Privileged Access to Financial Innovation

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Access to private funds is limited to an elite class of investors—wealthy individuals and large institutions. Individuals of more modest means—"retail investors"—face more limited investment choices; generally they can only invest in mutual funds. Despite this inequitable division, the current regulatory climate will lead to an even further expansion of the private fund industry. This Article argues that this loosening regulatory climate could lead to a talent drain amongst registered funds, could narrow the investment choices available to retail investors, and could deepen the already troubling income gap between wealthy and average earners. With respect to a possible talent drain, as it becomes easier for issuers to avoid the arduous registration requirements of the federal securities laws, many investment advisers will simply "go private" by instead offering hedge funds or other private investments. In assessing privileged access to strategies, because private funds are permitted to engage in more flexible trading strategies through the use of derivatives and other exotic instruments, elite investors have better opportunities for wealth maximization and diversification. A large body of empirical research has also found that private fund advisers often have privileged access to valuable information regarding upcoming investments. To the extent that this

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privileged access continues to grow, the options available to retail investors will continue to decline. From a broader perspective, this could magnify the financial challenges facing retail investors, some of which include dwindling retirement savings and declining property values, as well as deepen the already troubling income gap in this country. Alternative frameworks could entail: (1) loosening the capital restrictions that apply to mutual funds so that retail investors can access a greater degree of financial innovation, or (2) tightening the existing freedoms that apply to private funds, so as to level the playing field between retail and elite investors. However, the long-term and short-term effects to systemic risk, investor protection, and capital formation would have to be thoroughly investigated before adopting any proposed solution along this spectrum. This would necessarily require enhanced coordination between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), and improved collaboration with related industries (e.g., economic, financial, banking, quantitative analysis, etc.).

INTRODUCTION

"Performing in all Conditions" is the phrase that outlines the bottom of the advertisement.[1] Just above those words, three snowboarders are climbing a tall mountain that is covered in deep layers of snow.[2] It is evident that they have completed something special. Their arms wave in triumph. Each snowboarder miraculously persevered despite the blistering cold, the threatening mounds of snow, and the mountain's intimidating steepness. Thoughts of determination and drive are automatically elicited by this image. In fact, this picture seems to represent every possible characteristic that could generally be associated with success. At the very top of the page, the words "Balyasny Asset Management" are emblazoned in capital letters.[3] It is therefore implied that something about this firm holds the same promise of success and perseverance for a greater number of people: that, similar to these snowboarders, this firm can also achieve the impossible by delivering superior results under extreme conditions.

Upon further investigation, one can easily find that this company is a highly successful hedge fund that manages a total of approximately $4.3 billion.[4] Although this ad is visible to all members of the general public, only a finite number of elite investors can invest with this fund.[5] This elite class of investors includes wealthy individuals and institutional investors such as insurance companies, pension plans, and endowments.[6] Retail investors, which include the legions of individuals who do not meet the stringent net worth and income requirements for becoming an elite investor, are prohibited from investing directly with hedge funds.[7] Thus, they are largely excluded from accessing this vehicle that promises to "perform in all conditions."

Retail investors are mainly stuck with mutual funds, which is an industry that is plagued with severe regulatory constraints placed on the strategies of such funds.[8] These constraints make it difficult for mutual funds to consistently beat the market.[9] Numerous studies and surveys have found that a large percentage of mutual funds have not been able

1. Alexandra Stevenson, *With Ban on Ads Removed, Hedge Funds Test Waters*, N.Y. TIMES (Feb. 20, 2014, 6:12 PM), http://dealbook.nytimes.com/2014/02/20/with-ban-on-ads-lifted-hedge-funds-test-waters/?_php=true&_type=blogs&_r=1.

2. *Id.*

3. *Id.*

4. *Id.*

5. 17 C.F.R. § 230.506(b)(2)(i) (2015).

6. These elite investors are legally defined as "accredited investors" under the Securities Act of 1933, 15 U.S.C. § 77b(a)(15) (2012) & 17 C.F.R. § 230.501(a).

7. 17 C.F.R. § 230.506(b)(2)(ii).

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

9. *See* discussion *infra* Part III.B (explaining how the Company Act allows hedge funds to circumvent many of the restrictions that are placed on mutual funds).

to consistently earn returns that exceed the S&P 500.[10] Furthermore, restrictions under the Investment Company Act of 1940 ("Company Act") have historically narrowed the universe of investment options available to registered funds.[11] They are generally limited to stocks, bonds, and cash instruments. In contrast, private funds have unfettered access to innovative products such as derivatives, illiquid instruments, distressed securities, and other exotic instruments, which are minimally available to registered funds. The adverse consequences of these constraints were most visible during the recent financial crisis, where certain hedge funds relied on their increased freedoms to engage in short-trading and other innovative strategies to earn a sizable return for their underlying investors.[12] On the whole, the hedge fund industry outperformed the mutual fund industry during the financial crisis of 2007–10 (commonly known as the "Great Recession").[13] More specifically, in 2008, the value of global equities collectively fell "42 percent while hedge funds worldwide lost a comparatively smaller 19 percent for their investors."[14] As retail investors face dwindling retirement and savings accounts, an increasing retirement age, and decreasing property values, the disparities created by this divide become more problematic and more difficult to justify.[15]

These disparities are exacerbated by a regulatory climate that seems to support an even greater expansion of the private fund industry.[16] Although the Dodd-Frank Act of 2010 has subjected private funds to increased registration requirements under the Investment Advisers Act of 1940 ("Advisers Act"),[17] this Article demonstrates that the current

10. Richard Finger, *Five Reasons Your Mutual Fund Probably Underperforms The Market*, FORBES (Apr. 15, 2013, 9:16 AM), http://www.forbes.com/sites/richardfinger/2013/04/15/five-reasons-your-mutual-fund-probably-underperforms-the-market/ (referring to a study that found "66.08 percent of all domestic equity mutual funds underperformed when matched against the S&P 1500"). *See generally* Associated Press, *FAIL: 84% Of Actively Managed Mutual Funds Did Worse Than Their Benchmarks In 2011*, BUS. INSIDER (Mar. 12, 2012, 8:23 PM), http://www.businessinsider.com/84-mutual-funds-underperform-2012-3; Justin Fox, *Breaking News: Mutual Fund Managers Keep Failing to Beat the Market*, TIME (Apr. 20, 2009), http://business.time.com/2009/04/20/breaking-news-mutual-fund-managers-keep-failing-to-beat-the-market/ ("To be precise, 66.21% of actively managed domestic stock funds underperformed the S&P Composite 1500 Index in the five years from 2004 through 2008.").

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

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

13. *Id.*

14. *Id.* at 243–44.

15. *See* discussion *infra* Part IV.A.

16. *See* discussion *infra* Part II.

17. *See* discussion *infra* text accompanying notes 274–77 (providing a brief description of

regulatory environment has now shifted to support an even greater expansion of the private fund industry. For instance, hedge funds can now advertise, which is a monumental shift in our regulatory paradigm.[18] This new power to advertise will likely fuel growth by making it easier for private funds to access prospective investors.[19] Congress conferred this new power through the recently passed Jumpstart Our Business Startups Act ("JOBS Act"),[20] which also makes it easier for private funds to evade "public" status under the Securities Exchange Act of 1934 ("Exchange Act").[21] In addition, amendments to safe harbors provided under the Securities Act of 1933 ("Securities Act") have made it easier for investors in private funds to liquidate their private investments into cash.[22]

Commentators have offered intriguing explanations for this phenomenon. Some attribute this climate to the significant resources that private industries employ in lobbying for more lenient regulations.[23] Professor Zachary Gubler has argued, "the expansion of the private securities market can be viewed as a political strategy on the part of the SEC to maximize its bureaucratic career support in the face of uncertainty over how to reform the dysfunctionality of the public market."[24] Our current regulatory climate can be attributed to a number of factors, and can even benefit the elite class of investors that have access to private funds.[25] But it can potentially lead to troubling

new registration requirements under the Dodd-Frank Act).

18. *See* discussion *infra* Part I.B (detailing the elimination of the solicitation ban and its likely effects on private investment companies).

19. *Id.*

20. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

21. *See* discussion *infra* Part I.D (explaining how the increase in the threshold for the number of investors that will trigger public status allows investment companies to avoid periodic disclosure requirements).

22. *See* discussion *infra* Part II.C (describing how recent amendments have resulted in shorter mandatory holding periods).

23. Clea Benson & Cheyenne Hopkins, *Paulson Leads Hedge-Fund Lobby Push to Privatize Fannie*, BLOOMBERG (Apr. 30, 2013, 11:11 AM), http://www.bloomberg.com/news/2013-04-30/paulson-leads-hedge-fund-lobby-push-to-privatize-fannie.html; Sarah N. Lynch, *US Hedge Fund Industry Pushing Derivatives Regulator to Lift Ad Ban*, REUTERS (Jan. 8, 2014, 3:28 PM), http://www.reuters.com/article/2014/01/08/usa-hedgefunds-advertising-idUSL2N0JY21R20140108; Kevin Spak, *Hedge Funds Get 'Sweet Deal' in Finance Bill*, NEWSER (May 3, 2010, 8:28 AM), http://www.newser.com/story/87634/hedge-funds-get-sweet-deal-in-finance-bill.html; Jenna Staul, *Hedge Fund Industry Presses On With New Lobbying Effort*, HUFFINGTON POST (Mar. 18, 2010, 5:12 AM), http://www.huffingtonpost.com/2009/10/16/hedge-fund-industry-press
_n_324100.html.

24. Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 796 (2013).

25. *See* Cary Martin, *One Step Forward for Hedge Fund Investors: The Removal of the*

outcomes for the general public. This Article argues that the loosening regulatory climate could lead to a talent drain amongst registered funds, narrow the investment choices available to retail investors, and deepen the already troubling income gap between wealthy and average earners.

By and large, as it becomes easier for issuers to avoid the arduous registration requirements of the federal securities laws, many investment advisers will simply "go private" by offering hedge funds or other private investments.[26] This could lead to a significant drain of superior talent for those left behind as managers in the mutual fund industry.[27] Moreover, the economic disparities created by this growing industry have likely trumped the investor protection concerns that have historically supported the separation of private and public funds.[28] Because private funds are permitted to engage in more flexible trading strategies through the use of leverage and derivatives, such investors have better opportunities for wealth maximization and diversification.[29] A large body of empirical research has also found that private fund advisers often have privileged access to valuable information regarding upcoming investments.[30] Fostering a regulatory environment that promotes such inequities could further aggravate the financial challenges facing retail investors, some of which include dwindling retirement savings, declining property values, and a disappearing middle class.[31] It could also contribute to the growing income divide between the wealthy and the average earner in this country.[32] Professor Thomas Piketty's national bestseller, *Capital in the Twenty-First Century*, provides an in-depth economic analysis of both the scale and the drivers of this growing income gap.[33] Generally speaking, this deepening divide could hinder economic growth, and lead to political

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Solicitation Ban and the Challenges that Lie Ahead, 16 U. PA. J. BUS. L. 1143 (2014) [hereinafter Martin, *One Step Forward*].

26. *See* discussion *infra* Part III (highlighting the ability of hedge funds to avoid many of the restrictions placed on mutual funds).

27. *See* discussion *infra* Part II.C (explaining the potential benefits of going private including performance fees).

28. *See* discussion *infra* Part IV.A (suggesting that investor protection rationale becomes less convincing as private companies extend their reach to the general public).

29. *See* discussion *infra* Part III.

30. *See* discussion *infra* Part III.C (describing the advantage private fund advisers receive from the ability to access valuable information).

31. *See* discussion *infra* Part IV.A.

32. *See* discussion *infra* Part IV.B (outlining competing views from economists regarding the long term implications of inequality among investors).

33. *See* THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 15 (Arthur Goldhammer trans., 2014).

and social unrest.[34] Although it is admittedly difficult to directly correlate this divide with our federal securities laws, this Article should at least demonstrate that more research is needed in this regard. At face value, it seems unsettling to encourage a regulatory system where top earners have access to even greater capital gains through private investments, while the general public is left with investments that are perhaps subpar.

Crafting a viable solution highlights the unique challenges of applying a reliable cost-benefit analysis to new regulations in light of the growing complexities of the financial markets. Loosening the antiquated trading restrictions that apply to mutual fund investments would allow advisers to employ strategies that could further protect investors in declining markets. This would create better opportunities for wealth maximization and diversification for the general public. And because mutual funds are subject to the detailed registration requirements under the Company Act (and other enhancements under the Dodd-Frank Act),[35] they may be better suited to trade in such risky instruments given the heightened disclosure and governance requirements that are designed to protect retail investors. However, the costs to investor protection and market integrity could be monumental, particularly because these instruments are often inordinately complex, and could expose the broader economy to increased systemic risk.

Alternatively, specific limitations could be imposed on hedge funds' leverage exposure and speculative trading activities, since the overindulgence in these undertakings could expose the general public to negative externalities. However, the costs of limiting such activities could unduly constrain capital formation, which is further complicated by the fact that pension funds and other institutional investors (that are comprised of underlying retail investors) are increasingly investing in these vehicles.[36] As such, the long-term and short-term effects to systemic risk, investor protection, and capital formation would have to be thoroughly investigated before adopting any proposed solution along this spectrum. Enhancing coordination between the Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC"), and improving collaboration with related industries (e.g., economic, financial, banking, quantitative analysis,

34. *Id.*

35. 15 U.S.C. § 80b–3 (2012).

36. *But see* discussion *infra* text accompanying notes 178–83 (discussing the withdrawal of hedge fund investments by the California retirement system agency CalPERS, and the increased interest in hedge funds by institutional investors, in spite of CalPERS' recent withdrawal from the industry).

etc.), are necessary first steps for deriving an appropriate solution for these growing inequities.

This Article is a continuation of my prior research as I have consistently explored, from a variety of perspectives, the extent to which investor protection should be reframed to accommodate the rampant financial innovation that has occurred in the past decades.[37] This Article seeks to shift gears by focusing on the *economic* impact to retail investors, who have not directly benefited from the loosening of restrictions for private funds. In addition, this piece builds on the existing literature on this topic, which has consistently investigated the pervasive inequities that naturally derive from this division of investors.[38] This Article renews this debate within the framework of the current regulatory climate of fostering private fund expansion. It also proposes alternative solutions that entail reassessing the caps on leverage that currently apply to registered funds and enhancing coordination between the SEC and the CFTC to derive more effective regulation.

Part I begins by highlighting the growing prevalence of the

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37. *See generally* Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87 (2012) [hereinafter Martin, *Systematic Risk Prevention*] (arguing that Dodd-Frank does not provide enough information to adequately protect hedge fund investors); Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49 (2012) [hereinafter Martin, *Private Investment Companies*].

