THE SYSTEMIC RISK OF PRIVATE FUNDS AFTER THE DODD-FRANK ACT

BY

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ABSTRACT

The Financial Stability Oversight Council (FSOC) was created under the Dodd-Frank Act with the primary mandate of guarding against systemic risk and correcting perceived regulatory weaknesses that may have contributed to the financial crisis of 2008-09. The SEC collects data pertaining to private fund advisers in order to facilitate the FSOC's assessment of non-bank financial institutions' potential systemic risks. Evidence that the SEC's data collection encounters accuracy and consistency problems might hamper the FSOC's ability to evaluate the systemic risk of private fund advisers. The author shows that while the SEC's data plays a crucial role in all stages of FSOC's systemic risk assessment of private fund advisers, the FSOC relies most heavily on some of the most problematic disclosure items collected by the SEC.

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I. Introduction

The possible systemic risk posed by the private fund industry has been the subject of a long policy debate. Prior to the financial crisis of 2008 and 2009, the demise of large private funds[1] seemed to highlight the potential systemic risk posed by the private fund industry.[2] The retailization of the hedge fund industry,[3] and increasing hedge fund

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[1] Prominent examples include: Long-Term Capital Management (LTCM) in 1998*, see* Philippe Jorion, *Risk Management Lessons from Long-Term Capital Management*, 6 EUR. FIN. MGMT. 277 (2000) (drawing risk management lessons from LTCM); Paul N. Roth & Brian H. Fortune, *Hedge Fund Regulation in the Aftermath of Long-Term Capital Management*, *in* HEDGE FUNDS: LAW AND REGULATION 83 (Iain Cullen & Helen Parry eds., 2001) (describing the industry response to LTCM's collapse); Amaranth in 2006, René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSP. 175, 188 (2007) ("[T]he Amaranth losses led to calls for regulation of hedge funds."); *see* Ludwig B. Chincarini, *The Amaranth Debacle: A Failure of Risk Measures or a Failure of Risk Management?*, 10 J. ALTERNATIVE INV. 91, 92 (2007) (analyzing "the causes and details of the collapse of Amaranth"); other massive hedge fund failures such as Bailey Coates, Bayou Management, Cromwell Fund, Philadelphia Alternative Asset Management, Marin Capital, Aman Capital Global, Tiger Funds, Eifuku Master Trust, Lyceum Capital, and Wood River Partners. *See* MARK JICKLING & ALISON A. RAAB, CONG. RESEARCH SERV., RL33746, HEDGE FUND FAILURES 5–9 (2006).

[2] Ben S. Bernanke, Chairman, Bd. Of Governors of the U.S. Fed. Reserve Sys., Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/Bernanke20060516a.htm ("Following the LTCM crisis and the publication of the Working Group's recommendations, the debate about hedge funds and the broader effects of their activities on financial markets abated for a time. That debate, however, has now resumed with vigor—spurred, no doubt, by the creation of many new funds, large reported inflows to funds, and a broadening investor base. Renewed discussion of hedge funds and of their benefits and risks has in turn led to calls for authorities to implement new policies, many of which will be topics of this conference. . . . Authorities' primary task is to guard against a return of the weak market discipline that left major market participants overly vulnerable to market shocks. Continued focus on counterparty risk management is likely the best course for addressing systemic concerns related to hedge funds."); *See Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 109th Cong. 31 (2006) (statement of Christopher Cox, Chairman, SEC) ("[H]ad the Federal Reserve Bank of New York not intervened to organize a $3.6 billion bailout by the fund's creditor banks, the bankruptcy of LTCM 'could have potentially impaired the economies of many nations, including our own.'").

[3] *See generally* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 REV. BANKING & FIN. L. 581 (2009); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,058 (Dec. 10, 2004) (codified as amended at 17 C.F.R. pts. 275 & 279) ("Investors that have not been traditional hedge fund investors, including pension plans that have millions of beneficiaries, are thus today purchasing hedge funds. As a result of the participation by these entities in hedge funds, the assets of these entities are exposed to the risks of hedge fund investing. Losses resulting from hedge fund investing and hedge fund frauds may affect the entities' obligations to their beneficiaries or pursue other intended purposes."); Nicholas Chan et al., *Systemic Risk and Hedge Funds* (Nat'l Bureau of Econ. Research, Working Paper No. 11200, 2005), *available at* http://www.nber.org/papers/w11200 ("[S]ince the collapse of Long Term Capital Management in 1998, it has become clear that hedge funds are also involved in systemic risk exposures. The hedge-fund industry has a symbiotic relationship with the banking sector, and many banks now operate proprietary trading units that are organized much like hedge funds. As a result, the risk exposures of the hedge fund industry may have a material impact on the banking sector, resulting in new sources of systemic risks."); *see also Hearing on the Nomination of William H. Donaldson, of New York, To Be a Member of the U.S. Securities and Exchange Commission Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. 1, 37 (2003) (statement of William

adviser fraud[4] further increased demands for a heightened level of supervision for the private fund industry.[5] During[6] and after the financial crisis, many commentators blamed the private fund industry for taking excessive risks that destabilized the economy and contributed to the financial crisis.[7] Only a minority of scholars opined that private funds were not to blame.[8] More recent studies suggest that financial markets may be destabilized by private funds.[9]

H. Donaldson), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-108shrg90929/pdf/CHRG-108shrg90929.pdf (describing the retailization of hedge funds as a "distressing move"). *But see* U.S. SEC. & EXCH. COMM'N, STAFF REPORT: IMPLICATIONS ON THE GROWTH OF HEDGE FUNDS 80 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf ("[T]he staff has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds.");

[4] Majed R. Muhtaseb & Chun Chun "Sylvia" Yang, *Portraits of Five Hedge Fund Fraud Cases*, 15 J. FIN. CRIME 179 (2008) (identifying fraud committed by hedge funds); Franklin R. Edwards, *New Proposals to Regulate Hedge Funds: SEC Rule 203(b)(3)-2* (APEC Study Center, Columbia Univ. Discussion Paper No. 35, 2004), http://www8.gsb.columbia.edu/apec/sites/apec/files/files/discussion/35EdwardsHedge.pdf (examining the Commission's new proposal to address its current concerns about hedge funds, rule 203(b)(3)-2, which would require the registration of most advisers to hedge funds with the SEC); Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (June 22, 2011), *available at* http://www.sec.gov/news/press/2011/2011-133.htm ("These reporting requirements are designed to help identify practices that may harm investors, deter advisers' fraud, and facilitate earlier discovery of potential misconduct."); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,078 (Dec. 10, 2004) ("Registration allows us to conduct examinations of hedge fund advisers, and our examinations provide a strong deterrent to advisers' fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur.").

[5] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,077, 72,080.

[6] *Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 4 (2007) (statement of Rep. Spencer Bauchus); *Id.* at 8 (statement of E. Gerald Corrigan, Managing Director, Goldman Sachs & Company); Jón Daníelsson & Jean-Pierre Zigrand, *Regulating Hedge Funds*, 10 FIN. STABILITY REV. 29, 30 (2007) ("Hedge funds do . . . contribute to systemic risk whereby the failure of a systemically important hedge fund has the potential to create sufficient uncertainty in the markets for liquidity to dry up and for trading to cease with potentially costly consequences.").

