necessary

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Dodd–Frank's Title IV, "The Private Fund Investment Advisers Registration Act," achieved what the Securities and Exchange Commission (SEC) had tried in vain to do on its own—mandatory SEC registration of advisers to hedge funds.[1] Congress, motivated by systemic risk and investor-protection concerns,[2] directed the SEC to reinstitute mandatory registration for most advisers to hedge funds and other private funds. In addition, Title IV further limited the pool of potential investors in hedge funds and other private offerings and imposed substantial reporting requirements on private-fund advisers. Title IV will not achieve its objectives of enhancing financial stability and protecting investors—it will impede economic growth instead.

## WHAT TITLE IV DOES

Title IV of Dodd–Frank accomplishes several things. First, Title IV eliminates private-fund advisers' ability to opt out of SEC registration by eliminating the registration exemption for advisers with fewer than 15 clients.[3] Advisers to hedge funds and private equity funds must register with the SEC and are subject to recordkeeping rules and other requirements applicable to registered advisers. Dodd–Frank requires the SEC to "conduct periodic inspections of the records of private funds."[4] Venture capital funds and private-fund advisers with less than $150 million under management need not register, but are subject to reporting requirements and arguably examinations.[5] Certain foreign advisers are also excluded,[6] as are certain small business investment company advisers[7] and certain advisers registered with the Commodity Futures Trading Commission (CFTC).[8] Family offices, which manage wealthy families' money, are also exempt from registration.[9] Title IV imposes recordkeeping and reporting requirements on registered private-fund advisers. It requires the SEC to conduct "periodic inspections" of private-fund records and authorizes the SEC to conduct examinations.[10]

Second, Title IV allows collection of private-fund data by authorizing the SEC to require registered advisers to maintain records and file with the SEC "reports regarding private funds that registered advisers advise, as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council."[11] Dodd–Frank specifically requires the collection of information regarding the amount and type of assets under management, leverage, counterparty credit risk, trading and investment positions, valuation, side arrangements with investors, trading practices, and other information that is "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."[12]

Third, Title IV adjusted the minimum for permissible SEC registration from $25 million to $100 million for the purpose of shifting more advisers into states' regulatory jurisdiction.[13] This change helped to offset the influx of newly registered private-fund advisers, but increased the burden faced by small advisers operating in multiple states.[14] With fewer smaller registrants, the SEC could shift resources from the oversight of smaller advisers with retail clients to newly registered private-fund advisers.

Fourth, Title IV directed the SEC to modify the net-worth standard for accredited investors, which determines who is entitled to invest in certain nonpublic securities offerings.[15] In response to the dramatic rise and fall in home prices, Dodd–Frank directed the SEC to remove the value of investors' homes from their net-worth calculation.[16] The statute authorized the SEC to adjust the $1,000,000 net-worth threshold[17] and to periodically assess the continuing relevance of the other criteria that can make a natural person an "accredited investor" in light of investor protection, the public interest, and the economy.[18] In addition, Dodd–Frank required the SEC to periodically adjust for inflation dollar amounts in its standard for qualified clients—a set of investors who may pay performance-based fees to private funds.[19]

Title IV opens the door to future, more interventionist, regulation. Professor Lyman Johnson has described the requirements of Title IV as "really in the nature of an extended study" of hedge funds, which could eventually form the basis for "an even more potentially disquieting debate about the social responsibilities and legal rights of those who facilitate rapid, large capital movements in a way that may destabilize modern markets."[20] Regulators could use the information collected through Form PF, the centerpiece of Title IV's financial stability efforts, to push an interventionist regulatory agenda with respect to the asset management industry.[21]

## LIMITS OF TITLE IV IN ACHIEVING INTENDED OBJECTIVES

Title IV protects neither financial stability nor investors. Instead, it replaces an effective private, contractually based regulatory scheme with a costly, new government regulatory scheme that has potentially adverse effects on economic growth.

**Title IV Does Not Bolster Financial Stability.** Title IV is one component of Dodd–Frank's plan for enhancing systemic stability. By empowering regulators to collect information about private funds and their advisers, Title IV is intended to provide regulators a better sense of what is happening in the hedge fund industry and to stop emerging problems before they endanger the financial system. By displacing market monitoring with regulatory monitoring and imposing barriers on funds' ability to perform stability-enhancing functions, Title IV undermines market discipline.

If market participants believe that the government is monitoring the markets, private monitoring likely will decrease. Registered advisers will be presumed to be subject to close SEC oversight. Advisers themselves may rely on the government to warn them of imprudent investment strategies.[22] The perception of regulatory monitoring will dissuade market participants from undertaking due diligence of their own and responding rationally and promptly to emerging problems by raising them with investment advisers and—in the face of the adviser's unresponsiveness—switching to a new adviser.[23] Detailed, timely knowledge of what is going on in the markets will be lost if private fund investors outsource their due diligence to the SEC. A multitude of spontaneous decisions by individual investors, their representatives, and others who do business with investment advisers is more effective at uncovering and disciplining underperforming or inept advisers than a system that relies on coordinated actions by regulators to spot and correct problems. Policymakers would do well to heed the warnings of Friedrich Hayek, who has demonstrated the futility and danger of relying on government oversight and management of markets.[24]