38. *See* Samuel Brunson, *Mutual Funds, Fairness, and the Income Gap*, 65 ALA. L. REV. 139, 142 (2013) (focusing on inequitable tax rates between public and private funds as "mutual fund investors must pay taxes on non-existent gains, but the wealthy can use alternative investment strategies to avoid such taxes, the taxation of mutual funds violates the tax policy objective of vertical equity"); Gubler, *supra* note 24, at 754–68 (arguing that the SEC has implicitly supported the expansion of the private market due to uncertainty regarding effective regulation of public markets); Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3402–06 (2013) (examining the recent emergence of private secondary markets to highlight growing disparities among investors and to further illuminate resulting harms to overall markets); Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 568–83 (2009) (investigating reform agenda based on the libertarian-paternalist notion that government intervention should aim to bolster consumer decision making without undermining freedom of choice); Jasmin Sethi, *Another Role for Securities Regulation: Expanding Investor Opportunity*, 16 FORDHAM J. CORP. & FIN. L. 783, 829–36 (2011) (advocating for the inclusion of "opportunities for wealth accumulation" analysis, particularly for the average investor, as basis for adopting new securities regulations); Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 309 (2008) (discussing the economic harms of excluding retail investors from private fund markets but proposes the creation of "a retail [Fund of Hedge Funds ("FOHF")] that raises capital through a private placement to an underwriter (or syndicate of underwriters) who, in turn, lists the securities of the retail FOHF on a trading platform accessible only by sophisticated investors").

investment company industry.[39] This Part continues with a detailed explanation of how the current regulatory climate will nurture an even greater expansion of the private fund industry. Part II then explains how this future expansion could lead to a drain of talent from public funds.[40] As the private fund industry has grown easier to access, advisers may steer away from the arduous registration requirements of mutual funds. Part III continues this analysis by describing the growing inequities that retail investors will likely face with respect to access to strategies and information.[41] As private funds are granted increasing liberties, retail investors will be left with an even smaller universe of available strategies and investment options. Part IV illuminates the broader implications of promoting such inequitable access.[42] Though more research is needed in this regard, such inequities could exacerbate the already challenging financial environment facing retail investors. It could also contribute to the growing income gap between the wealthy and the average investor. The Article concludes with brief thoughts about the limitations of crafting an immediate solution without first enhancing coordination between the SEC and the CFTC and improving collaboration with related industries.[43]

I. Expansion of Private Fund Industry

This Part begins by elucidating the vital role that both public and private funds play in the financial markets as investors depend on these vehicles for a variety of saving mechanisms. Registered funds still account for a larger share of public savings,[44] but the prominence of private funds has grown exponentially over the years.[45] As such, this Part proceeds with a detailed explanation of how the current regulatory climate will lead to an even greater insurgence of these vehicles. The recently passed JOBS Act and amendments to the omnipresent Securities Act have removed many of the restrictions that previously applied to private funds.

A. Prevalence of Investment Companies

Investment companies play a dominant role in the public capital markets. Individual retail investors, who directly invest in a range of

39. *See infra* Part I.
40. *See infra* Part II.
41. *See infra* Part III.
42. *See infra* Part IV.
43. *See infra* Part V.
44. *See infra* notes 54–55 and accompanying text.
45. *See infra* notes 67–74 and accompanying text.

private or public issuers for their own personal accounts, are a dying breed.[46] An investor who wishes to utilize the public capital markets to boost his or her retirement savings would rarely spend time researching a plethora of companies for direct investment. Retail investors instead generally allocate their capital to a number of registered investment companies such as mutual funds, bond funds, and money market funds.[47] From a practical perspective, this evolution makes sense as these vehicles provide investors with immediate access to expertise, risk management, and diversification.[48] The advisers that manage such companies are presumably comprised of talented individuals who possess an astute expertise in financial management.[49] These "experts" collect investments from a large number of both individual and institutional investors and thereby invest that pool in a variety of issuers, instruments, and strategies.[50] This saves individual investors the time and money of having to parse through a seemingly infinite number of disclosures related to a range of companies across various sectors and concentrations. Advisers have also aggressively marketed their mutual fund products to the general public, which is yet another contributing factor to the growth of the industry.[51] In exchange for managing a mutual fund, such advisers receive significant management fees,[52] which are typically calculated as a percentage of the total net assets of the pool.[53]

Mutual funds are the most prevalent category of investment

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46. *See generally* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009) (asserting that the SEC faces new challenges as markets have become increasingly institutionalized).

47. *Mutual Funds Can Help Lower Investing Risks*, VANGUARD, https://investor.vanguard.com/mutual-funds (last visited Sept. 8, 2015); *Types of Mutual Funds*, AM. FUNDS, https://www.americanfunds.com/resources/choices/funds/mutual-funds.html (last visited Sept. 8, 2015); *Ultimate Guide to Retirement*, CNN MONEY, http://money.cnn.com/retirement/guide/investing_mutualfunds.moneymag/index3.htm (last visited Sept. 8, 2015).

48. U.S. SEC. & EXCH. COMM'N, MUTUAL FUNDS: A GUIDE FOR INVESTORS 6 (2010), http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [hereinafter MUTUAL FUND GUIDE].

49. *Id.*

50. *Id. But see* discussion *infra* Part II.B (describing how the rise of index funds has undercut the need for "expert" management since they rely on computer programs to replicate a basket of instruments represented by an index).

51. *See generally infra* Part II.B (discussing how growth in the mutual fund industry could be attributed to marketing as opposed to "talent").

52. John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 89–92 (2008) (summarizing statistics that prove high profitability of mutual fund managers largely results from management fees).

53. *Mutual Fund Fees & Expenses*, FIDELITY, https://www.fidelity.com/learning-center/investment-products/mutual-funds/fees-expenses#Managementfees (last visited Sept. 8, 2015).

companies in the United States, as they are available for investment by the general public. In 2014, the mutual fund industry managed nearly $16 trillion in assets.[54] Over half of the individuals in the United States have direct or indirect investments in mutual funds.[55] These individuals depend on mutual funds as a saving vehicle for college tuition, retirement, and many other major life events.[56] Because our federal securities laws are rooted in investor protection for the masses, these pooled investment companies must register under these laws.[57] Advisers are then required to provide detailed disclosures to their underlying investors and comply with numerous governance and compliance requirements.[58] Registered investment companies are also restricted from investing in "riskier" classes of instruments, and from leveraging a high percentage of its assets.[59] These restrictions are designed to protect the underlying investors from overzealous advisers who may engage in riskier practices to the detriment of unsuspecting investors.

In contrast, private investment companies include private equity funds, venture capital funds, and hedge funds, among others. These companies rely on various exemptions under our intricate, yet evolving, web of federal securities laws to maintain greater flexibilities with respect to trading strategies, disclosure practices, valuation mechanisms, and governance requirements.[60] Generally speaking, issuers can employ these flexibilities in exchange for restricting investments to accredited investors.[61] Such investors include natural persons who either earn over $200,000 of annual income, or own over $1 million in net assets (excluding the value of an individual's primary residence).[62]

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54. INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 26, http://www.icifactbook.org/fb_ch2.html#investor.

55. *Id.*

56. *Id.*

57. *See* Securities Act of 1933, 15 U.S.C. §§ 77a–77mm (2012) (outlining general registration requirements); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm; Investment Company Act of 1940, 15 U.S.C. § 80a-1(a)(2); Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (defining "Investment Adviser").

58. *See* 15 U.S.C. §§ 77a–77mm (outlining general registration requirements); *id.* §§ 78a–78mm; *id.* § 80a-1(a)(2); *id.* § 80b-2(a)(11) (defining "Investment Adviser").

59. *See* discussion *infra* Part IV.A (explaining unique financial challenges facing retail investors).

60. *See generally* U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 8–13 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC STAFF REPORT] (explaining regulatory exemptions upon which hedge funds rely).

61. 15 U.S.C. § 77b(a)(15); 17 C.F.R. § 230.501 (2015).

62. *See* 17 C.F.R. § 230.501 (regulating that under the Dodd-Frank Act, the SEC can re-

Accredited investors also include a wide range of institutions such as insurance companies, pension plans, endowments, and banks.[63] Theoretically, these investment schemes enjoy greater flexibilities because accredited investors have the resources to adequately protect themselves.[64]

Although these investment companies are in fact private, the private fund industry has grown exponentially over the past decades. For example, the total hedge fund industry is comprised of approximately 18,000 funds,[65] and in the United States, the industry manages approximately $2.93 trillion.[66] In February 2014, investors allocated $41 billion of additional capital to hedge fund investments, which is "the largest monthly allocation since [eVestment] began tracking monthly flows in October 2008."[67] Many investors are flocking to hedge funds because they enjoy greater flexibilities to maximize returns through derivatives trading and unrestrained leverage, which are minimally available to their mutual fund counterparts.[68] The New York City retirement systems recently made the controversial decision to increase its hedge fund investments from $450 million to $3.5 billion,[69] and the Princeton endowment has portioned as much as 25% of its portfolio into hedge fund investments.[70] This growth has occurred despite the increased registration requirements that were implemented under the Dodd-Frank Act.[71] Overall, the hedge fund industry still

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evaluate this definition, as it applies to natural persons, every four years); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. Law 111–203, 124 Stat. 1376. § 413 (codified as amended at 15 U.S.C. § 80b–3(b)) (familiarly known as the "Dodd-Frank Act").

63. *Id.*

64. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

65. *Hedge Fund Adviser FAQ's*, MANAGED FUNDS ASS'N, http://www.managedfunds.org/hedge-fund-investors/faqs/hedge-fund-advisor/ (last visited Sept. 8, 2015).

66. *eVestment Data Show Historic Inflows for Hedge Funds in February*, MANAGED FUNDS ASS'N, (Mar. 27, 2014), http://www.managedfunds.org/2014/03/evestment-data-show-historic-inflows-hedge-funds-february/.

67. Nina Bains, *Welcome Back, Hedge Funds*, WALL ST. J. (Mar. 21, 2014, 9:19 AM), http://blogs.wsj.com/moneybeat/2014/03/21/welcome-back-hedge-funds.

68. *See* discussion *infra* Part IV.B (discussing the growing income gap). However, this increased flexibility could expose investors, as well as the broader economy, to heightened risks given the increased exposure to excessive losses and systemic risk that can result from derivatives and leverage. *See* discussion *infra* Part III.C.

69. Daniel Solin, *The New York Pension Plan Folly*, USNEWS (Mar. 7, 2013, 10:30 AM), http://money.usnews.com/money/blogs/On-Retirement/2013/03/07/the-new-york-pension-plan-folly.

70. Gillian Wee, *Princeton Endowment Plans to Cut Ranks of Private-Equity Managers in Half*, BLOOMBERG BUS. (Oct. 21, 2010, 11:00 PM), http://www.bloomberg.com/news/2010-10-22/princeton-endowment-plans-to-cut-ranks-of-private-equity-managers-in-half.html.

71. *See infra* Part III.C. at 142 (providing a brief description of new registration requirements

plays a major role "on stock, bond, currency, commodity, and other markets, and they have been major players in virtually all aspects of modern finance, including mortgage lending."[72]

Private equity funds are yet another class of private investment companies that have grown in popularity in recent years. In 2013, private equity funds managed approximately $3.5 trillion.[73] During this same year, the private equity industry experienced the highest aggregate amount of capital raised since 2008, with 873 funds reaching a final close and raising an aggregate $454 billion.[74] There are several types of private equity fund structures, some of which include venture capital funds, leveraged buyouts, and mezzanine financing.[75] For the most part, private equity funds invest directly into private companies and typically acquire large blocks of illiquid securities.[76] Private equity funds "are seen as helping create new businesses, fostering innovation and assisting businesses in need of restructuring."[77] Private equity investors consist of elite and institutional investors who are able to invest for long periods of time since such investments often demand long holding periods.[78] Unlike registered funds, a private equity fund is usually a closed-ended vehicle, which means that it does not accept new investors once it acquires the majority of its initial capital and it does not permit investor withdrawals until the fund dissolves.[79]

Given these flexibilities, the private fund industry will continue to grow in the coming years. The Dodd-Frank Act required many hedge fund advisers to register under the Advisers Act and gave the SEC the power to collect confidential information from such registered advisers.[80] Many thought that the costs of these new requirements

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under the Dodd-Frank Act).

72. Michael Panzner, *Why Are Hedge Funds So Important in Today's Market?*, SEEKING ALPHA (Aug. 31, 2007, 4:26 AM), http://seekingalpha.com/article/46121-why-are-hedge-funds-so-important-in-todays-market.

73. 2014 PREQIN GLOBAL PRIVATE EQUITY REPORT, PREQIN 14 (2014), https://www.preqin.com/docs/samples/The_2014_Preqin_Global_Private_Equity_Report_Sample_Pages.pdf.

74. *Id.* at 70.

75. THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 12.1 (2013).

76. *Private Equity*, INVESTOPEDIA, http://www.investopedia.com/terms/p/privateequity.asp#axzz1Q2GK605U (last visited Sept. 8, 2015).

77. Andrew J. Donohue, *Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools* (July 15, 2009), http://www.sec.gov/news/testimony/2009/ts071509ajd.htm (statement of the Director of Division of Investment Management for the U.S. SEC).

78. *Private Equity*, *supra* note 76.

79. LEMKE ET AL., *supra* note 75, at 280.

80. *See infra* text accompanying notes 152–54 (providing a brief description of new registration requirements under the Dodd-Frank Act).

might hinder the growth of the industry. However, since the passage of the Dodd-Frank Act, the regulatory climate has shifted to in fact foster the accelerated growth of private funds. Exemptions provided under the Securities Act and the Exchange Act have recently been retooled.[81] Under these revisions, private funds can now advertise to the general public, can more easily evade "public" status under the Exchange Act, and can provide private investors with greater liquidity through newly created exchanges for private shares.[82]

B. Advertising

The JOBS Act was enacted under the Obama Administration on April 5, 2012.[83] One of the most notable components of the JOBS Act is its elimination of the solicitation ban for private companies that rely on Rule 506 of Regulation D.[84] As background, this rule was crafted by the SEC in 1982 to provide clarity to issuers who wanted to rely on the Section 4(2) exemption under the Securities Act.[85] Under Section 4(2), issuers could avoid the arduous disclosure requirements associated with offering securities (as defined under the Securities Act) if such transactions did not involve a "public" offering.[86]

The logic of this provision was quite simple. If an offering did not affect the general public, then there was no need for public disclosures and other kinds of protections.[87] Under these circumstances, the costs of registering an initial offering of securities would far exceed any potential benefits, particularly if there was no risk of harm to the public capital markets. In passing the statute in 1933, Congress did little to provide a specific definition of what exactly a "public" offering entailed.[88] The SEC and the courts did provide additional clarity as to the contours of a "public" offering, but issuers still faced significant uncertainty in legitimately crafting a private placement.[89] Regulation D

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81. *See infra* Part I.D (discussing how changes made it easier for private companies to avoid the cumbersome registration requirements).

82. *See infra* Part I.D (discussing the effects of the JOBS Act provisions).

83. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

84. *Id.* § 201(a), 126 Stat. 306 at 313.

85. *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 24 SEC Docket 1166 (Mar. 8, 1982) (debuting the uniform notice of sales to be used for all offerings).