[7] 155 CONG. REC. 30,851 (2009) (statement of Rep. Sheila Jackson-Lee) ("[The Dodd-Frank Act will] provide[] more transparency and tougher regulation of hedge funds, private equity firms, and credit rating agencies, whose seal of approval gave way to excessively risky practices that led to a financial collapse.").

[8] Andrew W. Lo, *Regulatory Reform in the Wake of the Financial Crisis of 2007-2008*, 1 J. FIN. ECON. POL'Y 4, 16 (2009) ("While the shadow banking system has no doubt contributed to systemic risk in the financial industry, hedge funds have played only a minor role in the current financial crisis, as evidenced by the lack of attention they have received in the government's recent bailout efforts."); Roberta Romano, *Against Financial Regulation Harmonization: A Comment* 3 (Yale Law & Econ., Research Paper No. 414, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 ("[T]here is an absence of evidence pointing to hedge funds as a contributing factor in the recent financial panic."); *See also* Stephen Brown et al., *Hedge Funds After Dodd-Frank*, NYU STERN SCH. BUS. (July 19, 2010, 3:41 PM), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html (assessing hedge funds' lack of contribution to systemic risk in general and during the recent crisis).

[9] See further summary of literature in Part II below. *See, e.g.*, Reint Gropp, *How Important Are Hedge Funds in a Crisis?*, FRBSF Economic Letter, Apr. 4, 2014, at 4, *available at* http://www.frbsf.org/economic-research/publications/economic-letter/2014/april/hedge-fund-risk-measurement-spillover-economic-crisis/ (finding "that hedge funds may play an even more prominent role in transmitting shocks to the rest of the financial market, and thus may amplify systemic risk more than previously thought."). *See also* Tobias Adrian et al., *Hedge Fund Tail Risk*, *in* QUANTIFYING SYSTEMIC RISK 155, 155 (Joseph G. Haubrich & Andrew W. Lo eds., 2013) ("While hedge funds are liquidity providers in usual times, during times of market crisis, they can be forced to delever, potentially contributing to market volatility."); Photis Lysandrou, *The Primacy of Hedge Funds in the Subprime Crisis*,

In part in reaction to the systemic risk concerns posed by the private fund industry,[10] Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[11] The Dodd-Frank Act defines potential systemic risk posed by a U.S. or foreign nonbank financial entity as the "material financial distress at the [company], or the nature, scope, size, scale, concentration,

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34 J. POST KEYNESIAN ECON. 225, 227 (2012) ("Take away hedge funds and a general financial crisis could still have occurred in 2007–8, but it is only because of the hedge funds that the crisis that actually occurred initially took on the specific form of a subprime crisis."); John Kambhu et al., *Hedge Funds, Financial Intermediation, and Systemic Risk* 11–12, 291 FED. RES. BANK OF NEW YORK STAFF REP. 1, 11 (2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003210 ("If systemic risk is fundamentally about financial markets linkages to the real economy, then hedge funds create systemic risk to the extent that they can disrupt the ability of financial intermediaries or financial markets to efficiently provide credit. . . . [B]anks' direct exposure to hedge funds has been growing proportionately with the hedge fund industry itself."); Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds* 10 (Nov. 13, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217 ("[O]ver the past decade, these investors and funds have become central to the global financial system, providing loans, liquidity, insurance, risk-sharing, and other importan[t] services that used to be the exclusive domain of banks. But unlike banks—which are highly regulated entities (but less so, since the repeal of the Glass Steagall Act in 1999), with specific capital adequacy requirements and leverage and risk constraints—hedge funds and their investors are relatively unconstrained. . . . [Hedge funds] can also cause market dislocation in crowded markets with participants that are not fully aware of or prepared for the crowdedness of their investments.").

[10] Following the financial crisis, there were a number of calls both in the Department of Treasury and Congress to create procedures to deal with the systemic risk posed by private funds. *Perspectives on Hedge Fund Registration: Hearing on H.R. 711 Before the Subcomm. On Capital Mkt., Ins., and Gov't Sponsored Enterprises of the H. Comm. On Financial Services*, 111th Cong. 6 (2009) (statement of Rep. David Scott, Member, Subcomm. On Capital Mkt., Ins. and Gov't Sponsored Enterprises) ("It is of utmost importance that we continue to assess systemic risk related to these funds, as well as how their processes might be improved to ensure our financial markets are more secure in the future. Hedge funds indeed hold unmatched sway over our markets, and I believe supervisors must have the necessary tools to effectively monitor the systemic risk posed by hedge funds, improve market surveillance, assure effective oversight, and improve transparency of the level of risk in the financial markets related to hedge funds."); U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 3 (2009), *available at* http http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf ("Financial institutions that are critical to market functioning should be subject to strong oversight. No financial firm that poses a significant risk to the financial system should be unregulated or weakly regulated. We need clear accountability in financial oversight and supervision. We propose…….The registration of advisers of hedge funds and other private pools of capital with the SEC.") When Dodd-Frank was making its way through conference, the bills new regulatory controls to deal with private funds' risks were mentioned by members as a reason to pass the legislation. 156 Cong. Rec. H5233, at H5238 (daily ed. June 30, 2010) (statement of Rep. Kanjorski, Conference Report on H.R. 4173). ("The bill that we are considering today contains a number of other worthwhile elements that should become law…….[such as] the registration of hedge fund managers and private equity fund advisers. To promote market integrity, we need those individuals who handle large sums of money and assets to register with the SEC and provide information about their trades and portfolios. While I remain concerned about the registration exemptions put in place by others during the legislative process, I believe that these reforms are necessary to improve the quality of regulation and protect against systemic risk. While hedge funds may not have directly caused this latest financial crisis, we do know that these investment vehicles have previously contributed to significant market instability, as was the case in the collapse of Long-Term Capital Management in 1998. Thus, this reform is an important step in understanding and controlling systemic risk.")

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

interconnectedness, or mix of the activities of the [company that], could pose a threat to the financial stability of the United States."[12]

To address concerns about the private fund industry's possible systemic risk, the Dodd-Frank Act authorized the SEC to promulgate rules requiring registration and enhanced disclosure for private funds advisers,[13] and facilitating data collection for the assessment of systemic risk. To fulfill its data collection obligations under the Dodd-Frank Act, the SEC Division of Investment Management adopted Form PF.[14] Form PF requires private fund advisers to disclose their strategies, products, performance, changes in performance, financing information, risks metrics, counterparties and credit exposure, percentage of assets traded using algorithms, and the percentage of equity and debt, among others.[15]

The reporting requirements in Form PF are intended to enable the FSOC,[16] a council of banking and securities regulators tasked with the monitoring of systemic risk in U.S. financial markets, to fulfill its mandate.[17] The FSOC was created under the Dodd-Frank Act[18] with the mandate to correct perceived regulatory weaknesses that may have