Regulators simply are not equipped to collect and process information and use it in a timely manner to stop problems, especially financial stability problems. According to SEC Chair Mary Jo White, the information collected on Form PF will facilitate regulators' oversight of financial stability:

> Form PF provides information on the types of assets [hedge funds] are holding to help to inform government regulators tasked with monitoring systemic risk. Using this information, regulators can then assess trends over time and identify risks as they are emerging, rather than reacting to them after they unfold.[25]

While regulators need insight into financial market activity, expectations about what they will be able to do with the information they collect must be moderated. As Michael King and Phillip Maier explain, "It is not clear that more transparency—in the extreme, hedge funds reporting on their positions in a timely fashion—would substantially limit systemic risks, since processing this information is difficult and time consuming."[26]

Proponents of Title IV might respond that the government is uniquely interested in systemic risk and therefore has a role to play in monitoring private funds. Government regulators, even when interested in systemic risk, are plagued by the knowledge problem. Aggregating, understanding, and responding to position-specific information in a timely manner is a difficult, and perhaps impossible, task for regulators.[27] Michael Cappucci has pointed out that collecting the right information and collecting it in a timely manner is extremely difficult:

> [T]he knowledge problem is endemic to any human activity that involves planning or prediction. Additional observation and data cannot solve the core problem, which stems from the inherent inability of finite beings to fully understand complex situations on the basis of insufficient knowledge. The prevalence of the problem is why genuine, true knowledge is scarce, expensive, and hard to come by, and why presumed knowledge so often wilts under close scrutiny.[28]

Cappucci argues that "the task of containing systemic risk given to the [Financial Stability Oversight Council] is not just difficult, but impossible."[29] Collecting the right information about the financial markets in a timely manner and then acting properly in response are impossible objectives.

Regulators must have access to sufficient information about private funds to develop a broad understanding of the markets. Policymakers, however, should moderate their expectations about how much regulators can do with the information and, accordingly, should limit the amount of information they collect.

Form PF is not a modest information collection effort; it is an ambitious undertaking that illustrates the difficulties in systemic risk regulation. The form consists of four parts[30] (some of which apply only to certain categories of private fund advisers) and allows periodic reporting by advisers to private funds.[31] Large advisers report quarterly and small advisers annually. The SEC and Commodity Futures Trading Commission (CFTC) jointly designed Form PF, although neither is intended to be the primary consumer of the information it collects.

Form PF is designed to collect information for the Financial Stability Oversight Council (FSOC). The chairmen of the SEC and CFTC are members of FSOC, but it is a distinct regulatory body with distinct powers. Consequently, Form PF reflects the best guesses of the SEC and CFTC—formed after consultation with the FSOC—as to what information the FSOC might want.[32] Figuring out what information will be useful in identifying and measuring risks is difficult.

The natural tendency of regulators is to expand the amount of information collected, as regulators hopefully anticipate that real discernment will come with the collection of additional information.[33] Requesting more data is a defensive measure by regulators who do not want to be faulted for failing to ask the right questions or collect the right information. For example, the Office of Financial Research (OFR)[34] recently released a paper concluding that Form PF does not do a good job of differentiating among funds posing different levels of risk.[35] The paper's authors recommend "captur[ing] additional characteristics on the form to constrain the range of possible risk profiles more tightly."[36] Yet, as the authors also note, Form PF is already "a complicated report, and its intricacies are a source of possible measurement errors and ambiguities."[37]

Most private-fund failures do not have financial stability implications. The failures of Long Term Capital Management and Amaranth, however, are stark reminders that private-fund failures can destabilize markets. Financial stability might be better achieved by relying on "indirect regulation" through hedge funds' prime brokers and counterparties.[38] As discussed below, there are also other, more effective, means for achieving investor protection—the other main objective of Title IV.

**Title IV Does Not Support Investor Protection.** In addition to its systemic risk objective, Title IV has an investor-protection objective. Registration of private-fund advisers is perceived to be an investor-protection measure. The experience with Bernard Madoff—who was a registered investment adviser during the final years of his fraud, and arguably should have been registered earlier—illustrates that a registration requirement does not necessarily protect investors.[39] Advisers determined to steal client money are also likely to be willing to ignore the registration requirement. Title IV undermines investor protection by serving as a tax on private-fund investors who must indirectly bear the cost of registration, and by diverting scarce SEC resources from retail-investor protection.[40] It also undermines investor protection by further narrowing the group of investors eligible to invest in private funds.

The time the SEC spends on matters related to private funds is not available for matters related to retail investors. Under existing accredited investor standards, few retail investors can directly invest in private funds, so they cannot benefit from the SEC's allocation of resources to oversight of private funds. As former SEC Commissioners Paul Atkins and Cynthia Glassman wrote in their dissent from the SEC's earlier unsuccessful attempt to register hedge fund advisers:

> In contrast to mutual fund investors, hedge fund investors have not been conditioned to rely on Commission oversight. They can perform due diligence (or hire someone else to do so for them), review audit reports or third-party internal control reports, and enlist help if they suspect fraud or malfeasance. By adopting the registration requirement, the Commission has upset the private-public balance and taken on a task that it might not have adequate resources to perform.[41]

Private-fund investors must satisfy wealth or sophistication criteria. Commission resources devoted to private funds protect these sophisticated institutional investors and wealthy individual investors. Some contend that SEC oversight is needed because private-fund investors include pension funds, operated for the benefit of individuals of modest income.[42] These funds, however, employ highly knowledgeable employees who are able to assess the quality of private-fund advisers.