86. Securities Act of 1933, 15 U.S.C. § 77d(2) (2012).

87. COMM. ON INTERSTATE & FOREIGN COMMERCE, H.R. REP. NO. 73–85, at 5 (1933).

88. *Id.*

89. Martin, *Private Investment Companies*, *supra* note 37, at 65–67 (describing the evolution of the sophisticated investor doctrine which presumes that sophisticated investors can fend for themselves).

was promulgated by the SEC in response to the ambiguities presented by these previous tests. This rule essentially provides bright-line safe harbors to prevent issuers from inadvertently engaging in a public offering.[90]

Rule 506 is the most permissive exemption provided for under Regulation D. It allows private issuers to raise an unlimited amount of capital and offer interests to an unlimited number of accredited investors.[91] The other exemptions provided under Regulation D place ceilings on the total amount of capital that an issuer can accept from investors.[92] For example, under Rule 504 an issuer cannot accept more than $1 million from prospective investors in a single private offering.[93] Under Rule 505, issuers cannot accept more than $5 million.[94] In exchange, however, vehicles relying on Rule 506 prior to the JOBS Act were prohibited from advertising their exempt offerings to the general public.[95] This restriction was designed to prevent retail investors from accidentally investing in such funds, to preserve the private nature of these entities, and to perhaps restrict the size of the industry.[96]

This advertising restriction encompassed a wide range of both direct and indirect communications between private issuers and prospective investors.[97] A private issuer could lose its Rule 506 exemption by communicating any aspect of its underlying business to the press, by mentioning a fund name in an interview, or by maintaining informative websites regarding its offerings or investment strategies.[98] Given this broad restriction on communications with prospective investors, issuers relying on Rule 506 were only allowed to solicit investors with which they had a sufficient preexisting relationship.[99] Such preexisting relationships are deemed sufficient if the nature of the relationship enables the issuer (or person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists.[100] The issuer must also acquire this relationship

90. Martin, *One Step Forward*, *supra* note 25, at 1145.
91. 17 C.F.R. § 230.506 (2015).
92. Martin, *One Step Forward, supra* note 25, at 1151.
93. 17 C.F.R. § 230.506.
94. *Id.*
95. *Id.* §§ 230.506, 502(c).
96. *Id.* § 230.502(c).
97. *Id.*
98. *See generally* Martin, *One Step Forward*, *supra* note 25, at Part II.A (explaining the rules that provided issuers with clear standards as to whether companies were acting as private vehicles).
99. *In re* Kenman Corp., Exchange Act Release No. 21962 (1982).
100. Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 WL 5568055694

before the terms of the offering are created and before the contemplated offering begins.[101] As a result, hedge funds would often restrict marketing activities to personal or close networks of potential investors with which they already had a relationship.[102]

If an issuer did not have access to these kinds of preexisting relationships with accredited investors, it could simply contract for such access from registered financial intermediaries, such as brokers or placement agents.[103] When utilizing this option, "funds enter into formal placement arrangements with major investment firms such as Morgan Stanley, [or] Merrill Lynch. . . . These firms are typically compensated through a placement fee or sales charge . . . ."[104] This practice has been deemed legally sound by the SEC as these intermediaries are simply soliciting investors who have a general interest in investing in private placements.[105] These solicitations often take the form of online suitability questionnaires, which are designed to determine whether a prospective investor qualifies as accredited under Rule 501.[106]

With this new ability to advertise, hedge fund advisers will no longer be constrained by the previous requirement to have a preexisting relationship with an investor before making a sales pitch. Nor will they be forced to forge a relationship with a placement agent to purchase access to pools of accredited investors. They will now have the ability to publicly advertise their products on their respective websites, to create elaborate marketing campaigns targeted towards an elite group of investors, to recruit such investors at industry seminars and meetings, and to disseminate informative and detailed publications in a variety of mediums. These new freedoms will essentially allow hedge funds to communicate with a larger range of prospective investors.

The resulting growth of this new power to advertise will likely be profound. The freedom to advertise will make it easier for smaller, emerging funds to more easily access this market.[107] The solicitation

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(Nov. 4, 1985).

101. *Id.*

102. Darian Capital Services Blog, *Impact of "Private Fund" Advertising*, INV. FUND COMPLIANCE & DISTRIBUTION NEWS (July 16, 2013), http://blog.dariancs.com/2013/07/16/impact-of-private-fund-advertising.

103. E.F. Hutton & Co., SEC No-Action Letter (Dec. 3, 1985); *see also* Bateman Eichler, Hill Richards, SEC No-Action Letter, 1985 WL 55680 (Dec. 3, 1985).

104. Ethan W. Johnson, *Hedge Fund Marketing Overview*, 7 J. INV. COMPLIANCE, no. 2, 2006, at 48.

105. 17 C.F.R. § 230.506 (2015).

106. IPOnet, SEC No-Action Letter (July 26, 1996).

107. ALI Webinar, *Hedge Fund Marketing: Understanding the JOBS Act*, AM. L. INST. 6, 7

ban made it difficult for such funds to effectively compete with their larger, more established counterparts, many of which have throngs of investors waiting to invest.[108] Under the prior regime, this system of "paying for access" was often referred to as an "old boys club" that thrived on insider privilege and exclusivity.[109] Consequently, the solicitation ban made it difficult for such funds to raise sufficient capital to access an accredited investor audience. With respect to the larger funds, this new opportunity for hedge funds to engage in healthy competition could give the more prominent advisers the tools to successfully bolster their brands to a wider audience.[110] The hedge fund industry can greatly benefit from these resulting increases to transparency and competition. Yet, the indirect effects that this exponential growth could have on the broader retail market remain subject to further investigation.

C. Liquidity Enhancements

The exemptions provided under Regulation D also mandate significant liquidity restrictions on shares resold in the secondary market. More specifically, accredited investors who purchase such private placement shares are restricted from reselling these shares to subsequent purchasers.[111] From a policy perspective, this restriction prevents accredited investors from dumping private securities on an uninformed public.[112] If an accredited investor is permitted to freely

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(2012), http://thehfa.org/documents/FG/hfa/documents/233881_JOBSact.pdf ("All four panelists agreed that the JOBS Act will have the greatest effect on emerging managers, including both small and midsize managers looking for increased exposure and AUM, as well as start-ups."); Letter from the Hedge Fund Ass'n to Elizabeth M. Murphy, Sec'y of Sec. Exch. Comm'n (June 6, 2012), http://www.sec.gov/comments/jobs-title-ii/jobstitleii-22.pdf; *Small and Large Hedge Fund Managers View JOBS Act Through Different Lens*, HEDGE FUND MARKETING ALLIANCE (July 11, 2012), http://www.hedgefundmarketing.org/small-and-large-hedge-fund-managers-view-jobs-act-through-different-lens/.

108. Amit Chokshi, *Hedge Fund Marketing's Gray Area,* SEEKING ALPHA (Feb. 2, 2010, 2:26 AM), http://seekingalpha.com/article/185671-hedge-fund-marketings-gray-area; Susan Lyon, *The Hedge Fund Advertising Ban Lifted: What Should Investors Know*?, NERD WALLET (July 24, 2013), http://www.nerdwallet.com/blog/investing/2013/sec-hedge-fund-advertising-ban-lifted/ (quoting Peter Turchan, Partner at Ready to Run Designs, "I think that the recent lift will not cause drastic change to the industry or greatly effect [sic] investors, but will offer lesser known funds to compete on a larger scale and reach a larger audience of potential investors").

109. Letter from Tom Dworzanski to Elizabeth M. Murphy, Sec'y of Sec. Exch. Comm'n (June 7, 2012), http://www.sec.gov/comments/jobs-title-ii/jobstitleii-23.pdf.

110. ALI Webinar, *supra* note 107, at 97–98.

111. 17 C.F.R. § 230.502(c) (2015).

112. Gilligan, Will & Co. v. SEC, 267 F.2d 461, 468 (2d Cir. 1959) (stating that restricting resales deters the following scenario: "[A] dealer who speculatively purchases an unregistered security in the hope that the financially weak issuer had, as is stipulated here, 'turned the corner,' to unload on the unadvised public what he later determines to be an unsound investment without

engage in the reselling of private placement securities, then the subsequent purchasers would not have access to the public disclosures and protections that would otherwise be available in a registered offering.[113] If an accredited investor does in fact resell private securities to the general public, such accredited investor could be deemed an underwriter.[114] This would automatically trigger the registration requirements under the Securities Act and the entire transaction would lose its Regulation D exemption.[115] An accredited investor in this scenario could avoid these harsh results by holding the private securities for at least two years before reselling them, or by restricting resells to other accredited investors.[116]

The SEC provided additional clarity to these restrictions when it promulgated the Rule 144 safe harbor in 1972.[117] Rule 144 initially adopted the common law standard of mandating a holding period of two years.[118] In 1997, however, the SEC reduced the holding period to one year so that private securities were no longer deemed "restricted" after complying with this reduced holding period.[119] Thus, accredited investors could freely resell their shares in the secondary market to the investing public after holding the securities for one year.[120] This holding period requirement presumes that the accredited investors purchased such securities with the intent to make a legitimate investment, as opposed to purchasing with the intent to distribute to the investing public (by inadvertently acting as an underwriter).[121] Rule 144 also clarified when this holding period actually began,[122] and provided additional guidance for any notice or disclosure requirements, as well as any restrictions on the volume and manner of selling restricted securities.[123]

In 2008, the SEC amended Rule 144 to provide accredited investors

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the disclosure sought by the securities laws, although it is in precisely such circumstances that disclosure is most necessary and desirable.").

113. *Id.*

114. Securities Act of 1933, 15 U.S.C. § 77b(a)(11) (2012).

115. *Id.*

116. Ackerberg v. Johnson, Jr., 892 F.2d 1328, 1335–37 (8th Cir. 1989).

117. Definition of Terms "Underwriter" and "Brokers' Transactions," Securities Act Release No. 5223 (Jan. 11, 1972).

118. *See* 17 C.F.R. § 230.144 (2015).

119. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 634 (3rd ed. 2012).

120. *Id.*

121. *Id.*

122. 17 C.F.R. § 230.144(d)(3).

123. *Id.* § 230.144(c), (e), (f).

with even more liquidity for their private placement investments.[124] Accredited investors wanted to enjoy the freedoms of quickly reselling their shares to subsequent purchasers, especially if such investments had significantly appreciated in value. Profiting from capital appreciation is one of the primary benefits of owning shares, and loosening the mandated holding period of private securities could induce greater investments in private offerings. As such, the 2008 amendments shortened the required holding period for private investments to six months.[125] Accredited investors no longer had to wait an entire year before reselling their shares to the investing public.

The SEC completely eliminated the required holding period for a certain subset of investors when it adopted the Rule 144A safe harbor.[126] Under this rule, accredited investors can immediately resell their shares a Qualified Institutional Buyer ("QIB") without being subject to any mandated holding period.[127] QIBs include entities that in the aggregate, own and invest on a discretionary basis $100 million or more in securities of companies unaffiliated with QIBs.[128] This class of investors can include qualifying insurance companies, investment companies, corporations, and partnerships.[129] Conceptually, these kinds of investors should be able to adequately fend for themselves and thus do not need the protections afforded by a mandated holding period. The SEC passed this safe harbor after facing growing pressures to expand the private placement market, which also served to attract foreign issuers that did not wish to be burdened by the severe liquidity restrictions placed on private placements previously.[130] Many of these issuers simply decided to offer interests in other countries that had looser restrictions.[131] Rule 144A served to retain or recruit a larger number of both domestic and foreign issuers to bolster capital formation in the United States.[132]

Financial innovation has naturally led to the creation of private trading platforms, where prequalified accredited investors, and QIBs,

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124. *Id.* § 230.144(d).
125. *Id.*
126. *See generally id.* § 230.144A (enumerating such safe harbors).
127. *Id.* § 230.144A(b), (d).
128. *Id.* § 230.144A(a)(i).
129. *Id.*
130. William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 411 (2008).
131. Paul G. Mahoney, *Regulation of International Securities Issues*, 14 CATO REV. BUS. & GOV'T 62, 64 (1991).
132. *Id.*

can freely trade restricted securities.[133] Before these trading platforms existed, such investors faced challenges in identifying willing buyers and sellers of private securities even if no holding period was required. On March 5, 2014, NASDAQ announced the launching of a new trading platform, the NASDAQ Private Market.[134] Various categories of private issuers, such as hedge funds, venture capital funds, and general private placements, can become members of this new platform.[135] Once a private issuer becomes a member, its underlying investors can exchange shares with other investors via this new exchange.[136] The NASDAQ press release provides,

> "We are excited to officially open NASDAQ Private Market for business," said Greg Brogger, President of NASDAQ Private Market. "We listened to the needs of private growth companies and developed NASDAQ Private Market to serve as a fully integrated end-to-end solution for managing their equity functions. NASDAQ Private Market will bring liquidity, efficiency and control to private companies. Member broker-dealers and their investor clients will benefit from greater access to financial information, transaction flow and liquidity."[137]

In effect, these platforms, or exchanges, are making it easier for private issuers to attract a greater number of investors as they can now promise such investors the freedom to easily trade their shares.

The loosening of the liquidity constraints provided under safe harbors 144 and 144A, coupled with the creation of private exchanges and trading platforms for restricted securities, will likely facilitate an even greater expansion of the private fund industry. Immediate liquidity was previously the distinguishing characteristic of registered investment companies, since mutual funds are obligated to honor purchases and redemptions on a daily basis.[138] As immediate liquidity becomes easier for private investment companies to guarantee, they will be more appealing to a larger group of accredited investors. This could in turn lead to a decreased demand for mutual fund investments.

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133. *See generally* Rodrigues, *supra* note 38 (providing analysis of burgeoning secondary markets for private placement shares).

134. *NASDAQ Private Market Launches New Marketplace for Private Companies*, NASDAQ (Mar. 5, 2014), http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=830434.

135. *Id.*

136. *Id.*

137. *Id.*

138. 17 C.F.R. § 270.22c-1(b) (2015); *see also Invest Wisely: An Introduction to Mutual Funds*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/inwsmf.htm (last updated July 2, 2008) ("Mutual fund investors can readily redeem their shares at the current NAV—plus any fees and charges assessed on redemption-at any time.").