[12] *Id*. at § 113(a)(1); *See also* W. Avery, Kathleen A. Scott & Lindsey Carson, *Dodd-Frank Act Attempts to Curtail Systemic Risk*, 127 BANKING L.J. 766, 768 (2010).
[13] Dodd-Frank Act §§ 402–408.
[14] *See* 17 C.F.R. § 275.204(b)-1; Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011)(codified as amended at 17 C.F.R. pts. 275 & 279); SEC. & EXCH. COMM'N, OMB No. 3235-0679, FORM PF, REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS (2011) [hereinafter Form PF], *available at* http://www.sec.gov/about/forms/formpf.pdf; SEC. & EXCH. COMM'N, OMB No. 3235-0049, FORM ADV, UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION AND REPORT BY EXEMPT REPORTING ADVISERS [hereinafter FORM ADV], *available at* http://www.sec.gov/about/forms/formadv.pdf.
[15] Form PF, *supra* note 14.
[16] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,128-32 (establishing the FSOC to monitor and assess risks to the U.S. financial system and to promote financial stability); *Id*. at 71,142 ("Form PF has been designed to collect information to assist FSOC in monitoring and assessing systemic risks that private funds may pose . . . ."); Dodd-Frank Act § 112(a)(2)(A) (authorizing the FSOC to collect information to support its functions).
[17] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,129; *see also* Dodd-Frank Act § 112(a)(2)(A)-(C) ("The purposes of the Council are—(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system."); EDWARD V. MURPHY & MICHAEL B. BERNIER, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK (2011), *available at* http://www.llsdc.org/assets/DoddFrankdocs/crs-r42083.pdf (describing the mission, membership, and scope of the FSOC and providing an analysis of FSOC-related policy issues Congress may face); Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation,* 37 J. CORP. L. 621, 627 (2012) (explaining the FSOC's charge to monitor and regulate systemic risk "throughout the entire U.S. financial sector"); Jason Rudderman, Article, *Eliminating Wall Street's Safety Net: How a Systemic Risk Premium Can Solve "Too Big To Fail"*, 11 FLA. ST. U. BUS. REV. 39, 46 (2012) (describing the responsibilities tasked to the FSOC).
[18] Dodd-Frank Act § 111.

contributed to the financial crisis of 2008-09, including the insufficient supervision of large non-bank financial institutions, the complexity of financial institutions and the lack of coordination among financial regulators.[19] The data collected via Form PF has been tailored primarily for the use of the FSOC.[20] The role of Form PF involved not only collecting the necessary data to aid in the process of designating systemically significant financial institutions, but also serving the additional role of providing the FSOC with information to assess the risk of the private fund industry within the financial system as a whole.[21]

Several observations from previous studies and anecdotal evidence suggest that the mandated data collection in Form PF could create issues for FSOC in evaluating the systemic risk of hedge funds.[22] Despite overall acceptance of Form PF by the private fund industry, the core challenges for the SEC in Form PF include: the ambiguity of several questions on Form PF, private fund advisers' disagreement with the definition of funds in Form PF and corresponding insufficiency of SEC guidance, insufficiency of private fund advisers' existing reporting systems, and challenges in aggregating the required Form PF data.[23]

This Article evaluates the feasibility of FSOC's assessments of private funds' systemic risk in light of the identified core challenges for Form PF. Part I provides a basic overview of the ideas presented in this Article and introduces the debate over hedge funds' systemic risk. Part II introduces the debate and literature on private funds' systemic risk. After a short introduction of the history of private fund transparency in the United States, Part III describes the legal requirements and private fund advisers' data collection obligations under the SEC's Form PF before assessing the FSOC's utilization of Form PF data in Part IV. In Part V, the author introduces evidence from prior empirical studies suggesting that the data reported by private funds in Form PF could be suboptimal. Based on these findings, the author evaluates possible challenges for the systemic risk analysis performed by FSOC and the SEC as it pertains to private funds. Part IV concludes.

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[19] *See generally*, MURPHY, *supra* note 17, at 1-2; Ben S. Bernanke, Chairman, Bd. Of Governors of the U.S. Fed. Reserve Sys., Speech at the 47th Annual Conference on Bank Structure and Competition: Implementing a Macroprudential Approach to Supervision and Regulation (May 5, 2011) [hereinafter Bernanke Speech 2011], *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm; Emerich Gutter, *Too-Big-to-Fail and the Financial Stability Oversight Council*, Developments in Bank and Financial Law, 30 REV. BANKING & FIN. L. 73 (2010); Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CAL. L. REV. 327, 369-70 (2013); EDWARD V. MURPHY, CONG. RESEARCH SERV., R43087, WHO REGULATES WHOM AND HOW? AN OVERVIEW OF U.S. FINANCIAL REGULATORY POLICY FOR BANKING AND SECURITIES MARKETS (2013), at 16-17, *available at* http://digitalcommons.ilr.cornell.edu/key_workplace/1148/). law

[20] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128, 71,129-71,130 (Nov. 16, 2011) (codified as amended 17 C.F.R. pts. 275 and 279) (suggesting that SEC would not necessarily have required the same level of reporting had the information reported on Form PF been intended for the sole use of the SEC).

[21] *Securities/Section 20/Broker-Dealer*, 40 BANKING & FIN. SERVICES POL'Y REP 26 (Dec. 2011).

[22] Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act,* 50 SAN DIEGO L. REV. 244-322 (2013) [hereinafter Kaal Registration]; Wulf A. Kaal, *The Effect of Private Fund Disclosures under the Dodd-Frank* Act (forthcoming) [hereinafter Kaal Disclosure].

[23] *Id.*

II. Systemic Risk of Private Funds

The debate on private funds' systemic risk has taken place primarily in two major phases. One of the key events that triggered debate regarding private fund systemic risk was the 1998 collapse of Long-Term Capital Management (LTCM) and the bailout orchestrated by the New York Federal Reserve Bank.[24] Some argued that the proliferation of hedge funds in combination with their risk/reward profile made hedge funds systemically risky.[25] Others found that hedge funds can create market events such as the Long-Term Capital Management failure, which in turn can turn into global financial crises if there are many highly leveraged funds with illiquid portfolios and if those funds are obligors of a small number of major financial institutions.[26] In addition to posing a direct systemic risk by damaging systemically important financial institutions, hedge funds can also pose an indirect threat to the financial system by generating a liquidity shock and increasing market volatility in key markets.[27] Yet other scholars saw the combination of leverage and the complexity of hedge funds' transactions employing derivative instruments and non-exchange traded derivative instruments as the main concerns in the field of hedge funds' systemic risk.[28] Hedge funds' systemic risk is mainly the result of their pursuit of aggressive investment strategies and a significant level of leverage in combination with adverse fluctuations in market prices that can dry up credit and negatively affect the market price of collateral.[29]

The 2008-09 global financial crisis changed market conditions and several related factors that contribute to private funds advisers' posing a possible systemic risk, precipitating the second major wave of scholarship in the context of possible systemic implications of private funds.[30] More specifically, the unprecedented growth of the

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[24] *See* Ben S. Bernanke, Chairman, Bd. Of Governors of the U.S. Fed. Reserve Sys., Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/Bernanke20060516a.htm; s*ee further supra* note 1.

[25] Nicholas Chan et al., *Do Hedge Funds Increase Systemic Risk*?, 91 FEDERAL RES. BANK OF ATLANTA ECON. REV. 49 (2006), *available at* http://www.frbatlanta.org/filelegacydocs/erq406_lo.pdf.