The SEC has established a Private Funds Unit, has conducted examinations of a quarter of the newly registered advisers,[43] and is bringing enforcement actions against private-fund advisers.[44] Yet, the SEC examined only 10 percent of all registered advisers in 2014.[45] The SEC, therefore, is devoting a lot of resources to the private-fund space that would otherwise be directed at firms serving retail investors of more modest means. In addition, the SEC's enforcement agenda has shifted as it has consciously chosen to devote resources to bringing a number of enforcement actions against private-fund advisers for alleged abuses.[46] As one commentator noted, the costs that the SEC incurs in overseeing private-fund advisers to protect investors amounts to a "public subsidy of wealthy investors" that runs counter to the decision to allow these investors to essentially opt out of certain investor protections.[47] Investors in private funds could instead be protected through antifraud rules, investor demands for transparency, and their own wealth and sophistication.[48] Given the SEC's frequent requests for additional resources, directing many of them to the investors that are best situated to monitor their advisers may be unwise.[49]

Particularly given the SEC's expenditure of resources to protect private-fund investors, Title IV's simultaneous move to reduce the number of investors eligible to invest in private funds is puzzling. By removing the value of an investor's home from the accreditation calculation, Dodd–Frank reduced the ranks of investors able to invest in private funds. Private funds can serve a valuable role in investors' portfolios and, as Professor Houman Shadab has explained, "the true impact of wealth-based qualifications is to prevent retail investors who have a sufficient understanding of hedge funds from reducing risk and maximizing their investment returns."[50]

**The SEC Is Indirectly Instituting a Broad Regulatory Regime for Private Funds.** Title IV of Dodd–Frank was not designed to provide the SEC with powers to regulate the disclosure that hedge funds, private funds, and venture capital funds provide to their wealthy and sophisticated investors. The SEC, however, appears to be indirectly using its authority under Title IV to change the way fund advisers communicate and interact with their investors.

As former SEC Chairman Harvey Pitt has explained, the SEC sometimes uses enforcement to accomplish regulatory ends:

> It is, understandably, far easier for SEC officials to defend and pursue individual enforcement actions, particularly if they are highly visible enforcement actions, than to attempt to develop and maintain comprehensive regulatory responses to difficult and technical industry and professional issues.... Among other things...the agency is not required to chart out, explicate, maintain or perfect a comprehensive solution to identified issues, taking into account those circumstances where deviation from normative standards might be appropriate.... [C]ritics and overseers of the agency's activities are less likely to be able to detect inconsistent approaches by the agency to comparable problems, or even to ascertain guiding principles or policies employed by the agency to respond to certain types of situations.[51]

In the private-fund context, the SEC is using a regulation-by-enforcement approach to achieve a regulatory framework that is more appropriate for retail funds. In a recent speech, SEC Chair Mary Jo White outlined obligations for the private-fund industry and signaled the prospect of an aggressive SEC examination and enforcement response for funds that do not adhere to these recommendations.[52] She cited advisers' fiduciary duty as the basis for a long list of concerns that could serve as the groundwork for a mandatory disclosure regime for private funds. White directed private-fund advisers to turn their attention to "some firm-specific risks you should be actively considering in your own business." She identified a long, detailed list of purported problems identified by SEC examiners in their Dodd–Frank reviews or that had been the subject of SEC enforcement actions against private funds. Highlighted problematic practices included misleading marketing materials, inadequate conflict disclosure, unfair trade and expense allocations, inadequate disclosure regarding hiring conflicted parties and borrowing from clients, misallocating expenses to funds, unauthorized and undisclosed payment of operating expenses, and failure to disclose service-provider fees and discounts. Chair White concluded that the SEC's "oversight and exam program...identifies practices that would have been difficult for investors to discover by themselves" and directed "investment advisers to funds—including private funds catering to sophisticated investors—[to] disclose material facts to clients." Thus, the SEC seems to be using its enforcement program to establish a de facto set of mandated disclosures. White has also contemplated mandating standardized performance disclosures for hedge funds.[53]

The SEC's antifraud authority allows it to pursue fraud by private-fund advisers, but the disclosures that Chairman White is calling for were not authorized by Dodd–Frank, were not adopted pursuant to a notice and comment rulemaking, and were not subjected to an economic analysis as is required of SEC rulemakings. These requirements pre-empt and impede the development of fund-specific governance arrangements that were previously developed pursuant to state contract law and state business entity law, as the following section will describe.

**Title IV Pre-Empts and Inhibits the State Law Contractual Rights by Which Investors in Private Funds Can Regulate Private Funds.** Investors in private funds typically become limited partners in limited liability partnerships (LLPs) formed under state business-law codes governing those business-entity forms.[54] The most popular domicile for creation of limited partnerships for hedge funds is the state of Delaware, which provides strong default contractual obligations for general partnerships to limited partnerships with respect to managerial decisions like those described by Chair White in the previous section. Those default obligations include a requirement that the general partner meet an obligation of a duty of the utmost loyalty and care in management of the partnership.