D. Exchange Act Registration

The Exchange Act was passed in 1934.[139] While the Securities Act mandates detailed disclosure requirements for an *initial* public offering ("IPO") (the primary capital market), the Exchange Act creates additional disclosure obligations for shares traded on the secondary market.[140] Once an issuer, or underwriter acting on the issuer's behalf, sells the full allotment of shares in an IPO, the disclosure obligations provided under the Securities Act no longer apply. Even still, once these same IPO shares enter the secondary market where investors are trading shares amongst each other, the ongoing disclosure and reporting obligations under the Exchange Act are automatically triggered.[141] Public companies must comply with these periodic disclosure requirements for at least one year following their effective registration date.[142] The ongoing disclosure obligations include the public filing of annual and quarterly reports (Forms 10-K and 10-Q, respectively), which contain any material information related to the underlying company as well as annual and interim financial statements.[143] Companies must also provide close to real-time disclosure of specified material events provided in the Form 8-K.[144]

In 1964, Congress expanded the Exchange Act's scope of what constituted a "public company" under its provisions by adopting Section 12(g).[145] This new provision sought to incorporate a larger range of companies that had a substantial impact on interstate commerce, even if such companies did not directly engage in a registered IPO.[146] The registration requirements under Section 12(g) are triggered based on the size and impact of the company.[147] More specifically, any company that held at least $10 million in total assets and offered interests to 500 shareholders of record for any class of equity securities had to register under the Exchange Act.[148] Section 12(g) pulled many large private companies into the Exchange Act's regulatory rubric. With respect to the hedge fund industry, while many funds successfully maintained

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139. Sec. Exch. Act of 1934, 15 U.S.C. § 78a (2012).
140. *Id.* § 78l.
141. *Id.*
142. *Id.*
143. *Id.* § 78m.
144. *Id.*
145. *Id.* § 78l.
146. CHOI & PRITCHARD, *supra* note 119, at 172.
147. *See generally* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 386 (2013) (explaining specific contours of Section 12(g) requirements and corresponding exemptions).
148. 15 U.S.C. § 78l.

exemptions under the Securities Act and the Company Act, if a particular fund grew to at least $10 million (which was more likely than not) and held at least 500 investors, it would have to register under the Exchange Act.[149] To avoid this scenario, many funds simply restricted their funds to 499 investors or less.[150]

In 2012, the JOBS Act retooled Section 12(g) to make it easier for private companies to avoid the cumbersome and costly registration requirements under the Exchange Act.[151] The amendment increased the 500-shareholder registration threshold to 2000 shareholders (or 500 unaccredited investors).[152] Thus, companies can now offer interests to 1999 investors without having to comply with the periodic disclosure requirements mandated under the Exchange Act.[153] With respect to the private fund industry, these vehicles can now recruit 1999 accredited investors and still maintain exemptions under the Securities Act, the Company Act (Section 3(c)(7)), and the recently revised Exchange Act.[154] Many private funds will likely take advantage of this new flexibility to recruit a larger number of investors without having to file periodic reports with the SEC.

Overall, the current regulatory climate seems to support the expansion of the private fund industry. Provisions under the JOBS Act reversed the advertising ban for private companies and increased the investor threshold for registration under the Exchange Act. Private fund advisers will now be able to market their products in the public sphere, although they can more easily avoid being identified as a "public" company under the Exchange Act. Liquidity for private shares has also been enhanced through the expansion of safe harbors provided under the Securities Act, and through the development of private exchanges where investors can more easily liquidate their investments. It is difficult to predict with certainty the full impact that these regulatory developments will have on future growth of hedge funds, private equity funds, and other pooled investment vehicles that are reserved for elite investors. Yet, given the increasing difficulties of "beating the market" through the restrictive strategies that constrain public companies (as will

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149. SEC STAFF REPORT, *supra* note 60, at 13.

150. *Id.*

151. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012); *see also* 15 U.S.C. § 78l(g)(1)(A).

152. Martin E. Lybecker, *The Effect of the JOBS Act on Private Investment Companies: Foreseen Consequences*, A.B.A. (May 2012), http://www.americanbar.org/publications/blt/2012/05/06_lybecker.html.

153. *Id.*

154. *Id.*

be further discussed in subsequent Parts), issuers are more likely to take advantage of the flexibilities associated with launching a private fund. This growth could arguably benefit the elite class of investors by creating a more competitive, transparent, and liquid market. However, the long-term impact on the retail investor population has yet to be sufficiently investigated. The remaining Parts of this Article seek to at least begin this discussion with a summary of the practical and theoretical implications that this burgeoning industry will have for investments available to the general public.

II. TALENT DRAIN

This Part begins by identifying the various ways in which adviser skill is measured. Education, past experience, and more importantly, the ability to generate consistent alpha, are all specific factors utilized in evaluating adviser talent. Part II then illustrates how the expansion of the private fund industry could drain superior talent from the mutual fund industry, leaving the general public with subpar management. This is compounded by the already limited incentives that public fund advisers have with respect to selecting optimal investments and receiving optimal fees.

A. Measuring Adviser Skill

Mutual funds are typically managed by an investment adviser entity that is registered under the Advisers Act.[155] This entity is considered the "brain" of the fund as it is responsible for developing and implementing its underlying investment strategy.[156] These specialized strategies are presumably the most important characteristic of a fund as they hold the key to earning a sizable return for a large group of investors. Mutual fund strategies are typically comprised of a variety of equities, bonds, and cash instruments, which are bought and sold by advisers in order to earn returns for investors.[157] Determining whether a manager can effectually administer its underlying strategy is paramount to deciding whether to invest in a particular fund.

The specific individuals responsible for this imperative function are known as the portfolio managers. Unique talents of such managers can be measured by a variety of factors such as educational pedigree and

155. MUTUAL FUND GUIDE, *supra* note 48, at 6.

156. *Id.* (noting that mutual fund advisers are also subject to oversight by the board of directors, which helps mitigate potential conflicts of interest between the fund and the adviser).

157. *Id.* at 7.

previous experience managing comparable investment products.[158] Investors can also investigate any prior lawsuits or enforcement actions that have been instituted against a particular adviser or portfolio manager.[159] Since mutual fund advisers are required to register under the Advisers Act, much of this information can be found in the publicly available Form ADV.[160] This form includes descriptions of the advisory services offered, material conflicts of interest, any pending disciplinary actions, advisory fees charged, and other general business descriptions.[161]

Although these characteristics are extremely important in evaluating the perceived talent of a particular adviser, investors tend to focus on an adviser's ability to generate alpha, which is the excess return a fund earns relative to a specified benchmark, such as the S&P 500 Index.[162] Generally speaking, alpha "is often considered to represent the value that a portfolio manager adds to or subtracts from a fund's return."[163] Investors can use the mandated performance data provided in a fund's publicly available prospectus to calculate alpha and further investigate how a particular fund has performed relative to comparable products or vehicles.[164] A portfolio manager's ability to pick the ideal basket of securities, as well as to know when to buy and sell such securities (to profit from capital appreciation), largely dictates whether a fund will be profitable.[165]

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158. *Protect Your Money: Check Out Brokers and Investment Advisers*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/brokers.htm (last visited Sept. 8, 2015).

159. *Id.*

160. *Id.*; *see also Form ADV*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/formadv.htm (last visited Sept. 8, 2015) ("Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities. The form consists of two parts. Part 1 requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees . . . . Part 2 requires investment advisers to prepare narrative brochures written in plain English that contain information such as the types of advisory services offered, the adviser's fee schedule, disciplinary information, conflicts of interest, and the educational and business background of management and key advisory personnel of the adviser.").

161. *See* Advisers Act of 1940, 15 U.S.C. § 80b–4 (c)(1)(A) (2006 & Supp. 2010) (explaining the requirements for record keeping and maintenance in order to comply with the Commission).

162. INVESTOPEDIA, http://www.investopedia.com/terms/a/alpha.asp (last visited Sept. 8, 2015).

163. *Id.*

164. MUTUAL FUND GUIDE, *supra* note 48, at 17–19. It should, however, be noted that past performance is not necessarily indicative of future results. There is an ongoing risk that the adviser will not be able to replicate past performance. *Id.*

165. *Mutual Funds*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/investors/mutual-funds (last visited Sept. 8, 2015) ("[W]hen the fund's underlying stocks or bonds pay income from dividends or interest, the fund pays those profits, after expenses, to its shareholders in payments known as income distributions. . . . [W]hen the fund has capital gains from selling

B. Limited Incentives of Mutual Fund Advisers: Stock Picking

Numerous commentators have queried whether mutual fund advisers are sufficiently talented to effectively generate returns over time.[166] Many have come to the troubling conclusion that the profits earned by advisers, if any, are solely attributable to luck.[167] This is consistent with the efficient market hypothesis, which posits that all publicly available information regarding a particular security is automatically impounded into its price.[168] Pursuant to this theory, traders cannot expect to consistently earn profits by reacting to newly released information related to their holdings. Such advisers simply collect handsome fees from investors, without having the means to actually beat the markets on a consistent basis. In contrast, a more recent study found that mutual fund advisers did in fact rely on unique skills such as stock picking and market timing to consistently create value for investors.[169] This study concluded that "the average mutual fund adds value by extracting about $2 million a year from financial markets . . . . Funds that have added value in the past keep adding value in the future, for as long as 10 years."[170] The study also found "that investors recognize this skill and reward it by investing more capital with better funds."[171]

The inconsistencies of these findings are attributable to a variety of factors, one of which relates to the different metrics used to measure adviser skill.[172] Thus, determining whether fund advisers can

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investments in its portfolio at a profit, it passes on those after-expense profits to shareholders as capital gains distributions.").

166. *See generally* Rodrigues, *supra* note 38 (discussing the implications of the disparities in the growing income gap).

167. *Id.*

168. John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 737 (1984); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 763 (1985).

169. Jonathan B. Berk & Jules H. van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. (forthcoming 2015–16).

170. *Id.* (manuscript at 1).

171. *Id.*

172. *See* Malcolm Baker et al., *Can Mutual Fund Managers Pick Stocks? Evidence from Their Trades Prior to Earnings Announcements*, 45 J. FIN & QUANTITATIVE ANALYSIS, 1111 (explaining that stock-picking skill of mutual fund managers are based on the earnings announcement returns of the stocks that they hold and trade); *see also* Jonathan B. Berk, *Five Myths of Active Portfolio Management*, 31 J. OF PORTFOLIO MGMT. 27, 31 (2005) ("[R]eturns cannot be used to measure managerial skill. Because researchers generally use return to measure skill, they have drawn the erroneous conclusion that active managers add little value."); Berk & van Binsbergen, *supra* note 169, manuscript at 1–2 (states the following regarding the various

consistently beat the markets is a highly contested topic that warrants further analysis.[173] This Article does not attempt to provide a definitive answer to this perpetual debate, but it does highlight how the capital restrictions provided under the Company Act present yet an additional barrier for mutual funds to consistently beat the markets. More specifically, mutual fund advisers are subject to a complex web of capital restrictions under the Company Act, which limits the kinds of instruments and strategies that an adviser can select for potential investment opportunities.[174] Mutual funds are therefore restricted to securities, bonds, and cash instruments.[175] Advisers' talent is essentially limited to a narrow slice of the total universe of investments. If advisers had more freedoms to transact in derivatives and other innovative financial products, they could perhaps be better incentivized to extend their stock-picking and market-timing skills to a larger variety of instruments. Having greater access to these instruments could also help advisers ensure returns in declining markets, and develop more innovative techniques for actually beating the market on a consistent basis. The limitations provided under the Company Act also narrow advisers' view of the interconnectedness of the markets. Further, an in-depth understanding of the relationship between certain derivatives and securities markets could perhaps enhance the abilities of advisers to better predict market movements.

It should however be noted that the Company Act was originally designed to restrict such access to innovative products because they can expose the general public to excessive losses.[176] Increased returns generally result from increased risks and the federal securities laws are fundamentally designed to protect the general public against excessive harms. Because derivatives are inherently leveraged financial products, trading in these instruments can result in losses that far exceed the

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metrics used to measure alpha: "prior studies have used the net alpha to investors, i.e., the average abnormal return net of fees and expenses, to assess whether or not managers have skill . . . . Some people have hypothesized . . . that the gross alpha . . . (the average abnormal return before fees are subtracted) would be the correct measure of managerial skill. . . . We argue that the skill of a mutual fund manager equals the value his fund extracts from markets.").

173. Berk & van Binsbergen, *supra* note 169, manuscript at 1 ("[A]n extensive literature in financial economics has focused on the question of whether stock picking or market timing talent exists. Interestingly, the literature has not been able to provide a definitive answer to this question.").

174. *See* discussion *infra* Part IV.A.

175. MUTUAL FUND GUIDE, *supra* note 48, at 7.

176. Company Act of 1940, 15 U.S.C. § 80a–1(b)(7). In outlining the policy goals of the Company Act, Congress declared that "the interest of investors are adversely affected . . . when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities." *Id.*

initial investment that underlies the contract. Moreover, these instruments are often highly complex, which makes understanding the accompanying risks even more difficult. It is undoubtedly arguable that certain categories of financial innovation should be limited to investors who could adequately protect themselves from extreme losses.

Even still, simply loosening (not eliminating) the existing caps on derivatives and leverage could be warranted given the increased need to diversify investments across a range of instruments and strategies.[177] Restricting direct access to financial innovation is becoming harder to justify as the dividing line between public and private investment companies has started to erode. More specifically, defined benefit pension plans have become major investors in the private fund industry even though retail investors are the underlying constituents of such plans.[178] If the general public has indirect exposure to private funds through pension plan investments, then it is plausible that mutual funds should also have comparable access. Mutual funds currently dominate the investment options available to retail investors through 401(k)s and other savings vehicles.[179] Whereas CalPERS, the California Public Employees' Retirement System, recently made the widely known decision to withdraw its allocations from hedge funds,[180] a recent survey administered by Quinnipiac University School of Business, found that institutional investors still largely favor private fund

177. *See generally* Rodrigues, *supra* note 38 (discussing the implications of the disparities in the growing income gap).

178. U.S. DEP'T OF LABOR, HEDGE FUNDS AND PRIVATE EQUITY INVESTMENTS 4–5 (2011).

179. *See* JACOB HACKER, THE GREAT RISK SHIFT: THE ASSAULT OF AMERICAN JOBS, FAMILIES, HEALTH CARE, AND RETIREMENT AND HOW YOU CAN FIGHT BACK 109–35 (2006) (providing a brief history of the vast brokerage loans and stock purchased between 1927 and 1929, which created the corporate surplus before the Great Depression). Over the past few decades, many companies have abandoned defined benefit pension plans and have instead opted for independently managed 401(k)s. *Id.* at 111. As background, these kinds of plans guarantee a lifetime stream of fixed payments upon retirement. Such plans have also become major investors in the private fund universe as ensuring returns in equities markets has become increasingly difficult. U.S. DEP'T OF LABOR, *supra* note 178, at 4–5. However, defined benefit pension plans (like CalPERS) are a dying breed as employers have opted for the more easily administered defined contribution plans. HACKER, *supra*, at 111. These plans, which frequently take the form of a 401(k), are independently managed by individual employees, who have the freedom to choose the basket of investments within their portfolios. *Id.* These plans only guarantee the amount invested, as well as any resulting profits or losses from the underlying investments. 401(k)s rarely include private funds as available investment options. U.S. DEP'T OF LABOR, *supra* note 178, at 4–9. They are mostly comprised of mutual fund investments. HACKER, *supra*, at 119.

180. James B. Stewart, *Hedge Funds Lose Calpers, and More*, N.Y. TIMES (Sept. 27, 2014), http://www.nytimes.com/2014/09/27/business/in-calperss-departure-a-watershed-moment-for-hedge-funds.html.

investments.[181] This survey gathered responses from institutional investors that collectively manage $1.12 trillion in assets.[182] The survey yielded the following results:

> While our respondents may be bullish on U.S. equities, they do not plan on allocating additional capital to these managers during the next year. However, they do wish to increase their allocations to hedge fund and private equity managers. These anticipated allocation decisions suggest that the alternative investment industry will continue to grow into the near future.[183]

These findings support the notion that investors still seek private fund investments to diversify their portfolios and maximize returns.