[26] Nicholas Chan et al., *Systemic Risk and Hedge Funds, in* THE RISKS OF FINANCIAL INSTITUTIONS 235, 236 (Mark Carey and René M. Stulz eds., 2007) (Pointing to the importance of two key themes post LTCM, liquidity and leverage, leverage can turn small losses into large losses and the more illiquid a portfolio the larger the impact of forced liquidations).

[27] Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: The State of the Debate* 1 (Discussion Paper 2007-9, 2007), *available at* http://www.bankofcanada.ca/wp-content/uploads/2010/01/dp07-9.pdf. (Suggesting that: "while the potential for a systemic risk from the hedge fund sector is considered small, the potential for *damage* from such shocks may have increased due to the increased spread, complexity, and tighter linkages of the global financial system. Going forward, the relationship between large complex financial institutions and hedge funds must be monitored closely. In terms of policy, direct regulation that increases transparency – whether of counterparty exposures or trading positions – does not appear feasible, may create a moral-hazard problem, and may reduce overall market efficiency. Indirect regulation via prime brokers, market discipline, and improved risk management practices are the most promising approaches for addressing potential risks from the hedge fund sector.").

[28] *Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 15-24 (2008) (statement of Professor David S. Ruder, Northwestern University School of Law); *see generally Id*.

[29] Anita I. Anand, *Is Systemic Risk Relevant to Securities Regulation?*, 60 U. TORONTO L.J. 941, 956 (2010)

[30] Reint Gropp, *How Important Are Hedge Funds in a Crisis?*, FRBSF Economic Letter, Apr. 4, 2014, at 1, *available at* http://www.frbsf.org/economic-research/publications/economic-letter/2014/april/hedge-fund-risk-measurement-spillover-economic-crisis/. (finding that: "financial crises amplify the spillover effects

private fund industry leading up to the financial crisis was a significant factor with knock-on effects in the changing assessment of the role of private funds' systemic risk after the financial crisis. According to some estimates, private funds surpassed banks in size and importance during and after the financial crisis.[31] The unprecedented growth in the private fund industry in combination with the low interest rate environment following the Federal Reserve's quantitative easing after the financial crisis of 2008-09 resulted in private fund managers' increasingly "reaching for yield".[32] The use of leverage and

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among certain types of financial institutions […] and hedge funds may be the most important transmitters of shocks during crises, more important than commercial banks or investment banks."); TOBIAS ADRIAN, DANIEL COVITZ & NELLIE J. LIANG, FINANCIAL STABILITY MONITORING (2013); David Easley, Maureen O'Hara & Liyan Yang, *Opaque Trading, Disclosure, and Asset Prices: Implications for Hedge Fund Regulation*, 27 REV. FIN. STUD. 1190 (2013), *available at* http://rfs.oxfordjournals.org/content/27/4/1190; Laura Zakaras, *Do Hedge Funds Pose a Systemic Risk to the Economy?,* RAND CENTER FOR CORP. ETHICS AND GOVERNANCE (2012), http://www.rand.org/pubs/research_briefs/RB9680/index1.html; Lloyd Dixon, Noreen Clancy & Krishna B. Kumar, *Hedge Funds, Systemic Risk, and Dodd-Frank: The Road Ahead,* RAND CENTER FOR CORP. ETHICS AND GOVERNANCE (2013), http://www.rand.org/pubs/conf_proceedings/CF308.html; Barbara Novick, *Systemic Risk and Asset Management: Improving the Financial Ecosystem for All Market Participants* (Harvard L. Sch. EU-US Symposium, Concept Paper, Mar. 2014), http://www.law.harvard.edu/programs/about/pifs/symposia/europe/2014-europe/hls-symposium---b-novick---final.pdf; Maria Stromqvist, *Hedge Funds and Their Impact on Systemic Stability*, *in* RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS 309 (Phoebus Athanassiou ed., 2012); Gregory W. Brown, Jeremiah Green & John R.M. Hand, *Are Hedge Funds Systemically Important?*, 20 J. DERIVATIVES 8 (2012); U.K. FIN. SERV. AUTHORITY, FINANCIAL SERVICES AUTHORITY, ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS: A REPORT ON THE FINDINGS OF THE FSA'S HEDGE FUND SURVEY AND HEDGE FUND AS COUNTERPARTY SURVEY (2012), http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-aug2012.pdf; Markus K. Brunnermeier & Martin Oehmke, *Bubbles, Financial Crises, and Systemic Risk* (NBER Working Paper Series, Working Paper No. 18398, 2012), http://www.nber.org/papers/w18398.pdf?new_window=1; Stephen J. Brown et al., *Systemic Risk and Cross-Sectional Hedge Fund Returns* (Working Paper, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2242685

[31] OFFICE OF FIN. RES., DEP'T OF THE TREASURY, ASSEST MANAGEMENT AND STABILITY 1 (2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf?n=60157 ("The U.S. asset management industry oversees the allocation of approximately $53 trillion in financial assets (see Figure 1)."); Andrew G. Haldane, Executive Director, Fin. Stability, Address at the London Business School: The Age of Assest Management? (Apr. 4, 2014, *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf; Sam Fleming, *Asset Managers Pose a Risk to Stability, Boe Warns*, THE FINANCIAL TIMES (Apr. 4, 2014), http://www.ft.com/intl/cms/s/0/d84aae26-bbda-11e3-84f1-00144feabdc0.html#axzz2zjWtcd00 (quoting Andrew Haldane, a member of the BOE's Financial Policy Committee: "although asset managers did not pose the same risks for stability as banks, their size could still damage financial markets. He said the industry, which collects $87tn globally, has the potential to cause frictions in markets such as via asset fire-sales."); Chris Flood, *Debate Over Fund Market Risks Grows*, THE FINANCIAL TIMES (Apr. 6, 2014), http://www.ft.com/cms/s/0/dd87b69c-bb38-11e3-948c-00144feabdc0.html#axzz2zjWtcd00; Huw Jones, *BoE's Haldane Says Funds Can Also Be 'Too Big to Fail'*, REUTERS (Apr. 4, 2014), http://uk.reuters.com/article/2014/04/04/uk-boe-funds-haldane-idUKBREA330EW20140404

[32] OFR, *supra* note 31, at 9; Renee Haltom, *Are the Fed's low interest rate policies pushing investors toward risk*?, ECON FOCUS, Third Quarter 2013, at 1, *available at* http://www.richmondfed.org/publications/research/econ_focus/ ("Not only have short-term rates been lower and for a longer period than in any episode since the Great Depression, but long-term rates are remarkably low as well, thanks to the Fed's unconventional monetary policies like quantitative easing and "Operation Twist". For the world's biggest bond investors, returns have been squeezed at all parts of the

complex financial transactions including derivatives to increase private fund advisers' yield expectations further increased private funds' systemic risk.[33]

Given the changing conditions for private funds, scholars evaluated several additional factors as possible sources of systemic risk in the financial system that may be associated with private fund advisers. Some of the core factors identified in the literature included: redemption risk that causes sudden reductions in funding to banks and other financial entities, insufficient credit risk transfer to private fund managers, and contagion through business relationships connecting private fund managers with their sponsors.[34]