Delaware and many other states also provide substantial contractual flexibility to limited partnerships to create stricter obligations, or more narrowly tailored obligations, as investors in the partnership prefer to define those obligations. Carefully tailored provisions in limited partnership contracts have typically created effective corporate governance arrangements to monitor and address possible conflicts of interest. These arrangements include the creation of advisory boards of directors that can police conflicts of interest by the general partner managing the fund. For specific transactions, those boards also are often empowered to hire outside advisers to opine on the usefulness and propriety of transactions subject to conflicted motives, such as fee arrangements.

Delaware limited partnership law also provides limited partners with default tools in addition to any tools they may bargain for through the initial contract. Default tools are common in the limited partnership laws of other states as well. For example, investors in LLPs have a default right to inspect partnership books and records. Limited partners can expect to be granted wide latitude from Delaware courts to inspect documents if alleging particularized facts showing mismanagement or wrongdoing by the general partner.[55] Investors in LLPs also typically have a right to a judicial appraisal of the value of their interest in the partnership upon certain triggering events.[56]

Furthermore, Delaware contract law includes an implied duty of "good faith and fair dealing." This obligation provides limited partners with judicial redress in the event of theft or fraudulent disclosure by the general partner, and actions by the managing general partner not otherwise authorized by the LLP's charter, undertaken in bad faith, that deprive LLP limited partners of the fruits of the LLP bargain.[57]

As the SEC undertakes action that pre-empts state contract law, the incentives of these sophisticated and wealthy investors in hedge funds to formulate and enforce their rights is reduced. A false signal of bonding from the SEC will reduce incentives to monitor and to enforce rights through litigation. It will also reduce incentives of private investors to bargain for specialized provisions in their LLP agreements with hedge funds and private equity funds, since they know the agreements they enter into can always be made redundant by SEC action.

**Title IV Imposes Costs on Investors, Competition, and Economic Growth.** Hedge funds, private equity funds, and venture-capital funds play an important role in investor portfolios, the financial system, and the economy. They not only strengthen and diversify investors' portfolios,[58] but foster financial system health and economic growth.[59] The burdens flowing from Title IV make it more difficult for private funds to perform these important roles.

Private-fund investors arguably benefit from SEC oversight, but they have to bear the costs associated with registration. Registration comes with recordkeeping, reporting, and other requirements. In addition, SEC examinations are costly for examined firms, which must expend considerable high-level time to meet examiner demands. Investors are likely to bear some or all of the costs of these regulatory requirements through increased fees. Prior to the adoption of Dodd–Frank, investors could choose to invest in a fund the adviser of which was registered or—if they believed the costs of registration outweighed the benefits—could invest with an unregistered adviser. Title IV eliminated this choice.

As noted, private-fund advisers must complete Form PF. Investors bear at least a portion of the cost of completing this form, but it is designed to meet the needs of systemic regulators, not fund investors.[60] As one would expect, burdens differ markedly depending on whether a firm is large or small.[61] Although costs will fall over time, the form's length, complexity, and potential for future expansion means that investors may continue to bear substantial costs for the preparation of Form PF without direct benefit.[62]

Dodd–Frank's enhanced regulatory framework makes it more difficult for new private funds to enter the industry to serve investors, allocate capital, act in the marketplace, add balance to the financial system, and foster economic growth. Mandatory registration has garnered support from existing fund advisers, who might view it as a welcome barrier to the entry of new competitors.[63] Start-up advisers will have to spend time and money wading through regulatory requirements, whereas their established competitors will have ready access to legal and compliance help.

Even firms that are not required to register may face burdens that affect their ability to serve a vital role in the economy. Title IV, as implemented by the SEC, substantially burdens venture capital firms and small private-fund advisers. As former SEC Commissioner Kathleen Casey noted when the SEC adopted its final rules:

> Venture capital fund advisers, along with mid-sized private fund advisers, although explicitly exempt from registration under the Dodd–Frank Act, have been designated under the rules' framework to be "exempt reporting advisers," and are therefore subject to many of the same requirements as registered advisers, including public reporting requirements, and eventually recordkeeping obligations, just as if they were registered.[64]

These burdens could increase. Commissioner Troy Paredes observed that "VC fund managers will likely be obligated to disclose more and more information over time, steadily thwarting the purpose behind the venture-capital (VC) registration exemption that Congress enacted."[65] Investors in these funds will bear additional costs as a result of these requirements.

Aside from the costs associated with being registered, maintaining required records, and hosting SEC examinations, private-fund advisers now face the potential cost of losing control of proprietary information. Commissioner Paredes made the additional point that the public disclosure required of VC funds could end up causing the release of "competitively sensitive" information, the mandatory disclosure of which "could harm VC funds and the very investors that the rule purports to protect."[66] For information provided only to the government, Title IV contains confidentiality protections,[67] but government data breaches happen.[68] Moreover, regulators with access to the information may use their knowledge of proprietary practices at private funds when they leave government. Title IV permits the SEC to share information it collects with other regulators.[69] Although there are good reasons for such interagency information sharing, doing so increases the likelihood that confidential information will be compromised either through a data breach or through a government regulator who departs for the private sector. The specificity of the information collected on Form PF raises particular concerns.