To the extent that a particular strategy could generate excessive systemic risk, regulators should perhaps subject such funds to heightened scrutiny that exceeds the existing regulatory framework for private funds.[184] This would entail creating precise measures of systemic risk, as well as corresponding limitations, that go beyond the disclosure framework implemented under the Dodd-Frank Act. It is equally difficult to justify a framework where private entities, with limited transparency and governance restrictions, have the market capabilities to create negative externalities that could expose the general public to harm. And because mutual funds are subject to the detailed registration requirements under the Company Act (and other enhancements under the Dodd-Frank Act), they may be better suited to trade in such risky instruments given the heightened disclosure and governance requirements that are designed to protect retail investors. These provisions could serve to mitigate systemic risk as the resulting transparency can "weed out" trading activities that are in fact harmful to the broader economy.

One could also argue that contrary to the prior assertions, the steady growth of the mutual fund industry over the past century proves that mutual fund advisers are indeed talented. Advisers have indeed been quite successful in recruiting an ongoing stream of new investors. But recruiting investors in this regard could be attributed to superior sales tactics as opposed to having superior talents in optimizing returns. This is supported by the fact that mutual funds have historically had the

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181. *See generally* QUINNIPIAC UNIV., INSTITUTIONAL INVESTOR SURVEY FALL 2014 (2014).

182. *Id.* at 1.

183. *Id.* at 3.

184. *See generally* Martin, *Private Investment Companies*, *supra* note 37 (discussing problems associated with relying on the sophisticated investor exemption to separate private and public investment companies and queries whether the dividing line should be based on underlying investment activities as opposed to the status of investors).

freedom to advertise to the general public, and private funds have not enjoyed these liberties prior to the passage of the JOBS Act.[185] Mutual fund advisers have entire marketing teams dedicated to generating advertisements across various media. There are countless commercials, broadcasts, articles, websites, and pamphlets, all of which urge the general public to invest in mutual funds.

Professor John Morley of Yale Law School has provided a useful historical perspective on this topic in his article, *Collective Branding and the Origins of Investment Management Regulation: 1936-1942*.[186] His research suggests that the early business models of mutual funds were historically designed to earn profits from new shareholder investments as opposed to generating profits from existing holdings.[187] Because of this early emphasis on sales, the mutual fund industry may have even advocated for the capital restrictions implemented under the Company Act as a way to brand the industry as being a relatively safe investment for the general public.[188] These restrictions have likely made it difficult for the industry to move past this emphasis on sales, as opposed to focusing on managerial talent in selecting optimal combinations of underlying instruments.

Given the difficulties of relying on managerial skill to exceed benchmarks such as the S&P 500 Index, new financial innovations such as index funds and exchange-traded funds ("ETFs") have eliminated the need for managerial talent.[189] These strategies rely on computer programs to directly replicate the basket of securities represented by a particular index.[190] Managers in these vehicles are not actively trading financial instruments, as they are instead passive monitors of the underlying computer models. Professor William Birdthistle, an expert in investment company law, has supported this assertion by arguing that the recent shortcomings of the mutual fund industry have paved the way for the advent of ETFs.[191] Because advisory fees charged to investors

185. *See* THOMAS P. LEMKE ET AL., REGULATION OF INVESTMENT COMPANIES §§ 14–22 (2014) (providing detailed description of regulatory framework for advertising by mutual funds, which includes applicable Company Act provisions, as well as corresponding rules and cases).

186. John Morley, *Collective Branding and the Origins of Investment Management Regulation: 1936–1942*, 6 VA. L. & BUS. REV. 341 (2012).

187. *Id.* at 392.

188. *Id.* at 391–92.

189. Deloitte Research, *Exchange-Traded Funds Challenging the Dominance of Mutual Funds?*, DELOITTE, http://www.runtogold.com/images/Deloitte-ETF-report.pdf (last visited Sept. 8, 2015).

190. *Id.*

191. *See generally* William Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69 (2008)

are necessarily lower with respect to these vehicles, mutual funds have been steadily losing investors to this growing category of investments.[192]

C. Limited Incentives of Mutual Fund Advisers: Fees

Relatedly, advisers who manage hedge funds can earn substantially higher fees. Hedge fund advisers earn both a performance fee of approximately 20% of profits, and a management fee of approximately 2% of net assets.[193] Mutual fund advisers are prohibited from charging a performance fee on the profits of a fund and are thus limited to earning a 1–2% management fee on net assets.[194] A number of high-profile mutual fund managers left mutual funds to manage less restrictive and more lucrative hedge fund investments in 2000.[195] During this time period, a handful of managers left prestigious Fidelity[196] funds to start their own hedge fund vehicles, which at the time was quite controversial.[197] Although this restriction on performance fees is designed to protect retail investors from excessive

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(providing a descriptive and detailed discussion on exchange-traded funds, which includes their structure, advantages, and shortcomings).

192. Trevor Hunnicutt, *Investors Shun Stock Pickers, Favor Vanguard, BlackRock, State Street*, INVESTMENTNEWS (Mar. 16, 2015, 12:28 PM), http://www.investmentnews.com/article/20150316/FREE/150319936/investors-shun-stock-pickers-favor-vanguard-blackrock-state-street; Chuck Jaffe, *Mutual Funds Lose Their Battle with ETFs*, MARKETWATCH (June 11, 2011, 1:38 PM), http://www.marketwatch.com/story/mutual-funds-lose-their-battle-with-etfs-2011-06-08.

193. *See* U.S. SEC. & EXCH. COMM'N, SEC Pub. No. 139, INVESTOR BULLETIN: HEDGE FUNDS (2012); *see also* JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS: STRATEGIES FOR THE NEW MARKETPLACE 165 (1st ed. 1999) (providing a brief discussion on hedge funds, which includes questions to ask to understand the level of risk in the fund's investment strategies compared to one's personal goals).

194. Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 306 (2010); *Mutual Fund Fees and Expenses*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/mffees.htm (last visited Sept. 8, 2014) (providing a brief discussion on the various fees and expenses of mutual funds).

195. *Hedge Fund Hiring: Momentum Continues but Skills Scarce*, THINK ADVISOR (Dec. 22, 2003), http://www.thinkadvisor.com/2003/12/22/hedge-fund-hiring-momentum-continues-but-skills-sc; Jennifer Karchmer, *Fund Managers Move*, CNNMONEY.COM (July 19, 2000 6:20 AM), http://money.cnn.com/2000/07/19/mutualfunds/q_funds_hedge/index.htm; Joseph Nocera, *Punishing Success At Harvard,* N.Y. TIMES (Oct. 22, 2005), http://www.nytimes.com/2005/10/22/business/punishing-success-at-harvard.html (stating that top money managers from Harvard University have resigned in order to reap the benefits of the higher compensation offered by hedge funds).

196. *About Fidelity*, FIDELITY, https://www.fidelity.com/about-fidelity/overview (last visited Sept. 8, 2015) (stating that Fidelity serves "24 million individual customers . . . through 10 regional offices and more than 180 Investor Centers in the United States. With 40,000-plus associates, our global presence spans eight other countries across North America, Europe, Asia, and Australia who are also working tirelessly to meet the needs of our customers.").

197. Karchmer, *supra* note 195.

risk taking on the part of their advisers, the promise of higher fees can lure otherwise talented advisers into the management of private pools.

These incentives (or the lack thereof) are compounded by the current regulatory climate that eases the process of organizing private funds. As many of the barriers of entry have recently been lifted under the JOBS Act, the mutual fund industry could experience a significant talent drain, particularly since the mutual fund investment climate is already subject to excessive constraints. A recent empirical study investigated the extent to which mutual fund talent is being transferred to the hedge fund industry.[198] This study found evidence of "an increasing flight of top-performing young managers from mutual funds [to hedge funds], a drop in mutual fund returns, and deterioration in recruiting standards."[199] Another commentator has observed:

> The hedge fund industry continues to grow rapidly. To support this growth, it is gathering much of its new talent from the mutual fund industry. Those mutual fund portfolio managers who are most interested in actually delivering superior investment performance are migrating to the hedge fund industry. Hedge funds have been able to attract the best and the brightest—offering them significantly higher compensation. A surprisingly large brain-drain has resulted, sapping the strength of the mutual fund industry.[200]

One could argue that the new regulatory requirements provided under the Dodd-Frank Act create a substantial barrier to entry for private fund advisers. The Dodd-Frank Act requires that private advisers register under the Advisers Act and report certain confidential information directly to the SEC.[201] However, a recent survey conducted by Professor Wulf Kaal found that although hedge funds expressed concerns with these new regulatory requirements, the actual costs and impact of compliance are not as significant as the industry had originally anticipated.[202] Furthermore, the potential for exponential profits that result from the trading flexibilities of managing such funds likely far exceeds the incremental costs of complying with the Dodd-Frank Act. These costs are also significantly less than the costs of complying with the Securities Act, Company Act, and Exchange Act,

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198. Leonard Kostovetsky, *Human Capital Flows and the Financial Industry*, *in* EFA 2009 BERGEN MEETINGS PAPER (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013421.

199. *Id.* at 1.

200. Rob Brown, *The Death of Mutual Fund Wrap*, RIA CENT. (Aug. 27, 2012), www.riacentral.com/2012/08/27/death-mutual-fund-wrap.

201. *See* Dodd-Frank Act, §§ 403, 404, 124 Stat. 1376, 1571 (codified as amended at 15 U.S.C. § 80b–3(b) (2012)).

202. Wulf Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243, 315 (2013).

all of which provide lenient exemptions for private funds.

III. Privileged Access to Strategies

This Part first provides a detailed description of the specific capital restrictions promulgated under the Company Act. Limitations with respect to leverage and derivatives trading have been implemented under this legislation. Part III then identifies the inaccessible strategies that have been created by this framework. Private funds can access an abundance of instruments and strategies that simply are unavailable to their mutual fund counterparts. These strategies can often guarantee returns despite declining markets. This Part concludes by assessing how both private adviser talent and unique relationships with counterparties have allowed advisers to have privileged access to information. It references and summarizes numerous studies that have effectually proved privileged access to information for at least certain categories of hedge fund investments.

A. Mutual Fund Restrictions

The Company Act is distinguishable from the Securities and Exchange acts in that it goes beyond the "truth in securities" framework that exclusively relies on the disclosure of material information.[203] This legislation includes strict capital restrictions on the underlying assets of registered funds by prohibiting or restraining certain types of investment activities and transactions that are found to expose investors to undue risk.[204] Because our country was founded upon principles of capitalism and free market, where businesses have the freedom to transact with minimal interference from the government, these kinds of restrictions typically elicit significant pushback from the business community. Yet, the events that led to the Great Depression proved that the government had to play a larger role in regulating the markets to prevent the devastating abuses that crippled the financial system.[205] In fact, these abuses led to a severe contraction of business in this country, which in turn led to widespread unemployment for millions of Americans.[206]

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203. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml (last visited Sept. 8, 2015).

204. *See generally* LEMKE ET AL., *supra* note 185, § 8 (providing a detailed description of the regulatory framework underlying mutual fund capital restrictions, which includes applicable Company Act provisions, as well as corresponding rules and cases).

205. *See* RALPH F. DE BEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 7–10 (1964) (providing a discussion of government programs, such as the Employee Retirement Income Security Act ("ERISA") and Social Security, which prevent risky retirement investments by creating strict rules to ensure that workers are guaranteed their full benefits).

206. *Id.*

With respect to the investment company industry, the SEC estimated that between 1929 and 1936 "investment company shareholders lost 40 per cent of their investments" due to various abuses that infected the market at that time.[207] Unscrupulous advisers were found to have used funds as "dumping grounds" for unmarketable securities, as vehicles to earn excessive returns based on shoddy investments, and as an unlimited pool of leverage for their own personal gain.[208] Many used the lax regulatory environment to operate funds as Ponzi schemes, where instead of implementing a legitimate investment strategy, advisers relied on new investments to fund their excessive fees.[209] Because investment companies attract a significant portion of the national savings from the general public, the trading activities of such vehicles could have a vital effect on capital formation within the broader economy. Thus, these provisions are designed to mitigate the abuses that led to the severe losses for a wide range of investment company investors.

Section 18 under the Company Act provides the basic framework for these restrictions.[210] This provision prohibits investment companies from issuing "senior securities" to investors, which are defined broadly to include any obligation constituting indebtedness on behalf of the fund.[211] This severely restricts the amount of debt that a fund can carry. For example, taking out a loan to bolster fund returns would automatically constitute a senior security interest as the bank counterparty would be offered a promissory note, bonds, or shares in exchange for the specified amount of the loan.[212] Section 18(f), however, allows open-ended funds to borrow capital from a bank if, immediately after the bank borrowing, the fund's total net assets are at least three times the total aggregate borrowings (300% asset coverage).[213] If a fund borrows $300 for example, then it must have at least $900 of total assets to cover this loan. If at any time asset coverage falls below 300%, the company must, within three days, reduce its borrowings until it has 300% coverage.[214]

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207. Paul Roye, Dir., Div. of Inv. Mgmt., Speech at U.S. Security & Exchange Commission, A Celebration of the 60th Anniversary of the Investment Company Act (Oct. 4, 2000) (transcript available at http://www.sec.gov/news/speech/spch405.htm).

208. Richard M. Phillips & Robert G. Bagnall, *The Investment Company Act of 1940: A Time For Reassessment*, *in* 2 22ND ANNUAL INSTITUTE ON SECURITIES REGULATION 593, 596 (1990).

209. *Id.*

210. Company Act of 1940, 15 U.S.C. § 80a–18 (2012).

211. *Id.* § 80a–18(a), (g).

212. *Id.* § 80a–18(c).

213. *Id.* § 80a–18(f).

214. *Id.* § 80a–18(f)(1).

Trading in derivatives can also constitute indebtedness and therefore run afoul of Section 18 of the Company Act.[215] This is because in order to trade derivatives, parties must post margin or collateral at the outset of the transaction (and for the duration of the transaction), since one party will inevitably incur losses once the transaction closes.[216] Derivatives are not specifically defined under the federal securities laws, but in their most basic form, they are contracts between a future buyer and future seller that specify a future price at which some item can or must be sold.[217] Common examples include forwards, futures, swaps, and options.

The Company Act does provide some leeway for derivatives trading by registered funds. The SEC will not automatically treat derivatives as senior securities provided that the adviser takes certain steps to limit the potential for leveraged losses by "covering" their obligations.[218] Fund advisers can "cover" derivative contracts by earmarking or segregating liquid securities equal in value to the fund's potential exposure from the leveraged transaction.[219] Assets set aside must be liquid, unencumbered, and marked to market daily.[220] They may not be used to cover other obligations, and, if disposed of, they must be replaced.[221] Advisers can also cover an obligation by directly owning the instrument underlying that obligation.[222] For instance, a fund that wants to take a short position in a certain stock can comply with the Company Act by owning an equivalent long position in that stock.[223] Thus, if a particular fund wants to engage in a short trade by borrowing 500 shares of Microsoft, which has a total value of $5000, the fund can maintain appropriate coverage by directly owning 500 shares of Microsoft, or by segregating liquid assets in the amount of $5000 until it repays its 500 shares of Microsoft. These transactions must also be closely monitored by boards of directors and funds must consistently assess accuracy and completeness of their disclosure relating to derivatives.[224]

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215. LEMKE ET AL., *supra* note 185, § 8(b)(ii).