A large part of the post-crisis debate pertained to the role of the so-called *shadow banking system* in the global financial crisis, focusing in large part on the possible systemic risk of private funds.[35] Private fund advisers can create funds that may function as a close substitute for the money-like liabilities created by banks.[36] Like banks, private fund advisers can provide liquidity to clients and to financial markets and engage in various forms of liquidity transformation. The vulnerabilities created by private fund advisers engaging in bank-like activities may have large implications for financial stability.[37]

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yield curve. This time, some Fed policymakers have also voiced concerns about reaching for yield. Fed Governor Jeremy Stein has been the most vocal detailing what he views as causes of excessive risk in a February speech, and Bernanke and Vice Chair Janet Yellen have said that the Fed is watching the issue")

[33] U.K. FIN. CONDUCT AUTHORITY, HEDGE FUND SURVEY 27 (2014), http://www.fca.org.uk/static/documents/hedge-fund-survey.pdf; Letter from Jiří Król, Deputy Chief Executive Officer Alternative Inv. Mgmt. Association, to the Secretariat of the Financial Stability Board, *available at* http://www.aima.org/objects_store/assessment_methodologies_for_identifying_nbni-g_sifis_-_response_to_consultation.pdf ("Based on available data, it is unlikely that, today, an individual hedge fund or family of funds managed by a hedge fund manager could pose systemic risk: Although the hedge fund sector has grown in recent years, collectively, it remains a small part of the financial sector as a whole, employing lower levels of leverage than the banking sector, managing more liquid portfolios and capable of managing and stemming investor redemptions in stressed market conditions.").

[34] Elias Bengtsson, *Fund Management and Systemic Risk – Lessons from the Global Financial Crisis*, 23 FIN. MKTS., INSTITUTIONS & INSTRUMENTS 101 (2014), *available at* http://onlinelibrary.wiley.com/doi/10.1111/fmii.12016/abstract; R. Glenn Hubbard, *Financial Regulatory Reform: A Progress Report*, 95 FED. RES. BANK OF ST. LOUIS REV. 181, 181 (2013) *available at* http://research.stlouisfed.org/publications/review/13/03/181-198Hubbard.pdf ("some hedge funds may pose a systemic risk to the financial system. A very large, unsustainably leveraged fund exposes a number of large financial institutions to increased counterparty risk.").

[35] *See* Anita K. Krug, *Financial Regulatory Reform and Private Funds* 2 (Berkeley Center for Law, Bus. and the Econ., White Paper, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1682623 ("More indirectly, prevalent sentiment has it that there exists a "shadow" banking system" — a swath of financial institutions that are unregulated but that engage in activities that regulated financial institutions engage in — and that, given the lack of regulatory oversight, the activities within the shadow banking system, perhaps more than the activities of regulated financial institutions, contribute to systemic risk. Typically included as participants of this shadow banking system are affiliates of brokerage firms, insurance companies, and other regulated entities, along with private investment funds, including hedge funds and private equity funds"). H. Kent Baker et al, *Hedge Funds and the Financial Crisis*, *in* ALTERNATIVE INVESTMENTS: INSTRUMENTS, PERFORMANCE, BENCHMARKS, AND STRATEGIES (2013).

[36] OFR, *supra* note 31, at 1.

[37] *Id. ("*Some activities highlighted in this report that could create vulnerabilities—if improperly managed or accompanied by the use of leverage, liquidity transformation, or funding mismatches—include risk-taking in separate accounts and reinvestment of cash collateral from securities lending.").

Recognizing the increasing risk emanating from the private fund industry in the aftermath of the financial crisis, several governmental entities and agencies issued reports on the question of the systemic risks posed by private funds.[38] The Office of Financial Research (OFR) identified several activities of hedge fund managers as important threats to the financial system, including "reaching for yield", herding, responding to investors' frequent or large-scale redemption requests, and "fire sales" of assets in a liquidity crunch.[39] Similarly, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) issued a Consultative Document suggesting a set of methods for the identification of globally active systemically important investment funds.[40] The OFR as well as FSB and IOSCO reports provide reasons as to why globally active investment funds should be designated as systemically important but differ on what specific entities in the fund structure should be considered for the systemic assessment. Although the proposed designation criteria are similar, the FSB and IOSCO emphasize the assessment of systemic importance at the *fund-level*, while the OFR suggests systemic assessment at the asset manager-level with all funds combined.[41]

In contrast with the OFR, FSB and IOSCO, the Financial Services Authority (FSA) in the United Kingdom concluded in its first comprehensive survey of London's hedge fund industry that the hedge fund industry poses no systemic risk to the financial system.[42] The FSA's report caused widespread industry endorsements.[43] The Australian

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[38] OFR, *supra* note 31, at 11; FIN. STABILITY BD. & INT'L ORG. OF SEC. COMMISSIONS, CONSULTATIVE DOCUMENT: ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (2014) [hereinafter FSB & IOSCO], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD435.pdf; FIN. STABILITY OVERSIGHT COUNCIL, 2013 ANNUAL REPORT (2013) *available at* http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2013-Annual-Report.aspx; for further analysis of FSOC's evaluation of systemic risk see Part III below.

[39] OFR, *supra* note 31, at 2.

[40] FSB & IOSCO, *supra* note 38 at 3 (identifying exposures / counterparty channel and asset liquidation / market channel as the two systemic risk transmission channels for investment funds).

[41] *See supra* note 38 at 1.

[42] U.K. FIN. SERVS. AUTHORITY, ASSESSING POSSIBLE SOURCE OF SYSTEMIC RISK FROM HEDGE FUNDS: A REPORT ON THE FINDINGS OF THE HEDGE FUND AS COUNTERPARTY SURVEY AND HEDGE FUND SURVEY (2010) (finding that: "major hedge funds did not pose a potentially destabilising credit counterparty risk across the surveyed banks. HFS data shows a relatively low level of 'leverage' under our various measures and suggests a contained level of risk from hedge funds at that time. [O]ur analysis revealed no clear evidence to suggest that, from the banks and hedge fund managers surveyed, any individual fund posed a significant systemic risk to the financial system at the time"). *Cf* INT'L ORG. OF SEC. COMM'N, REPORT ON THE SECOND IOSCO HEDGE FUND SURVEY 25 (Oct. 2013), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD427.pdf ("[…]it has not been possible at this stage to draw definitive conclusions relating to the systemic importance of the global hedge fund industry as a whole.").

[43] Press Release, Alternative Investment Management Association, Europe's Hedge Fund Industry Does Not Pose Systemic Risk (Feb. 25, 2010), *available at* http://www.aima.org/en/media/press-releases.cfm/id/F688E5B9-17B0-415A-800B2EC217FEB585 ("The Alternative Investment Management Association (AIMA) – the global hedge fund industry association – has welcomed the hedge fund survey published by the UK's Financial Services Authority which concluded that the industry does not pose a systemic risk and features relatively low levels of leverage.").

Securities and Investment Commission concurred in its assessment, concluding that the private fund industry posed no systemic concerns.[44]

Critics of the systemic risk assessments used to examine the private fund industry[45] have suggested that private fund advisers are unlikely to trigger a systemic event because losses in private investment funds are directly absorbed by the multitude of investors and their equity capital.[46] In the aftermath of LTCM, regulators have encouraged banks to monitor their private fund adviser clients through limitations on

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[44] AUSTL. SEC. & INV. COMM'N, HEDGE FUNDS NO SYSTEMIC RISK TO FINANCIAL SYSTEM 5 (2013), http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep370-published-10-September-2013.pdf/$file/rep370-published-10-September-2013.pdf (" The survey results indicate that Australian hedge funds do not currently appear to pose a systemic risk to the Australian economy .").