Private funds play an important role in monitoring the financial system and identifying potential dangers. During the crisis, for example, certain hedge fund advisers spotted the growing housing finance problems.[70] During a crisis, private funds can bolster stability. As Jón Daníelsson, Ashley Taylor, and Jean-Pierre Zigrand point out, "the trading behavior of hedge funds can improve market efficiency, price discovery and consumer choice" and can offset trading by banks directed by regulators during a crisis.[71] They also point out the theoretical, albeit "not settled" possibility "that regulating hedge funds could actually increase market volatility and decrease liquidity and stability of financial markets."[72] By placing a regulatory tax on hedge funds performing beneficial roles in the market, Title IV ironically could make the financial system more—not less—unstable.

## A BETTER WAY TO ACHIEVE TITLE IV OBJECTIVES

The objectives of Title IV—promoting financial stability and protecting investors—are valid. A more effective way to achieve these objectives would be to return to a voluntary registration model. Investment advisers could choose to register with the SEC, if they believe their investors would value it. To address concerns that such an approach would unduly burden the SEC, Congress could require that advisers to private funds pay for SEC examinations or periodic third-party examinations. This requirement might dissuade some advisers from choosing SEC registration and encourage them to explore other alternatives, such as hiring third-party examiners to conduct periodic compliance reviews.[73] Such a result would help to preserve SEC resources for purposes more directly related to retail-investor protection and would enable fund investors to tailor outside monitoring arrangements to their needs.

The information-collection requirements under Title IV are intended to form the basis for systemic intervention by the FSOC. Not only is it difficult to collect the appropriate information, but properly calibrating the regulatory reaction to such information is difficult. Accordingly, Form PF should be discontinued or pared back so that it only serves a basic census function to provide the SEC with information about the number and type of private funds. The elimination of the general solicitation ban pursuant to the Jumpstart Our Business Startups (JOBS) Act removes one barrier to private-fund transparency, which means that—even absent a census framework—investors and regulators likely will find it easier to obtain information about private funds.[74]

If the accredited investor definition is not fundamentally reconsidered, it should be reworked to allow broader participation in private offerings by individuals who do not meet current wealth and income thresholds. Geographic adjustments to the numerical values should be considered a way to ensure that wealthy investors in the heartland—not just investors who live on the comparatively wealthier East and West Coasts—can participate in private offerings. Policymakers should avoid one-off exclusions of assets from the wealth calculation, such as Dodd–Frank's primary residence exclusion. Exclusions of these types lead to arbitrary distortions in investor behavior. The required inflation adjustments of the qualified client standard should also be eliminated. A more meaningful change would be the elimination of the standard so that performance-based fees are no longer limited to a small subset of wealthy investors.

## CONCLUSION

Title IV of Dodd–Frank embraced the theme that pervades the rest of the statute—regulators, armed with enough information, can stop financial crises. As with the other key pieces of Dodd–Frank, the prescription in Title IV places unrealistic hope in regulators to collect the right data and use it properly to avert systemic problems. A better way to achieve financial stability is to minimize regulatory burdens on private funds so that they can continue to play their important role in disciplining market participants, fostering economic growth, and contributing to market liquidity. Antifraud provisions of the federal securities laws and private contracting under state law effectively protect private-fund investors. Reducing regulatory burdens also will make it easier for new entrants to join the industry. Opportunities to invest in private funds should be opened to a broader circle of investors than is currently allowed under the restrictive accredited-investor standard. Finally, private-fund investors should be permitted to choose SEC-registered advisers, but should bear the cost so that they choose wisely.

*Any views expressed here are those of the author, not necessarily of The Heritage Foundation.*