216. *Id.*

217. MICHAEL DURBIN, ALL ABOUT DERIVATIVES 3 (2006).

218. Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,132 (April 27, 1979) (codified at 17 C.F.R. pt. 271 (2015)).

219. *Id.*

220. *Id.*

221. *Id.*

222. Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987).

223. *Id.*

224. Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. at 25,133.

These exemptions allow advisers to allocate a portion of fund assets to derivative instruments, but they are still considerably restrictive. Maintaining a large portion of cash reserves to cover any and all potential losses, as briefly discussed above, is simply not a viable investment scheme for most vehicles. The majority of fund assets should be invested in specific instruments as opposed to sitting in an earmarked account. As such, these stringent requirements make it difficult for advisers to rely on derivatives as a primary component of their strategies and they are often used for narrow hedging purposes. Derivatives such as futures and forwards can be used to lock in various exchange rates, to guarantee that a particular interest rate will be at a certain amount at a specified date in the future, or for a number of other peripheral strategies.[225] Some advisers rely on derivatives to a greater extent to mimic the absolute return strategies of many private funds.[226] Yet, the general effectiveness of these strategies is quite limited due to the restrictions provided under Section 18 of the Company Act.[227]

In addition, illiquid instruments such as distressed securities, venture capital, private equity, and other private investments are largely unavailable to public funds. The SEC recommends that registered investment companies limit such illiquid investments to a maximum of 15% of a fund's total Net Asset Value ("NAV")[228] so that funds can easily honor investor redemption requests on a daily basis.[229] When advisers receive redemptions, the adviser must be able to quickly sell a proportionate amount of mutual fund assets in order to fulfill the request in a timely fashion.[230] Thus, underlying assets must be sufficiently liquid in order to fund any and all investor redemptions. Maintaining this flexibility is likely rooted in investor protection, as ensuring that investors can quickly exit a fund protects them from having their capital locked within a particular vehicle for an extended period of time.

Many funds further limit illiquid investments to an even lower level than the allowable 15% due to challenges in complying with the

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225. LEMKE ET AL., *supra* note 185, §8(b)(iii).

226. Simeon Hyman, *Hedge Funds for the Masses? Hedge Fund Strategies Are Showing Up in More Mutual Funds*, USNEWS (June 10, 2013, 9:35 AM), http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/06/10/hedge-funds-for-the-masses.

227. *Id.*

228. Periodic Repurchases by Closed-End Management Investment Companies, Securities Act Release No. 33,6948, Exchange Act Release No. 34, 30967, 57 Fed. Reg. 34,701 (July 28, 1992).

229. *Id.*

230. 17 C.F.R. § 270.22c-1(b) (2015); *see also Invest Wisely*, *supra* note 138 ("Mutual fund investors can readily redeem their shares at the current NAV—plus any fees and charges assessed on redemption—at any time.").

mandated valuation mechanisms provided under the Company Act.[231] More specifically, since there are no readily available market quotations for illiquid instruments, advisers must value them at their "fair value as determined in good faith by the board of directors."[232] The process through which fair value is determined is often subjective and complex. Boards can be overly conservative in valuing illiquid instruments, incur additional expenses in valuing such assets due to their underlying complexities (which get passed down to the investors), or are exposed to the risk of liability for mispricing a particular asset.[233]

The capital restrictions described above, have narrowed the universe of available strategies for public funds. Mutual fund strategies are largely restricted to the following three categories of investments: equities, bonds, and cash instruments. Managerial talent can only go so far when advisers are limited to this constrained pool of options. This has arguably paved the way for ETFs to increasingly dominate the mutual fund landscape as these passive strategies often mirror the basket of securities represented by an index. Given the massive financial innovation that has occurred over the past decades, coupled with the growing flexibilities afforded to private funds, it is increasingly troubling that the general public has been excluded from a variety of investments and strategies since the passage of the federal securities laws.

B. Inaccessible Strategies

Private investment companies that effectively maintain exemptions from the Company Act are not shackled by this restrictive legislation. Congress made it easier to maintain such exemptions when it adopted Section 3(c)(7) in 1996.[234] Under this provision, funds that restrict their offerings to "qualified purchasers" are automatically exempt from the act.[235] This exemption quickly became the most popular amongst private fund advisers as it allows them to raise an unlimited amount of capital and still offer interests to an unlimited number of qualified purchasers. Conceptually, qualified purchasers are similar to accredited

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231. Sam Diedrich, *'Alternative' or 'Hedged' Mutual Funds: What Are They, How Do They Work, and Should You Invest?*, FORBES (Feb. 28, 2014, 10:29 AM), http://www.forbes.com/sites/samdiedrich/2014/02/28/alternative-or-hedged-mutual-funds-what-are-they-how-do-they-work-and-should-you-invest; Eleanor Laise, *Mutual Funds Delve into Private Equity*, PITT. POST-GAZETTE (Aug. 2, 2006), http://www.post-gazette.com/business/businessnews/2006/08/02/Mutual-funds-delve-into-privateequity/stories/200608020156.

232. Company Act, 15 U.S.C. § 80a–2(41)(B)(ii) (2012).

233. *See generally* Roye, *supra* note 207.

234. Company Act, 15 U.S.C. § 80a–3(c)(1), (7).

235. *Id.* § 80a–3(c)(7).

investors insofar as income or institutional status or both are used as primary determinants. But qualified purchasers are subject to higher net worth requirements.[236] While individual investors must earn over $200,000 in order to qualify as accredited, a qualified purchaser includes institutions that own at least $5,000,000 in investments as well as any natural person who owns not less than $5,000,000 in investments.[237] If funds restrict offerings to these high net worth investors then they are afforded more flexibility to invest in a wider range of instruments than registered investment companies. Theoretically, these freedoms arise from the notion that these kinds of investors do not need the investor protection measures mandated under our federal securities laws. They can adequately fend for themselves and can therefore bear the increased risk of investing in assets that perhaps yield less predictable results.

The greater investment freedoms afforded to private funds are often implicit in their commonly known monikers. With respect to hedge funds, the term "hedge" refers to the fact that advisers can use a variety of strategies in order to aggressively hedge, or protect, their portfolios against market losses, which is a strategy not available to mutual funds.[238] For example, a hedge fund adviser could simultaneously take long and short positions in the same type of instrument, without having to comply with the Section 18 restrictions provided above, in order to ensure a return in both high and low markets.[239] Because hedge funds are not subject to constraints on leverage[240] or derivatives trading,[241] such advisers can rely on a plethora of exotic instruments, illiquid investments, and non-U.S. opportunities, so as to maximize investor returns. Hedge funds are frequently the leaders in extracting the benefits of financial innovation as they attract the best managerial talent to take advantage of these broad liberties. They are habitually described as having the ability to earn "absolute returns" which means that they seek to guarantee returns irrespective of market performance.[242]

236. *Id.* § 80a–2 (51).

237. *Id.*

238. NICHOLAS, *supra* note 193, at 15.

239. *Id.*

240. *Leverage Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/l/leverage.asp (last visited Sept. 8, 2015) (defining leverage as "the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment").

241. REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12 (Apr. 28, 1999). The amount of leverage employed by a particular hedge fund is only limited to the extent requested by its actual counterparties. *Id.*

242. *See* SEC STAFF REPORT, supra note 60, at 33–36 (explaining several investment

Strategies include market neutral, global macro, opportunistic, emerging markets, and distressed securities.[243]

With respect to private equity and venture capital funds, these vehicles typically invest in an assortment of private companies and investments. These can include start-ups, leveraged buyouts, mezzanine financing, and distressed companies, among others.[244] Because private fund advisers are not obliged to fulfill daily redemption requests, and are even able to suspend redemptions at their election, they can invest in instruments that are highly illiquid as investor subscriptions can be locked into private vehicles for an extended period of time.[245] Moreover, because exempt vehicles are not subject to the mandated valuation constraints provided under the Company Act, advisers have complete discretion to utilize internal valuation policies, without being subject to the independent oversight of a board of directors.[246] Private fund advisers are also exempt from the standardized valuation policies mandated under the Company Act,[247] and they can deviate from any provided valuation policies when deemed necessary.[248] Such flexibilities allow private funds to invest in a variety of illiquid instruments without facing the same liability risks as mutual fund boards.

A common investment for private equity and venture capital funds is restricted shares, which are exclusively offered by private companies such as the pre-IPO Facebook or Microsoft. Generally speaking, restricted shares are considered illiquid because they are not publicly traded on active exchanges, making it more difficult to appropriately derive consistent and reliable valuations. Although restricted shares are typically offered at a discount relative to post-IPO offerings,[249] they are largely unavailable to mutual fund advisers due to the difficulties in producing "fair value" determinations, and mandated SEC limitations described herein. This allows private fund advisers to exclusively enjoy

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strategies that hedge funds utilize to generate returns in various market conditions).

243. Dion Friedland, *Synopsis of Hedge Fund Strategies*, MAGNUM FUNDS, http://www.magnum.com/hedgefunds/strategies.asp (last visited Sept. 8, 2015).

244. LEMKE ET AL., *supra* note 75, §12.

245. *Id.*

246. *Id.*

247. *See* Ryan Sklar, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3268 (2009).

248. *Id.* at 3268–69.

249. Dr. Janet Kilholm Smith et al., *The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6 FORDHAM J. CORP. & FIN. L. 421, 439 (summarizing empirical evidence that finds "on average the discounts [of private placement shares] relative to registered shares is substantial").

the informational advantages that are often attributed to being an early investor in private companies.

For instance, many commentators alleged that private investors in Facebook, who purchased restricted shares before the company went public, wrongfully reaped the benefits of having inequitable access to information related to the company's true valuation with respect to its ongoing technological developments.[250] These elite investors were able to cash out their investments when the IPO price reached its peak, while the general public suffered massive losses due to inaccurate disclosures related to Facebook's valuation.[251] As one commentator noted: "The early bird gets the cheap stock; the late bird gets the bird."[252] According to the Private Equity Quarterly Index ("PrEQIn"), private equity funds, on average, have outperformed the markets over the past ten years.[253] The exclusion of public investors from the private placement market is becoming less justifiable particularly with the development of private exchanges such as SecondPost and the NASDAQ Private Market, which are making restricted shares a more liquid investment.[254]

The diversity of instruments and strategies available to private funds is astounding compared to the narrow universe offered to the general public. Modern portfolio theory dictates that maintaining a diverse basket of investments is essential for optimizing investor returns.[255] Given the inequitable structure of our federal securities laws, elite investors disproportionately reap the benefits of this assorted selection of both short-term and long-term investments. Mutual fund advisers are admittedly required to maintain a diverse basket of securities under the

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250. Henry Blodget, *The Full Story Of How Facebook IPO Buyers Got Screwed*, BUS. INSIDER (Dec. 20, 2012, 1:38 PM), http://www.businessinsider.com/how-facebook-ipo-investors-got-screwed-2012-12?op=1; Aswath Damodaran, *Was Facebook's Botched IPO a Conspiracy?*, CNN (May 28, 2012, 11:51 AM), http://www.cnn.com/2012/05/28/opinion/damodaran-facebook-ipo/index.html; Elizabeth Ody & Margaret Collins, *Facebook IPO Seen Deepening Investor Distrust of Stocks*, BLOOMBERG (May 25, 2012, 11:01 AM), http://www.bloomberg.com/news/2012-05-25/facebook-ipo-fallout-deepens-investor-distrust-of-stocks.html.

251. *See generally* Blodget, *supra* note 250; Damodaran, *supra* note 250; Ody & Collins, *supra* note 250.

252. Robert Lezner, *The Facebook IPO Proves The New Rule That Private Markets Trump Public Markets*, FORBES (Aug. 19, 2012), http://www.forbes.com/sites/robertlenzner/2012/08/19/the-facebook-ipo-proves-the-new-rule-that-private-markets-get-the-best-deal.

253. 2014 PREQIN GLOBAL PRIVATE EQUITY REPORT, *supra* note 73, at 7.

254. *See generally* Rodrigues, *supra* note 38 (discussing recent emergence of exchanges for private shares).

255. Charles Rotblut, *The Benefits of Modern Portfolio Theory*, AAII J., http://www.aaii.com/journal/article/the-benefits-of-modern-portfolio-theory.touch (last visited Sept. 8, 2015).

Company Act and the Internal Revenue Code. Yet numerous commentators have noted the valid limitations of simply diversifying among publicly traded stocks in terms of maximizing returns and minimizing risks. As one prominent hedge fund adviser noted:

> Hedge funds strive to generate returns that have a very low correlation with traditional asset classes . . . . Meaning, that those asset classes with diverse correlations will not all react in the same manner to market conditions . . . . Since many well-managed hedge funds act independently of market movements, they often have the ability to stabilize a portfolio during times of market uncertainty. This may be the strongest argument for giving hedge funds a significant role in your asset allocation. Whereas mutual funds provide a certain degree of diversification by investing in multiple stocks, they are still subject to cyclical, sector and asset class volatility and overall market declines.[256]

By and large, private funds have the power to invest in assets that are negatively correlated to publicly traded stocks.[257] When market indices experience volatility due to financial crises or other economic shocks, a portfolio that includes a sizable allocation to private funds can maintain smoother returns.[258]

During the Great Recession, certain hedge funds relied on their increased freedoms to engage in short trading and other innovative strategies to actually beat the market.[259] In some cases, private funds were able to earn a sizable return for their underlying investors when the general public suffered average losses of over 40%.[260] The global macro funds managed by George Soros gained 5% during the lowest points of the financial crisis.[261] As Professor Houman Shadab has noted in his often-cited research, "[h]edge funds use short sales and derivatives to manage risk and reduce losses when the overall market is performing poorly. This practice is difficult for mutual funds because the legal restrictions on their investment activities."[262] Consequently, more institutional investors, such as endowment trustees for

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256. *Advantages & Disadvantages of Hedge Funds*, MORTON CAPITAL MGMT., https://web.archive.org/web/20141029110940/http://www.mortoncapital.com/advantages-of-hedge-funds (last visited Sept. 8, 2015).

257. *Id.*

258. *Id.*

259. Houman Shadab, *Hedge Funds and the Financial Crisis* 3 (Mercatus on Policy, Working Paper No. 24, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1564847.

260. *See generally* Shadab, *supra* note 259.

261. Richard Teitelbaum, *Soros Imitators Reap Riches in Financial Crisis on Macro Funds*, BLOOMBERG (Feb. 4, 2009, 7:01 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ay.jqGduLoH8.

262. Shadab, *supra* note 259, at 2.

universities, have been increasingly allocating a sizable portion of assets to private funds.[263]

However, reports have recently surfaced that contrary to the aforementioned data, hedge funds, similar to their mutual fund counterparts, are not able to beat the markets and have historically failed to exceed the S&P 500 Index.[264] Such conflicting reports likely result from the different methodologies used to measure hedge fund returns, as private fund advisers are not required to employ standardized valuation mechanisms. Private fund indexes are also naturally underinclusive, as these entities are not mandated to report performance results to any existing index. Publicly available indexes primarily rely on voluntary reporting from private funds. Analyzing average returns across the industry is also problematic because private funds are extraordinarily heterogeneous. Some funds mirror conservative strategies comparable to mutual funds, while others pursue innovative strategies that invest in exotic instruments and strategies.[265] A more useful comparison would account for the wide range of strategies utilized by private funds, and would also consider the extent to which performance results are negatively correlated to the markets that could actually enhance the diversity of an existing portfolio.