[45] Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel of the Managed Funds Association, to Secretariat of the Financial Stability Board (Apr. 7, 2014), *available at* https://www.managedfunds.org/wp-content/uploads/2014/04/MFA-comment-letter-on-GSIFI-assessment-methodologies.pdf ("In that regard, we generally support the FSB's and IOSCO's efforts to develop quantitative-based metrics for establishing thresholds at which investment funds might be considered to pose systemic risk, though we believe the FSB and IOSCO should modify the proposed metrics, as discussed in more detail below."); Luke Clancy, *IOSCO Report Exaggerates Hedge Fund Leverage*, Critics Claim, HEDGE FUNDS REV. (Nov. 5, 2013), http://www.risk.net/hedge-funds-review/news/2302823/iosco-report-exaggerates-hedge-fund-leverage-critics-claim ("market participants claim the [IOSCO] figures are overblown, largely because of the decision to consider derivatives exposures on a gross basis."); *ICI Responds to the FSB Consultation on Systemic Risk and Investment Funds*, INV. COMPANY INST. (Apr. 8, 2014), http://www.ici.org/viewpoints/view_14_fsb_comment ("Designation of regulated funds as "systemically important financial institutions" (SIFIs), whether in the United States or other jurisdictions, is neither necessary nor appropriate as a means to address concerns about stability of the global financial markets. The consequences of designating regulated funds would be highly adverse to the designated fund, its investors, the overall fund marketplace, and fund investing at large."); Hazel Bradford, *SIFMA Study Responds to Stability Oversight Council*, PENSIONS & INV. (Apr. 10, 2014), http://www.pionline.com/article/20140410/ONLINE/140419999/sifma-study-responds-to-stability-oversight-council ("A study released April 4 by the Securities Industry and Financial Markets Association's asset management group, which looked at nine of the largest managers with $3.86 trillion in separate account assets, found 99% of large separate accounts were invested in long-only strategies and 53% were in passively managed index strategies. Less than 4% of the firms employ leverage and less than 2% engage in securities lending. All of the responding firms monitor counterparty risk, SIFMA found."); Stephen A. Keen & C. Todd Gibson, *United States: Systemic Risk and Asset Management: Progressing from Ignorance to Confusion*, MONDAQ (Feb. 22, 2014), http://www.mondaq.com/unitedstates/x/294868/asset+finance/Systemic+Risk+And+Asset+Management+Progressing+From+Ignorance+To+Confusion (concluding that the OFR report "engaged in purely speculative assessments that ignored fundamental characteristics of the asset management business."); Emily Stephenson & Sarah N. Lynch, *U.S. Senators Slam Study on Systemic Risks Posed by Asset Managers*, REUTERS (Jan. 24, 2014) http://www.reuters.com/article/2014/01/24/us-financial-regulation-asset-idUSBREA0N1LG20140124 ("Five U.S. senators slammed a government report that raised red flags about risks posed by asset management firms in a letter to Treasury Secretary Jack Lew that was dated Thursday. The bipartisan group said the September study mischaracterized the asset management industry and in some places relied on faulty information, and that the report could threaten the credibility of the Treasury Department unit that published it.[…] The U.S. Securities and Exchange Commission, which oversees asset managers, asked for public feedback on the study, a sign that it disagreed with the OFR's findings. The OFR did the research with little input from the SEC and, as a new agency, has struggled to obtain data it needs in some cases, Reuters has reported.");

[46] Peter J. Wallison, *Unrisky Business: Asset Management Cannot Create Systemic Risk*, Am. Enter. Inst. (Jan. 13, 2014), http://www.aei.org/outlook/economics/financial-services/banking/unrisky-business-asset-management-cannot-create-systemic-risk/.

leverage.[47] The lack of financial market repercussion after the Amaranth failure seems to suggest that this approach was successful.[48]

III. Private Fund Transparency under the Dodd-Frank Act

Prior to the enactment of the Dodd-Frank Act in 2010,[49] private fund advisers were largely exempt from the securities laws provided they limited the sale of their securities to a limited number of accredited investors,[50] did not advertise or otherwise hold themselves out to the public, and limited the resale of their securities.[51] After more than sixty years of limited regulatory constraints, despite several failed attempts by the SEC to register private funds,[52] Congress enacted the Private Fund Investment Adviser Registration Act (PFIARA) under Title IV of the Dodd-Frank Act.[53]

To end the speculative trading practices and close alleged regulatory gaps that may have contributed to the 2008 financial market crisis,[54] PFIARA, by amending the

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[47] Roger Ferguson & David Laster, *Hedge Funds and Systemic Risk*, 10 FIN. STABILITY REV. 45, 45 (2007) *available at* http://www.banquefrance.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etud5_0407.pdf; *see also* Wulf A. Kaal, *Hedge Fund Regulation via Basel III*, 44 VAND. J. TRANSNATNL. L. 389, 395 (2011) (suggesting that indirect regulation of hedge funds through their relationships with banks could sufficiently curtail the hedge fund industry).

[48] Ferguson & Laster, *supra* note 47 at 45; Roberta Romano, *supra* note 8, at 3-4.

[49] *See infra* Part II.B.

[50] *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (holding that investors who met the Regulation D criteria qualified to invest in hedge funds because they could "fend for themselves"); 17 C.F.R. § 230.501(a)(5)–(6) (defining the term "accredited investor" as a natural person whose individual net worth exceeded $1 million at the time of the purchase, or whose individual income exceeded $200,000 in each of the two most recent years and who had a reasonable expectation of reaching the same income level in the year of investment). In August 2007, the SEC dramatically expanded fraud protection for investors after its defeat in attempting to require hedge fund registration. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,757 (Aug. 9, 2007) (codified as amended at 17 C.F.R. pt. 275) ("The rule prohibits advisers from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors."); Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 404 (proposed Jan. 4, 2007) ("many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments").

[51] *See* Kaal, *supra* note 47, at 412–16 (2011) (summarizing hedge fund regulation before the Dodd-Frank Act). Hedge funds, for the most part, limited the sale of their securities to accredited investors to remain exempt from registration and supervision. *See* 17 C.F.R. §230.501(a)(5) (providing a safe harbor under §4(2) of the Securities Act and defining an "accredited investor" as a person with a net worth of more than $1 million). The SEC proposed amending Regulation D, noting that inflation might have eroded the significance of a $1 million net worth as good indication of investor sophistication. *See* Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 405 (proposed Jan. 4, 2007) (proposing two steps for determining whether an investors would be accredited: (1) whether the individual meets the test in rule 501(a) or rule 215 and (2) whether the individual "owns at least $2.5 million in investments"). *But see* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756 n.2 (deferring consideration of proposed change to definition of "accredited investor")

[52] *See further* with background and historical perspective on private fund regulation under PFIARA - Kaal Registration, *supra* note 22, at 249.

[53] *See* Dodd-Frank Act §§ 401–416.