## ENDNOTES:

1. The SEC adopted a registration requirement only to have it overturned in court. *Goldstein v. SEC* (D.C. Cir., 2006) vacated and remanded the SEC's hedge fund registration rule, which was grounded in the SEC's "manipulation of [the] meaning" of the term "client."
2. See, for instance, U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act," p. 9, (undated), https://web.archive.org/web/20100707081557/http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (accessed February 12, 2016). The summary explains that the legislation "(e)nds the 'shadow' financial system by requiring hedge funds and private equity advisors to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk."
3. Dodd–Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
4. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(6)).
5. Dodd–Frank §§ 407–408 (adding 15 U.S. Code § 80b-3(l)-(m)). Commissioner Troy Paredes pointed out that "because Congress put the new VC registration exemption in Section 203(l) of the Advisers Act instead of Section 203(b), where the former private adviser exemption was found, the SEC would appear to have the authority to examine VC fund managers that are exempt from registration, meaning that exempt VC fund managers may be subject to still more regulatory burdens than the new public reporting obligations." Securities and Exchange Commission, "Speech by SEC Commissioner Troy A. Paredes: Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940," June 22, 2011, http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm#_ftnref1 (accessed February 10, 2016).
6. This exemption "has only very limited application." Kaitlin Curry Albiez, "Hedge Fund Oversight and Title IV: Less than Meets the Eye," *Seton Hall Legislative Journal*, Vol. 37, No.1 (2013), pp. 145 and 157, http://scholarship.shu.edu/cgi/viewcontent.cgi?article=1046&context=shlj (accessed February 10, 2016).
7. Dodd–Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
8. Dodd–Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
9. Dodd–Frank § 409 (amending 15 U.S. Code § 80b-2). The SEC's implementation of this section warrants retrospective review. Dodd–Frank and the implementing regulations caused many family offices to register, or to change their structure to avoid registration.
10. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(6)).
11. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(1)). The SEC has made the data available to the Office of Financial Research rather than directly to the Financial Stability Oversight Council. Securities and Exchange Commission, "Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports," August 13, 2015, p. 4. The SEC also makes certain data available in aggregate form to the Financial Stability Board and the International Organization of Securities Commissions: SEC, "Annual Staff Report," p. 6.
12. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(3)).
13. Dodd–Frank § 410 (adding 15 U.S. Code § 80b-3a(a)).
14. See, for instance, Seth Chertok, "A Detailed Analysis of Title IV of the Dodd–Frank Wall Street Reform and Consumer Protection Act," *University of Virginia Law and Business Review*, Vol. 6, No. 1 (Spring 2011), p. 22. Chertok points out that "given a choice between federal and state registration, many investment advisers will choose to register with the SEC, rather than register with the applicable state authorities because state registration can be more onerous by requiring registration and filing fees in multiple states, various testing requirements for investment adviser representatives and compliance with certain state rules."
15. Dodd–Frank § 413 (15 U.S. Code § 77b note).
16. Dodd–Frank § 413(a).
17. Dodd–Frank § 413(a).
18. Dodd–Frank § 413(b).
19. Dodd–Frank § 418 (amending 15 U.S. Code § 80b-5(e)).
20. Lyman Johnson, "Why Register Hedge Fund Advisers—a Comment," *Washington and Lee Law Review*, Vol. 70, No. 1 (2013), pp. 723–724.
21. See, for instance, Board of Governors of the Federal Reserve System, "Speech: Daniel K. Tarullo, Advancing Macroprudential Regulatory Objectives," January 30, 2015, http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm (accessed February 11, 2016). Governor Tarullo noted that "[a]sset management activities have commanded considerable attention lately, both internationally at the [Financial Stability Board (FSB)] and domestically at the Financial Stability Oversight Council (FSOC)." The FSB is looking at "financial stability risks from asset management activities." News release, "Next Steps on the NBNI G-SIGI Assessment Methodologies," Financial Stability Board, July 30, 2015, http://www.financialstabilityboard.org/2015/07/next-steps-on-the-nbni-g-sifi-assessment-methodologies/ (accessed February 11, 2016).
22. Michael R. King and Phillip Maier, "Hedge Funds and Financial Stability: The State of the Debate," Bank of Canada *Discussion Paper* No. 2007-9, September 2007, p. 16. King and Maier observe that "[h]edge funds might take on positions in the false belief that supervisors will alert them if different strategies become crowded or hazardous."

23. See, for instance, Franklin R. Edwards, "Hedge Funds and Investor Protection Regulation," as presented at Federal Reserve Bank of Atlanta Financial Markets Conference, May 15–18, 2006, footnote 15, https://www.frbatlanta.org/news/conferen/06fmc/06fmc_edwards.pdf (accessed February 11, 2016). Edwards notes that "[t]here also is a possibility that SEC registration will result in a higher incidence of fraud because hedge fund investors may become more reckless in their choice of advisers because of a belief that SEC oversight now protects them against such fraud."

24. Nobelprize.org, Prize Lecture by Friedrich von Hayek, "The Pretence of Knowledge," December 11, 1974, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html (accessed February 11, 2016). Hayek remarked: "The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals."

25. Mary Jo White, "Hedge Funds—A New Era of Transparency and Openness," Securities and Exchange Commission, speech, October 18, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1370539892574 (accessed February 11, 2016).

26. King and Maier, "Hedge Funds and Financial Stability."

27. See, for instance, Jón Daníelsson, Ashley Taylor, and Jean-Pierre Zigrand, "Highwaymen or Heroes: Should Hedge Funds Be Regulated?" *Journal of Financial Stability*, Vol. 1, No. 4 (2005), pp. 36–37. The authors observe, in connection with position-level reporting to regulators, that "[e]ffectively, the supervisor would have to run a risk engine that simultaneously encompasses the positions of all hedge funds. Such a task is beyond the limits of existing technology."

28. Michael Cappucci, "Prudential Regulation and the Knowledge Problem: Towards a New Paradigm of Systemic Risk Regulation," *Virginia Law and Business Review*, Vol. 9 (Fall 2014), p. 25.

29. Ibid., p. 5.

30. Specifically, Form PF is broken into one section each for: all private fund advisers, large hedge funds, large liquidity fund advisers, and large private equity fund advisers.

31. Securities and Exchange Commission, "Form PF: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors," OMB No. 3235–0679, https://www.sec.gov/about/forms/formpf.pdf (accessed February 11, 2016).