Mutual funds are beginning to offer hedge fund-like strategies to recruit investors who want to enjoy the benefits of alternative investments, but they are still significantly limited in their investment capabilities.[266] Because of the constraints provided under the Company Act, mutual fund advisers cannot engage in the same level of

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263. *Diversification Beyond Stocks*, INVESTOPEDIA, http://www.investopedia.com/articles/05/021105.asp (last visited Sept. 8, 2015).

264. Simon Lack, *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True*, CFA INST. CONF. PROC. Q., Dec. 2012, at 14–17, http://www.cfapubs.org/doi/pdf/10.2469/cp.v29.n4.4 (arguing that on average, hedge funds have not been able to exceed the risk-free rate of return provided by government issued treasury bills). *But see generally* Thomas Schneeweis & Hossein B. Kazemi, *An Academic Response to the 'Hedge Fund Mirage,'* INST. FOR GLOBAL ASSET & RISK MGMT. (Sept. 30, 2012), http://ssrn.com/abstract=2228851 (providing a direct critique of the methodologies employed by the author of *Hedge Fund Mirage*: "The author of 'Hedge Fund Mirage' does not have the net profits to hedge funds but such data is required before true comparisons between net profit to investor and net profit to hedge fund manager can be made . . . .").

265. FILIPO STEFANINI, INVESTMENT STRATEGIES OF HEDGE FUNDS 2 (2006).

266. William Conroy, *A Look At Hedge-Fund-Style Mutual Funds*, FIN. ADVISOR (June 25, 2014), http://www.fa-mag.com/news/build-a-better-mousetrap—and-the-world-will-beat-a-path-to-your-door-18405.html; Rob Copeland, *The New Hedge-Fund-Like Retail Funds*, WALL ST. J (Mar. 21, 2014, 5:24 PM), http://www.wsj.com/articles/SB10001424052702303287804579445134053667514; Sam Mamudi, *Hedge Funds for the Masses*, MKT. WATCH (Mar. 19, 2010, 7:29 PM), http://www.marketwatch.com/story/hedge-fund-like-mutual-funds-bid-for-your-money-2010-03-19.

derivatives trading and other innovative investments. In addition, they do not have the same flexibility to react quickly to unforeseen market swings. SEC officials have also started to investigate whether these new products expose retail investors to increased harm.[267] This could perhaps deter public advisers from delving into these unique strategies as the SEC may decide to implement more restrictive regulations.

C. Information

In addition to having privileged access to strategies, private fund advisers often have privileged access to valuable information related to such strategies. The tremendous value of information has been recently illuminated by Michal Lewis's bestselling commentary, *Flash Boys*, where he shed light on the evolution of high-frequency trading ("HFT").[268] HFT generally refers to the practice of relying on complex algorithms to greatly accelerate the speed through which traders can exploit informational gaps.[269] Traders who gain access to the most speed will essentially be the most profitable. Such timing advantages are now measured in terms of milliseconds as technology continues to rapidly evolve to produce higher speeds of transmitting data.[270] For those who do in fact develop the best technology in this regard, they reap enormous profits because of the riskless nature of being first-in-line. In fact, Tactical Trading Fund, a HFT hedge fund managed by Chicago-based Citadel Investment Group, has increased in value by over 300% since it opened its doors in 2007.[271]

Historically, the value of information has largely driven the structure of our federal securities laws. Transparency is the cornerstone of this intricate legal framework as issuers must publicly disclose all material information related to an offering.[272] This sweeping requirement originates from the efficient market hypothesis, which broadly asserts that any public information regarding a security will be immediately impounded into its price.[273] Mandating the disclosure of all material

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267. Trevor Hunnicutt, *Popular Liquid Alts Funds Face Regulatory Scrutiny: As Assets in Retail Alternative Funds Balloons Regulators Probe Risks and Marketing*, INVESTMENTNEWS (June 24, 2014), http://www.investmentnews.com/article/20140624/FREE/140629964.

268. *See generally* MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (2014).

269. *High-Frequency Trading—HFT*, INVESTOPEDIA, http://www.investopedia.com/terms/h/high-frequency-trading.asp (last visited Sept. 8, 2015).

270. Eamon Javers, *High-Speed Trading: Profit—and Danger—in Milliseconds*, CNBC (May 15, 2012, 3:31 PM), http://www.cnbc.com/id/47432428.

271. *Citadel High-Frequency Trading Fund Up 300% Since Debut*, FIN. ALTERNATIVES (Apr. 15, 2014, 12:25 PM), http://www.finalternatives.com/node/26756.

272. DE BEDTS, *supra* note 205, at 48.

273. *See generally* Gilson & Kraakman, *supra* note 168.

information will thus ensure that the underlying prices of securities are in effect accurate. As background, issuers of public companies must provide a detailed registration statement upon issuing new offerings to the general public.[274] This document includes comprehensive descriptions of the offering's financial terms, management history, key risk factors, audited financial statements, and a number of other relevant items.[275] Once this registration statement is filed and deemed effective, companies must then submit public filings for any new material developments that are not reflected in the initial registration statement.[276] Companies that are registered under the Exchange Act must also file periodic reports on an annual and quarterly basis.[277] A variety of traders and other market participants quickly react to this steady flow of information that is mandated under the federal securities laws, as well as to information that is regularly released by unrelated third parties. Through this immediate reactionary time, which has grown faster over the years, the prices of publicly traded securities rapidly incorporate publicly released information.

To guarantee that investors are not given an unfair advantage by having privileged access to new information, insider trading is prohibited under Rule 10b-5 of the Exchange Act.[278] The specific contours of the insider trading laws are beyond the scope of this Article, but corporate insiders such as executives and employees are generally restricted from trading on private information before disclosing it to the general public.[279] Relatedly, such insiders cannot provide material nonpublic information to a family member or friend without potentially running afoul of the insider trading laws.[280] Regulation FD also prohibits issuers from engaging in selective disclosure to certain covered persons, which include individuals and entities likely to trade on the information, such as broker-dealers, securities analysts,

274. Securities Act of 1933, 15 U.S.C. §§ 77g–77aa (2012).

275. *Id.*

276. *Id.*

277. *See generally* Langevoort & Thompson, *supra* note 147.

278. Securities Exchange Act of 1934, 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5 (2015).

279. Chiarella v. United States, 445 U.S. 222, 227 (1980).

280. Dirks v. SEC., 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."); United States v. Newman, 773 F.3d 438, 449 (2d Cir. 2014) (clarifying that in order for a tippee to face liability, such tippee needs to have direct knowledge of the personal benefit that the tipper sought to acquire in disclosing the material non-public information, which has arguably made it easier for tippers to evade liability under the insider trading laws).

investment advisors, and institutional investors.[281] Prohibiting these kinds of trading practices encourages participation in the public capital markets by ensuring that the markets are fair and efficient. If investors believe that they are allocating their limited capital to a rigged market which serves the interests of a privileged few, then they are less likely to purchase shares. This would in turn constrain the overall liquidity of the public capital markets.

This Article does not broadly assert that private fund advisers are knowingly and consistently violating the insider trading laws by wrongfully profiting from nonpublic information. However, such advisers often possess higher degrees of talent and technology to process freshly released information, than their mutual fund counterparts. This builds on the discussion provided in Part IV.B, which describes the industry's exclusive access to strategies.[282] One could argue that private fund advisers have more information regarding the markets as a whole due to their exclusive access to a number of instruments. Financial innovation has expanded the interconnectedness of such markets, as the intricate relationship between derivatives, securities, illiquid investments, fixed income products, and a number of others, have correlative properties that are often exploited via arbitrage by private funds. What happens on one corner of a particular derivatives market will inevitably impact an innocuously related corner of the securities markets. Furthermore, the insider trading laws that apply to derivatives are not as well developed, or stringent, as the laws that apply to securities.[283] This is compounded by the risk that the loosening restrictions for private funds could lead to an ongoing talent drain in the mutual fund industry, which could further constrain the potential returns for mutual fund investors.

Relatedly, this exclusive access to instruments can foster more involved relationships with broker-dealers and other counterparties. These relationships can yield privileged access to new developments regarding various financial products and entities. As background, private funds depend on prime brokers for a host of services such as "centralized custody, clearing and settlement, financing, and

281. 17 C.F.R. § 243.100; *id.* § 243.103.

282. *See infra* Part IV.B.

283. *See, e.g.*, Gary Rubin, *CFTC Regulation 1.59 Fails to Adequately Regulate Insider Trading*, 53 N.Y.L. SCH. L. REV. 599, 610–18 (2009) (highlighting limitations of applying insider trading doctrine to commodities instruments since these markets are not generally governed by corporate insiders such as CEOs, employees, and other categories of executives; further identifying the limitations of CFTC 1.59 which attempts to prohibit insider trading by governing members of commodities exchanges).

recordkeeping."[284] Hedge fund advisers frequently trade higher volumes of instruments than publicly registered funds, which produces higher commissions for their prime broker counterparties. Private funds can be a highly sought-after client for these large brokerage houses. In a similar vein, counterparties may feel inclined to divulge valuable information to private funds to garner positive ratings, which could then boost their compensation and lead to increased future business.[285]

A number of empirical studies have found evidence of privileged access to information.[286] One such study compared publicly released analyst reports to hedge fund holdings disclosed in Form 13F filings.[287] This statistical comparison showed that hedge funds were opportunistically adjusting their positions prior to the release of a publicly available analyst reports.[288] For instance, if an analyst published a downgrade for a particular company, a hedge fund would decrease its holdings in such company immediately prior to the release of such public statement. This study found no evidence that other institutions, such as banks, insurance companies, and mutual funds, also trade prior to analyst recommendations.[289] Another study investigated the extent to which hedge funds were front running the announcement of merger and acquisition ("M&A") deals.[290] This study found that certain hedge funds were increasing their holdings in a target's stock while decreasing holdings in an acquirer's stock (or buying put options), prior to the public announcement of the underlying M&A deal.[291] This

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284. LEMKE ET AL., *supra* note 75, § 1.

285. April Klein et al., *Do Hedge Funds Trade on Private Information? Evidence from Upcoming Changes in Analysts' Stock Recommendations* 6–7 (Apr. 7, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2421801.

286. *See, e.g.*, Nadia Massoud et al., *Do Hedge Funds Trade on Private Information? Evidence from Syndicated Lending and Short-Selling*, 99 J. FIN. ECON. 477, 477–98 (2011) (finding that a number of hedge fund participants in syndicated lending deals are short-selling equity of borrowers before loan originations are publicly announced); David H. Solomon & Eugene F. Soltes, *What are We Meeting For? The Consequences of Private Meetings with Investors*, 58 J. L & ECON (forthcoming 2015-16) (finding that hedge fund advisers who meet privately with management make more profitable trading decisions than other categories of investors as a result of those meetings); Meng Gao & Jiekun Huang, *Capitalizing on Capitol Hill: Informed Trading by Hedge Fund Managers* (June 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707181## (finding evidence that hedge fund managers gain an informational advantage in securities trading due to connections with lobbyists).

287. Klein et al., *supra* note 285, at 6.

288. *Id.* at 3.

289. *Id.* at 4.

290. *See generally* Rui Dai et al., *Hedge Funds in M&A Deals: Is There Exploitation of Private Information?*, (Jan. 11, 2011), (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1742641) (explaining how hedge funds abuse private insider information by disclosing before the announcement of a merger or acquisition).

291. *Id.* at 6.

strategy proved to be very profitable for this subset of funds.[292]

The implications of these studies are indeed debatable. Some results can be attributed to heightened skill in processing information, and others may imply that private fund advisers are systematically engaged in illegal insider trading activities. Attributing the appropriate causes to these clearly identifiable results is an admittedly difficult task. Even still, acknowledging that private funds have exclusive access to information regarding a broad spectrum of financial instruments is important for assessing the adverse impacts of the current regulatory climate. As this industry continues to grow, the general public will face growing inequities in terms of access to strategies, as well as access to information that is integral to understanding the increasing interconnectedness of the markets.

IV. BROADER IMPLICATIONS

This Part sheds light on the broader implications of the growing inequities discussed herein. For the most part, retail investors are facing unique financial challenges, some of which include dwindling retirement accounts and declining property values. These challenges are likely adding to the unfortunate disappearance of the middle class. Creating a framework that allows elite investors to have disproportionate access to a variety of strategies and information could potentially aggravate these issues and further deepen the already embarrassing income gap between the wealthy and the average investor.

A. Unique Financial Challenges Facing Retail Investors

Easing the regulatory burdens for private funds seems to embody one of the primary goals of the current regulatory climate. Academics have even called into question the underlying meaning of the term "public" as the JOBS Act, and other regulatory reforms, have gradually chipped away at the boundary between public and private vehicles.[293] Despite the fact that these increased freedoms could facilitate capital formation in the broader economy, they will inevitably lead to even greater inequities between elite and average investors. Professor Gubler identifies this phenomenon as the "crowding out" of the retail investor.[294] He specifically states that "[a]s the private securities market expands, the retail investor is crowded out, and the model of

292. *Id.*

293. *See generally* Langevoort & Thompson, *supra* note 147; Hillary A. Sale, *The New 'Public' Corporation,* 74 L. & CONTEMP. PROBS. 137 (2011).

294. Gubler, *supra* note 24, at 799–801.

democratic capitalism that has defined the American corporate landscape for nearly a century is upended."[295] The fact that retail investors are often excluded from a massive and growing market that could greatly improve portfolio diversification, as well as access to information related to mutual fund investments, seems to undercut notions of freedom and equity implicit in a free market economy.

The regulatory justification for this divide is rooted in investor protection principles, as the law recognizes that the general public may not have the financial acumen or the resources to appropriately protect themselves against riskier investments. Yet, as the private industry continues to grow and extend its reach to the general public, albeit indirectly through systemic risk and retailization, these investor protection rationales become less convincing.[296] Given the exponential growth of the private fund industry, if a systemic risk event should occur with respect to a private fund, or a group of private funds, the entire economy would be at risk.[297] This Article does not suggest that investor protection should be completely disregarded for the sake of expanding investment opportunities for the general public. Rather, it asserts that inequitable opportunities should be systematically researched by a variety of disciplines, particularly since the economic conditions facing retail investors are dire.

As retail investors face dwindling retirement and savings accounts, an increasing retirement age, and decreasing property values, the disparities created by this divide become more problematic and more difficult to justify. Several politicians and commentators have highlighted the growing woes for middle class Americans, even when such families come from two-income households.[298] The Great Recession annihilated the retirement income for the general public as millions of 401(k) accounts, which largely depend on mutual fund

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295. *Id.*

296. *See generally* Martin, *Private Investment Companies*, *supra* note 37 (discussing the extent to which investor protection principles have been undermined by the sophisticated investor exemption).