[54] *See* Tom Braithwaite, *U.S. Senate Passes Financial Reform*, FINANCIAL TIMES (July 16, 2010, 1:01 AM), http://www.ft.com/intl/cms/s/0/6b9d4542-9026-11df-ad26-00144feab49a.html#axzz2DrwfWezl ("The

Investment Advisers Act (IAA), gave the SEC authority to issue rules and regulations for the registration of private funds with the SEC,[55] increasing record keeping and disclosure.[56] Private fund advisers with more than $150 million assets under management (AUM) [57] are required to register as investment advisers and have to disclose systemically relevant information to the SEC.[58] Motivated by a desire to curtail those who operate in the shadows of our markets,[59] prevent fraud, limit systemic risk, and provide information to investors,[60] Congress authorized the SEC to collect information from registered private fund advisers. Under the Dodd-Frank Act, the SEC is also required to set up rules for the registration and reporting of hedge fund managers who were previously exempt from registration.[61]

The PFIARA also requires registered private fund advisers to maintain records and any other information the SEC and the systemic risk regulators may deem necessary and

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financial reform legislation approved by Congress today represents a welcome and far-reaching step toward preventing a replay of the recent financial crisis." (quoting Ben Bernanke) (internal quotation marks omitted)).

[55] Dodd-Frank Act § 406; 15 U.S.C. 80b-11 (West, Westlaw current through 2014 Legis. Sess.).

[56] *See* Dodd-Frank Act § 408 ("The Commission shall require investment advisers exempted by reason of this subsection to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.").

[57] Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42,955. The IAA defined Regulatory Assets Under Management (RAUM) as "the 'securities portfolios' with respect to which an adviser provides 'continuous and regular supervisory or management services.'" *Id.* (quoting Advisers Act § 203A(a)(3)). Under revised Form ADV, advisers must report their gross RAUM rather than net; this means they will no longer be able to deduct outstanding debt or other accrued but unpaid liabilities from their totals. *Id.* at 42,956. To increase consistency, revised Form ADV also gives investment advisers less room to exercise discretion in counting or excluding assets from RAUM. *Id.*; *see also id.* at 42,955. The Dodd-Frank Act gives the SEC authority to require reporting and record keeping for assets carrying systemic risk. Dodd-Frank Act, Pub L. No. 111-203, § 404, 124 Stat. 1376, 1571 (2010); Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42,955.

[58] FORM ADV, *supra* note 14, pt. 1A, at 5 (requiring exempt reporting advisers to check that they qualify for an exemption from registration: (i) "as an adviser solely to one or more venture capital funds" or (ii) because they act "solely as an adviser to *private funds* and have assets under management in the United States of less than $150 million"); *See* Dodd-Frank Act § 408 ("The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000."); *see also* Dodd-Frank Act § 403 (striking private adviser exemption under section 203(b)(3) of the Advisers Act, thereby precluding many private fund advisers from avoiding registration); Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 4 at 42,955 ("We are adopting revisions to the instructions to Part 1A of Form ADV to implement a uniform method for advisers to calculate assets under management that will be used under the Act for regulatory purposes in addition to assessing whether an adviser is eligible to register with the Commission."); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 76 Fed. Reg. 39,646, 39,666 (July 6, 2011) (codified as amended 17 C.F.R. pt. 275) (providing an exemption from registration for advisers with less than $150 million in private fund assets under management in the United States); U.S. SEC. & EXCH. COMM'N, FORM ADV: INSTRUCTIONS FOR PART 1A, at 6–9 (2011), *available at* http://www.sec.gov/about/forms/formadv-instructions.pdf (explaining how to calculate regulatory assets under management).

[59] 155 CONG. REC. 30,824 (2009) (statement of Rep. Paul Kanjorski).

[60] 156 CONG. REC. S5925–26 (daily ed. July 15, 2010) (statement of Sen. Richard Durbin).

[61] Dodd-Frank Act § 404.

appropriate to avoid systemic risk.[62] Private fund advisers are required to file confidential reports with the SEC pertaining to information related to systemic risk.[63] Required disclosures in such reports include counterparty credit risk exposures; valuation policies; trading practices; the amount of AUM; side letters; the use of leverage, including off-balance sheet leverage; and other information deemed necessary.[64]

1. Private Fund Adviser Registration and Disclosure

To implement the registration requirements under PFIARA, the SEC amended Form ADV, a disclosure document with periodic amendments.[65] Any investment adviser registering with the SEC was required to file Form ADV.[66] Amended Form ADV requires registered investment advisers and exempt reporting advisers[67] to report to the SEC information regarding the private funds they manage.[68] The required disclosures include information regarding the number and type of clients, including an assessment of the percentage of AUM attributable to each client type,[69] financial industry affiliations, non-advisory activities, the scope of services provided, investment strategy, the fund structure, ownership, the gross asset value, and the adviser's use of consultants and other gatekeepers.[70]

To help the SEC identify the entities and individuals with exposure to private fund investments, advisers are required to provide information on the type of clients they

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[62] *Id*. at §§ 404–405, § 404(b)(1)(A).
[63] *Id.* § 404(b)(3).
[64] *Id.*
[65] FORM ADV, *supra* note 14.
[66] *Id.*; *see also* 17 C.F.R. § 279.1 (2012) (establishing filing requirements for Form ADV); James F. Koehler & P. Wesley Lambert, *Impact of the Dodd-Frank and Registration Acts of 2010 on Investment Advisers*, 13 DUQ. BUS. L.J. 29, 34–35 (2011); Marybeth Sorady et al., *Summary and Analysis of Dodd-Frank Rules for Investment Advisers: Registration Requirements, Exemptions, Family Offices, Performance Fee Eligibility*, 12 J. INVEST. COMPLIANCE 4, 4 (2011); Michael P. Coakley & Matthew P. Allen, *The New Form ADV Part 2 and the "Plain English" Movement of the SEC, FINRA, and Michigan's OFIR*, 31 MICH. BUS. L.J. 19 (2011). Investment advisers that were registered with the SEC on January 1, 2012, were required to file the amendment to Form ADV by March 30, 2012. *See* 17 C.F.R. § 275.203A-5(b) (2012); *see also* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42, 950, 42,953–54 (Jul. 19, 2011) (codified as amended 7 C.F.R pt 275)(discussing rule 203A-5(b), which provides that SEC-registered advisers not required to file an annual updating amendment between January 1, 2012, and March 30, 2012, will file an other-than-annual amendment, but they will complete all of the items on Part 1A of Form ADV, not just the items required to be updated in a typical other-than-annual amendment).
[67] FORM ADV, *supra* note 14, pt. 1A, at 5–6 (requiring exempt reporting advisers to disclose only a limited subset of items on Form ADV).
[68] *Id.*
[69] FORM ADV, *supra* note 14, pt. 1A, at Item 5.C–D.
[70] Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42, 950, 42,965–66 (Jul. 19, 2011) (codified as amended 7 C.F.R pt 275) (requiring advisers to complete section 7.B.(1) of Schedule D for any private fund that the adviser manages when, previously, Item 7 required advisers only to complete section 7.B.(1) of Schedule D for "investment-related" limited partnerships or limited liability companies that the adviser or a related person advised). Part A of Section 7.B.(1) "requires an adviser to provide basic information regarding the size and organizational, operational, and investment characteristics of each fund." *Id.* at 42,965. Part B of the same section "requires advisors to report information concerning five types of [private fund] service providers that generally perform important roles as 'gatekeepers'"—which will both identify gatekeepers and give investors an idea of what kinds of roles particular gatekeepers play. *Id.* at 42,968. For example, advisers must indicate if a prime broker has custody of fund assets. *Id.* Information reported on this section of Schedule D will be publicly available. *Id.* at 42,965.