32. "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF," *Federal Register*, Vol. 76, November 16, 2011, p. 71129. The notice explains: "The SEC is adopting Advisers Act rule 204(b)-1 and Form PF to enable FSOC to obtain data that will facilitate monitoring of systemic risk in U.S. financial markets. Our understanding of the utility to FSOC of the data to be collected is based on our staffs' consultations with staff representing the members of FSOC.... The policy judgments implicit in the information required to be reported on Form PF reflect FSOC's role as the primary user of the reported information for the purpose of monitoring systemic risk. The SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC's use."

33. Admittedly, there is a countervailing incentive for regulators *not* to collect information for fear of later being faulted for not stopping a crisis despite being in possession of information. See, for instance, Daníelsson, Taylor, and Zigrand, "Highwaymen or Heroes: Should Hedge Funds Be Regulated?" p. 537: "In the event of future problems relating to hedge fund activity, regulators are exposed to an ex post criticism that they had the information and should have prevented the problem." Because Title IV authorizes the collection of extensive information, however, if regulators choose not to collect it, they are likely to be blamed for not exercising their authority.

34. The OFR is associated with, but distinct from the FSOC, and receives Form PF information from the SEC.

35. Mark D. Flood, Phillip Monin, and Lina Bandyopadhyay, "Gauging Form PF: Data Tolerances in Regulatory Reporting on Hedge Fund Risk Exposures," OFR *Working Paper* July 30, 2015, p. 22. The authors "show that equivalent filings of Form PF can represent a wide range of actual risk as measured by a broad array of measures."

36. Ibid., p. 26.

37. Ibid., p. 10.

38. See King and Maier, "Hedge Funds and Financial Stability." See also Daníelsson, Taylor, and Zigrand, "Highwaymen or Heroes: Should Hedge Funds Be Regulated?" p. 537. Daníelsson and his co-authors argue that prime brokers "play a role as risk managers and can use their power to recall short-term credit lent to the hedge funds in order to impose acceptable levels of risk taking." Daníelsson and his co-authors also argue for a resolution mechanism, in which "[p]rime brokers may also need to make funds available during such a resolution procedure, which provides incentives for their closer prudential monitoring of hedge funds" (pp. 540–541).

39. SEC Office of Investigation, "Investigation of the Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Public Version)," Office of Inspector General Report No. OIG–509, August 31, 2009, p. 348. "The Enforcement staff decided that Madoff was not eligible for the broker-dealer exemption of the Investment Advisers Act of 1940, because he managed more than fifteen discretionary accounts." (Footnote omitted.)

40. See, for instance, Cynthia A. Glassman, "Policy Session II: Hedge Funds and Investor Protection Regulation," remarks at Federal Reserve Bank of Atlanta Financial Markets Conference May 2006, https://www.frbatlanta.org/news/conferen/06fmc/06fmc_glassman_comments.pdf (accessed February 11, 2016). Glassman notes that hedge-fund-adviser registration would result in "the diversion of resources that would otherwise be available to inspect the much larger universe of advisers to mutual funds, 529 plans, and annuities—whose investors number more than 90 million, relative to the fewer than 1 million individual and institutional hedge fund investors."

41. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, *Federal Register*, Vol. 69, December 10, 2004, p. 72094. (Footnotes omitted.)

42. See, for instance, Securities and Exchange Commission, Registration Under the Advisers Act of Certain Hedge Fund Advisers, *Federal Register*, Vol. 69, December 10, 2004, p. 72057. The SEC noted that with the increased investment by "public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations" to hedge funds, unsophisticated and non-accredited investors are indirectly exposed to hedge funds.

43. SEC Office of Compliance Inspections and Examinations, "Private Equity: A Look Back and a Glimpse Ahead," speech by Mark Wyatt, acting director, May 13, 2015. Wyatt stated: "OCIE has now completed our Presence Exams, which examined 25 percent of the newly registered private fund advisers (including both private equity and hedge funds)."

44. For example, SEC enforcement director Andrew Ceresny was quoted recently, in connection with a case about allegedly improper fees: "Our clear message to the entire private-equity industry is that this is an area of great risk, and that whatever the success of the fund over time, hidden or inadequately disclosed fees will not be tolerated regardless of the size of the adviser." Lisa Beilfuss and Aruna Viswanatha, "Blackstone in $39 Million SEC Settlement," *The Wall Street Journal*, October 7, 2015.

45. See, for instance, Mary Jo White, "Testimony on the Fiscal Year 2016 Budget Request of the U.S. Securities and Exchange Commission," Securities and Exchange Commission, May 5, 2015, http://www.sec.gov/news/testimony/testimony-fy-2016-sec-budget-request.html (accessed February 11, 2016). White explains that "the SEC was only able to examine 10 percent of registered investment advisers in FY 2014," and observes that a "rate of adviser examination coverage at that level presents a high risk to the investing public."

46. See, for instance, the enforcement cases cited in footnotes 21–24 of Mary Jo White, "Five Years On: Regulation of Private Fund Advisers after Dodd–Frank," keynote address at the Managed Fund Association, MFA Outlook 2015 Conference, New York, October 16, 2015, http://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html (accessed February 11, 2016).

47. Vijay Sekhon, "Can the Rich Fend for Themselves? Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010," *Hastings Business Law Journal*, Vol. 7 (2011), p. 8.