297. Andrew Lo, Professor, Mass. Inst. Tech., Written Testimony for the U.S. House of Representatives Committee on Oversight and Government Reform 8–11 (Nov. 13, 2008) (transcript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217).

298. *See generally* ELIZABETH WARREN & AMEILIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS PARENTS ARE GOING BROKE (2003); Jan Diehm & Katy Hall, *Middle Class Jobs, Income Quickly Disappearing*, HUFFINGTON POST (Nov. 11, 2013), http://www.huffingtonpost.com/2013/06/06/middle-class-jobs-income-_n_3386157.html; Roger Runningen, *Obama Highlights Middle-Class Struggles*, *Stalled Congress*, BLOOMBERG NEWS (July 30, 2014), http://www.bloomberg.com/news/2014-07-30/obama-highlights-middle-class-struggles-stalled-congress.html (asserting that President Obama has routinely advocated to increase support for the disappearing middle class).

investments, rapidly declined in value. Some estimates have found that the Great Recession "reduced the median balance in 401(k)s by a third between 2007 and 2008."[299] According to a recent Gallop poll, 59% of Americans have identified retirement as their highest financial concern.[300] Moreover, close to 25% of the workforce has postponed their retirement and 61% are saving little to nothing.[301] They are essentially living paycheck to paycheck.[302] It is also questionable whether the government-funded social security program is sustainable in the long run, which is compounded by the fact that by 2040, there will be approximately 40 million additional senior citizens living in the United States.[303]

B. Growing Income Gap

While most of the American population is facing heightened financial struggles, the top earners are doing quite well. Popular discourse has recently shed light on the embarrassing yet increasing income gap between the wealthy and the average earner in this country. According to one study instituted by Emmanuel Saez of the University of California, Berkeley, the "top 1 percent [of earners] captured 93% of the income gains during the first year of recovery from the [Great Recession]."[304] On average, "more than half [of nation's income gains accrue] to the richest 1 percent [of the nation while] . . . over 6 percent of national income accru[es] to the top .01 percent of families."[305] These top earners predominantly include company executives/managers and financial company executives/managers.[306] Hedge fund managers are often the top earners in this group.[307] Professor Thomas Piketty

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299. JACOB S. HACKER & PAUL PIERSON, WINNER-TAKE-ALL POLITICS: HOW WASHINGTON MADE THE RICH RICHER AND TURNED ITS BACK ON THE MIDDLE CLASS 30 (2010).

300. Kate Rogers, *Fewer Americans Plan to Rely on 401(k) Plans in Retirement*, FOX BUS. (May 6, 2014), http://www.foxbusiness.com/personal-finance/2014/05/06/fewer-americans-plan-to-rely-on-401k-plans-in-retirement.

301. Laura Bassett, *Dwindling Retirement Savings 'Undiscussed Explosive Bomb' Of Recession*, HUFFINGTON POST (July 30, 2010), http://www.huffingtonpost.com/2010/07/30/dwindling-retirement-savi_n_665484.html.

302. *Id.*

303. Peter G. Peterson, WILL AMERICA GROW UP BEFORE IT GROWS OLD? HOW THE COMING SOCIAL SECURITY CRISIS THREATENS YOU, YOUR FAMILY, AND YOUR COUNTRY 23 (1996).

304. Emmanuel Saez, *Striking it Richer: The Evolution of Top Incomes in the United States*, http://eml.berkeley.edu/~saez/saez-UStopincomes-2013.pdf (last updated Jan. 25, 2015).

305. HACKER & PIERSON, *supra* note 299, at 17.

306. *Id.*

307. *See generally* Nathan Vardi, *The 25 Highest-Earning Hedge Fund Managers And Traders*, FORBES (Feb. 26, 2014), http://www.forbes.com/sites/nathanvardi/2014/02/26/the-highest-earning-hedge-fund-managers-and-traders/ (discussing the large sums of money earned by

likewise provides an in-depth economic analysis of both the scale and the drivers of this growing income gap.[308] He examined historical data from over twenty countries, spanning across the past two centuries, to find that the main contributor to these disparities is the troubling trend of returns on capital exceeding total economic growth.[309] He specifically states:

> The inequality *r* [return on capital] >*g* [growth] implies that wealth accumulated in the past grows more rapidly than output and wage. This inequality expresses a fundamental logical contradiction. The entrepreneur inevitably tends to become a rentier, more and more dominant over those who have nothing but their labor. Once constituted, capital reproduces itself faster and faster than output increases. The past devours the future.[310]

The implications of these disparities are a widely contested topic. On one end of the spectrum, economists have found that they are a natural result of economic growth, and that aggressively advocating for equality can actually reduce overall efficiency, weaken incentives to work, and mitigate future innovations.[311] Economists on the opposite end of this debate have found that such disparities can lead to slower economic growth, less stable expansions, and political unrest.[312] A 2011 study instituted by Andrew G. Berg and Jonathan D. Ostry of the International Monetary Fund came to similar conclusions.[313] They found that "[t]he difference between countries that can sustain rapid growth for many years or even decades and the many others that see growth spurts fade quickly may be the level of inequality. Countries may find that improving equality may also improve efficiency, understood as more sustainable long-run growth."[314] From a social and psychological perspective, others have found that severe income disparities can lead to "cycles of entitlement for the affluent and an acceptance of less equitable outcomes by the poor"[315] and that "[w]ealthy individuals are more likely to break traffic laws and cheat at games."[316] Despite where

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certain hedge fund managers in 2013).

308. *See* PIKETTY, *supra* note 33, at 15 (explaining the methodology used in the author's research).

309. *Id.*

310. *Id.* at 571.

311. *See generally* ARTHUR OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF (1975).

312. Annie Lowrey, *Costs Seen in Income Inequality*, N.Y. TIMES, Oct. 17, 2012, at B1.

313. Andrew G. Berg & Jonathan D. Ostry, *Equality and Efficiency*, 48 FIN. & DEV., Sept. 2011.

314. *Id.*

315. Sethi, *supra* note 38, at 798.

316. *Scientists Study the Negative Effects of Income Inequality*, PBS (June 25, 2013), http://www.pbs.org/newshour/extra/daily_videos/scientists-study-the-negative-effects-of-income-

one falls on this spectrum, growing inequities tend to be unsustainable and they can actually harm capital formation in the long run.[317]

The causes of the financial dilemmas facing retail investors, as well as the causes of the growing income gap, are admittedly complex. Inequitable tax rates,[318] excessive executive pay,[319] and technological innovation,[320] are a few of the contributing factors that have been researched by commentators across disciplines. It is also difficult to immediately draw a direct correlation between the structure of our federal securities laws, and the increasing divide between the wealthy and the average earner. However, this Article should at least demonstrate that more research is needed in this regard. At face value, it seems unsettling to encourage a regulatory system where top earners have access to even greater capital gains through private investments, while the general public is left with investments that are subpar. Mutual fund strategies account for an extremely narrow portion of the universe of available strategies within the broader financial sector. This inequitable access will continue to grow, as the current regulatory climate will lead to an even greater expansion of the private fund industry. The extent to which these private investments simply agitate the problematic conclusion derived by Professor Piketty, in that returns on capital exceed economic growth, likewise needs to be further researched. Certain private vehicles could be utilizing strategies that do not promote overall economic growth by encouraging naked speculation and other problematic innovations. This is yet another hotly contested topic that warrants additional investigation.

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inequality/.

317. *See generally* STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW (N.Y. Univ. Press, 2014) (arguing that the concentration of political and economic power among the "super" elite, particularly in the context of the recent subprime mortgage crisis, can actually nullify the positive aspects of capitalism in the long run).

318. THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R42729, TAXES AND THE ECONOMY: AN ECONOMIC ANALYSIS OF THE TOP TAX RATES SINCE 1945, at 16 (2012), ("[C]hanges over the past 65 years in the top marginal tax rate and the top capital gains tax rate do not appear correlated with economic growth. The reduction in the top tax rates appears to be uncorrelated with saving, investment, and productivity growth. The top tax rates appear to have little or no relation to the size of the economic pie.").

319. Roberto A. Ferdman, *The Pay Gap Between CEOs and Workers Is Much Worse than You Realize*, WASH. POST (Sept. 25, 2014), http://www.washingtonpost.com/news/wonkblog/wp/2014/09/25/the-pay-gap-between-ceos-and-workers-is-much-worse-than-you-realize/.

320. Philippe Aghion et al., *Innovation and Top Income Inequality* 1 (Nat'l Bureau of Econ. Research, Working Paper 21247, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2617607 ("[T]he rise in top income shares is partly related to innovation-led growth, where innovation itself fosters social mobility at the top through creative destruction.").

CONCLUSION: STUCK BETWEEN A ROCK AND A HARD PLACE

Crafting a viable solution highlights the unique challenges of applying a reliable cost-benefit analysis to new regulations in light of the growing complexities of the financial markets. For example, loosening the antiquated trading restrictions that apply to mutual fund investments would allow advisers to employ strategies that could further protect investors in declining markets. This would create better opportunities for wealth maximization and diversification for the general public. And because mutual funds are subject to the detailed registration requirements under the Company Act (and other enhancements under the Dodd-Frank Act), retail investors would still be given appropriate investor protections through mandated disclosures and other heightened governance requirements. These provisions could also serve to mitigate systemic risk as the resulting transparency can "weed out" speculative activities that are in fact harmful to the economy.

However, the costs to market integrity and investor protection could be monumental. Contrary to the previous assertion, loosening these restrictions could also increase the collective levels of speculative trading activity, which in itself is difficult to appropriately quantify. John Bogle, a notable expert in the mutual fund industry, has insistently noted the risks of increasing speculation in the broader economy.[321] Exclusively profiting from the short-term prices movements in instruments, as opposed to making long-term investments in companies, could arguably compromise economic growth. Moreover, increased flexibilities granted to mutual fund advisers could result in heightened litigation costs with respect to insider trading violations if advisers do in fact gain increased access to information.

Alternatively, specific limitations could be imposed on private funds' leverage exposure and related derivatives trading activities. This would level the playing field for retail investors and simultaneously reduce systemic risk as excessive leverage could expose the general public to substantial harms. Nevertheless, the costs of limiting such activities could unduly constrain capital formation. This is further complicated by the fact that pension funds and other institutional investors (that are comprised of underlying retail investors) are increasingly investing in these vehicles. Choosing appropriate caps would also seem like an arbitrary endeavor as it is not clear that our regulators have sufficient expertise to properly assess the long-term impacts of such a

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321. *See generally* JOHN C. BOGLE, THE CLASH OF THE CULTURES: INVESTMENT VS. SPECULATION (2012) (arguing that excessive speculation can divert capital from its optimal use).

monumental change. Enforcing such caps could be problematic as well, because the SEC and the CFTC are already faced with limited resources.

There is a plethora of both doctrinal and empirical research that supports both of these positions, each of which are rooted in a rich history of legal and economic theories. But much of this research is limited by a pervasive lack of coordination regarding the broad spectrum of areas that are implicated by these complex and evolving issues. This is particularly troubling because this area produces a large volume of new regulations on an annual basis, and the SEC, as well as Congress, is required to incorporate a cost-benefit analysis before adopting each rule. In the event of a financial crisis, Congress hurriedly produces corrective legislation to quiet public uproar. As a result, it is often unclear whether the legislation is closely tailored to the problems at hand. Furthermore, lawyers are often limited in their overall knowledge of the financial markets, even though they are the primary drafters and enforcers of new and existing rules. For instance, Bernie Madoff evaded the SEC for years despite the SEC being tipped off by a whistleblower and being subsequently registered under the Advisers Act.[322]

In order to effectively incorporate a reliable cost-benefit analysis in the context of minimizing the inequities discussed herein, a greater effort must be undertaken by our regulators to aggressively study these issues from the perspective of a wide range of experts (e.g., legal, economic, financial, banking, quantitative analysis, etc.). The SEC made recent improvements in this area when it created the Division of Economic and Risk Analysis ("DERA") in September 2009.[323] This division was designed to "integrate financial economics and rigorous data analytics into the core mission of the SEC"[324] and it "relies on a variety of academic disciplines, quantitative and non-quantitative approaches, and knowledge of market institutions and practices to help the Commission approach complex matters in a fresh light."[325] The DERA is also comprised of the Office of Asset Management which "[p]rovides economic and other interdisciplinary analysis in support of the Commission on issues related to the regulation of investment advisers, investment companies, hedge funds, and other institutional

322. Robert Chew, *A Madoff Whistle-Blower Tells His Story*, TIME (Feb. 4, 2009), http://content.time.com/time/business/article/0,8599,1877181,00.html.

323. *About Division of Economic and Risk Analysis*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/dera/Article/about.html (last visited Sept. 8, 2015).

324. *Id.*

325. *Id.*

investors."[326] Creating this division has undoubtedly assisted the SEC in exploring these emerging developments from a variety of perspectives. Heightened coordination is needed particularly with respect to private actors in the private fund industry to deepen the SEC's familiarity with innovative products and strategies. This heightened coordination could perhaps happen through an intensive study conducted through the DERA. From an even broader perspective, a greater commitment by law schools to further develop the curricula related to financial regulation should also be undertaken. This would further ensure that new lawyers are exposed to these pertinent issues at earlier points in their careers.

In addition, the SEC has only partial jurisdiction over the instruments traded by investment funds. The SEC has direct jurisdiction to supervise the securities industry,[327] and the CFTC is authorized to supervise the bulk of the derivatives industry.[328] Investment companies that trade in both securities and derivatives must therefore comply with the arduous registration requirements of these two separate regimes. This creates several inefficiencies in producing optimal regulation and has even been identified as a culprit in failing to foresee numerous financial crises.[329] As these two industries have become increasingly interwoven,[330] both agencies must combine their resources to develop an optimal solution for the growing inequities facing retail investors. This could perhaps be accomplished through the creation of a joint advisory commission of the SEC and the CFTC, comprised of experts from both the public and private sectors. This commission would be committed to the ongoing task of collecting and studying information related to the financial markets, in an effort to enhance the factors that are used to implement an effective cost-benefit analysis.

Overall, the importance of these issues should be duly noted and further researched by a variety of disciplines. Financial innovation has been expertly mined by a growing private industry while antiquated regulations have excluded retail investors from many of the resulting benefits. These inequities will only serve to further aggravate the

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326. *Id.*

327. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last visited Sept. 8, 2015).

328. *Mission and Responsibilities*, U.S. COMMODITIES FUTURES COMM'N, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Sept. 8, 2015).

329. Jerry Markham, *Merging the CFTC and SEC—Clash of Cultures*, 78 U. CIN. L. REV. 537, 572 (2009).

330. *Id.* at 587.

already dire financial challenges facing the average investor. The need for effective regulations that minimize the costs incurred to both individual investors and society at large is pressing. The markets have grown exceedingly complex and developing sound regulations, as opposed to regulations that simply serve the highest bidder or that are passed in haste to quiet public uproar, will inevitably entail enhanced coordination between the SEC and the CFTC, and improved collaboration with related industries (e.g., economic, financial, banking, quantitative analysis, etc.). These suggestions, of course, necessitate further analysis and will likely form the basis for my future research.