48. Luther R. Ashworth II, "Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd–Frank Act's Title IV?" *Washington and Lee Law Review*, Vol. 70, No. 1 (2013), p. 654.

49. As noted earlier, dissenting Commissioners Paul Atkins and Cynthia Glassman made a similar argument when the SEC adopted its subsequently invalidated hedge fund registration mandate.

50. See, for instance, Houman B. Shadab, "Hedging One's Bets—Increasing Access to Hedge Funds," *Mercatus on Policy* No. 15, February 2008, p. 4, http://mercatus.org/publication/hedging-ones-bets-increasing-access-hedge-funds (accessed February 11, 2016).

51. J. W. Verret, "Economic Analysis in Securities Enforcement: The Next Frontier at the SEC," *University of Cincinnati Law Review*, Vol. 82 (2013), p. 494 (quoting Harvey L. Pitt and Karen L. Shapiro, "Securities Regulation By Enforcement: A Look Ahead at the Next Decade," *Yale Journal on Regulation*, Vol. 7 (1990), pp. 156–157).

52. White, "Five Years On: Regulation of Private Fund Advisers after Dodd–Frank."

53. White, "Hedge Funds—A New Era of Transparency and Openness." White asks whether "the SEC or some other organization attempt to mandate standardized performance disclosure for hedge funds [is] consistent with a recommendation from our Investor Advisory Committee."

54. Grant Thornton LLP and Stonegate Capital Partners, "How Do You Start a Hedge Fund? The New Era of Hedge Fund Creation and Operational Management," December 2011, https://www.managedfunds.org/wp-content/uploads/2012/03/Starting-a-hedge-fund-GrantThornton-Stonegate-Capital-Dec-2011.pdf (accessed February 11, 2016).

55. Delaware Code, Title 6, Section 17–305.

56. Delaware Code, Title 6, Section 17–212.

57. *Nemec v. Schrader*, 991 A.2d 1120 (Del. 2010).

58. See, for instance, Shadab, "Hedging One's Bets—Increasing Access to Hedge Funds," pp. 2–3. Shadab notes that "while hedge fund returns do not always beat market returns, they almost always produce annual gains regardless of the direction of the general market."

59. See, for instance, J. W. Verret, "Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal," *Delaware Journal of Corporate Law*, Vol. 32, No. 3 (2007), pp. 804 and 815. Verret discusses some of the positive functions played by hedge funds.

60. For survey-generated cost estimates associated with Form PF, see Wulf A. Kaal, "Private Fund Disclosures Under the Dodd–Frank Act," *Brooklyn Journal of Corporate, Financial, and Commercial Law*, Vol. 9 (2015), pp. 439–453.

61. Kaal found that small firms spent an average of just under $10,000 on the initial filing, and that large firms spent an average of $155,000. Ibid., p. 447.

62. Approximately one-quarter of advisers was asked by investors for the Form PF, and some advisers accommodate these requests. Ibid., pp. 467–468.

63. See, for instance, J. W. Verret, "Review: Is Hedge Fund Registration Necessary?" *Washington and Lee Law Review*, Vol. 70 (2013), p. 710. Verret notes that "the fact that the hedge fund industry itself embraced the mandatory registration regime, or at least did not fight against it, presents a puzzle for which public choice theory may provide an answer."

64. Kathleen L. Casey, "Statement at SEC Open Meeting—Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers," speech by SEC Commissioner, June 22, 2011, https://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm (accessed February 11, 2016).

65. Troy A. Paredes, "Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940," speech by SEC Commissioner, June 22, 2011, http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm#_ftnref1 (accessed February 11, 2016).

66. Ibid.

67. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(8)).

68. See, for instance, Marcia Breen, "OPM Finishes Mailing Letters to Most Data Breach Victims," NBCNews.com, December 11, 2015, http://www.nbcnews.com/tech/tech-news/opm-finishes-mailing-notification-letters-data-breach-victims-n478721 (accessed February 11, 2016). Breen reports that "21.5 million Americans…had their personal information stolen" due to "a data breach at the U.S. Office of Personnel Management."

69. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(7)).

70. See, for instance, Gregory Zuckerman, "Trader Made Billions on Subprime," *The Wall Street Journal*, January 15, 2008. Zuckerman explains how hedge fund manager John Paulson identified and profited from the housing bubble.

71. Daníelsson, Taylor, and Zigrand, "Highwaymen or Heroes," p. 523.

72. Ibid., p. 535.

73. See, for instance, Verret, "Dr. Jones and the Raiders of Lost Capital," pp. 833–835. Verret recommends that the SEC "take steps to encourage creation of a private market intermediary" (citing Harvey Westbrook Jr., "Hedge Fund Industry Structure and Regulatory Alternatives," SEC Office of Economic Analysis, September 8, 2003, http://www.q-group.org/conf/Westbrook.pdf (accessed February 11, 2016)).

74. See, for instance, White, "Hedge Funds—A New Era of Transparency and Openness." White observed that because of the lifting of the general solicitation ban, "hedge fund managers feel they have a new freedom to communicate with the public, to advertise, to talk to reporters, to speak at conferences and, most importantly, communicate with investors openly and frankly…without the fear of securities regulators knocking on your door, or your outside counsel screaming at you."