service including high net worth individuals, investment companies, banks, charities, and insurance companies.[71] Private fund advisers must also identify the type of services they provide,[72] what compensation arrangements the adviser uses,[73] and what percentage of the adviser's total RAUM is owned by a particular type of client.[74]

In order to help the SEC understand the respective adviser's business and provide the SEC with relevant data, amended Form ADV also requires advisers to disclose their clients, employees, compensation arrangements, and advisory activities.[75] Required disclosures in this context include the number of employees,[76] the number of employees who perform advisory functions, are registered representatives of broker-dealers, are registered with state authorities as investment adviser representatives, and are insurance agents,[77] and the number of nonemployees—firms or other persons—who solicit advisory clients on the adviser's behalf.[78]

To avoid potential conflicts of interest between the different types of businesses and services provided by private fund advisers,[79] amended Form ADV requires advisers to identify their types of business activity,[80] if one of those businesses is primary to the adviser,[81] and whether the adviser provides any services other than investment advice to advisory clients.[82] Advisers are also required to disclose transactions between advisers or related persons and clients because conflicts of interest may arise in such transactions.[83]

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[71] FORM ADV, *supra* note 14, at Item 5.D.(1).

[72] *Id.* at Item 5.G.; *see also id.* at Item 5.H (requiring disclosures pertaining to the number of clients the adviser provided with financial planning services); *id.* at Item 5.I (asking whether the adviser participates in a wrap fee program); *id.* at Item 5.J (asking whether the adviser previously indicated that it provides investment advice only with respect to limited types of investments).

[73] *Id.* at Item 5.E.

[74] *Id.* at Item 5.D.(2).

[75] FORM ADV, *supra* note 14, pt. 1A, at Item 5; *see* Rules Implementing Amendments to the Investment Advisers Act of 1940, *see also* 76 Fed. Reg. 42,950, 42,970 (Jul. 19, 2011) (codified as amended 7 C.F.R pt 275) (adopting amendments to Item 5 largely as they were originally proposed, with only a few minor changes).

[76] FORM ADV, *supra* note 14, pt. 1A, at Item 5.A.

[77] *Id.* at Item 5.B.

[78] *Id.*; *see also Id.* at Items 5.C, 5.H (specifically excluding as clients investors in private funds that the adviser advises unless that investor also has a separate advisory relationship with the adviser); *Id.* at Item 5.C.(1)–(2) (asking for the number of clients and what percentage are non-U.S. persons).

[79] Rules Implementing Amendments to the Investment Advisers Act of 1940, *see also* 76 Fed. Reg. 42,950, 42,970 (Jul. 19, 2011) (codified as amended at 17 C.F.R. pts. 275 & 279).

[80] FORM ADV, *supra* note 14, pt. 1A, at Item 6.A (providing that business activities include broker-dealer, futures commission merchant, real estate broker, banking, legal work, or accounting).

[81] *Id.* at Item 6.B.(1)–(2).

[82] *Id.* at Item 6.B.(3) (asking the adviser to describe other products and services).

[83] Rules Implementing Amendments to the Investment Advisers Act of 1940, *see also* 76 Fed. Reg. 42,950, 42,971 (Jul. 19, 2011) (codified as amended at 17 C.F.R. pts. 275 & 279); FORM ADV, *supra* note 14, pt. 1A, at Item 8.A (requiring disclosure as to whether the adviser or related person buys securities from or sells securities to advisory clients, buys securities for himself that he also recommends to advisory clients, or recommends securities to advisory clients in which the adviser or related person has a proprietary ownership interest other than the two described immediately above); *id.* at Item 8.B (requiring disclosure as to whether the adviser or related person acts as a broker-dealer or a registered representative of a broker-dealer in securities trades for brokerage customers in which advisory client securities are sold or bought, recommends the purchase of securities for which the adviser or related person is an underwriter, general or managing partner, or purchaser representative, or recommends purchase or sale of securities to advisory clients for which the adviser or any related person has any other sales interest); *id.* at Item 8.C (requiring disclosure as to whether the adviser or related person has discretionary authority to determine what securities should be sold on a client's account or the amount of securities to be sold on that account, to

Other required disclosures in this context include compensation for client referrals,[84] related-persons status of brokers and dealers,[85] and research or other products and services in connection with client transactions.[86]

2. Systemic Risk Data

To facilitate the FSOC's assessment of systemic risk that may result from private fund activities in the financial system of the United States,[87] the Dodd-Frank Act authorized the SEC to collect the relevant data via Form PF and tasked the SEC with providing the FSCO with the data collected via Form PF.[88] After jointly developing Form PF with the Commodity Futures Trading Commission (CFTC) and in consultation with FSOC members and several international regulators,[89] Form PF was primarily intended

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determine the broker or dealer to be used for purchases or sales for a client's account, or to determine the commission rates to be paid to a broker or dealer for a client's account).

[84] *Id.* at Items 8.H–I; *see* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42,971–72 (adopting three amendments to Item 8: (1) an adviser who indicates that he has discretionary authority to determine brokers or dealers or that recommends brokers or dealers must report whether any of those brokers or dealers are related persons; (2) advisers receiving soft dollar benefits must report whether they are eligible for research or brokerage services under § 28(e) of the Exchange Act's safe harbor; and (3) an adviser must report whether it or its related person receives direct or indirect compensation for client referrals); *see also* FORM ADV, *supra* note 14, pt. 1A, at Items 8.C.3, 8.D–F, 8.G.(2); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-54165, 71 Fed. Reg. 41,978, 41,981–82 (July 24, 2006), *available at* http://www.sec.gov/rules/interp/2006/34-54165fr.pdf (providing interpretive guidance in determining whether soft dollar benefits fit under the safe harbor of § 28(e) of the Securities Exchange Act).

[85] FORM ADV, *supra* note 14. pt. 1A at Items 8.D, 8.F.

[86] *Id*. at Item 8.G.

[87] Dodd-Frank Act, Pub. L. No. 111-203, § 404(7)(A), 124 Stat. 1376 (2010) (codified as amended 15 U.S.C. 80b-4) (under the PFIARA, the Commission is required to make available to the Financial Stability Oversight Council "copies of all reports, documents, records and information filed with or provided to the Commission" by private equity and hedge fund advisers "as the Council may consider necessary for the purpose of assessing the systemic risk posed by a private fund."); Charles K. Whitehead, *Regulating for the Next Financial Crisis*, 24 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 3, 17-18 (2011) (information the SEC gathers can be provided to the FSOC; and, in principle, that should assist efforts to assess systemic risk. The principal regulator, however, remains the SEC, with a rules-based (rather than prudential) approach to overseeing the industry."); *see generally* Cheryl Nichols, *Addressing Inept Sec Enforcement Efforts: Lessons from Madoff, the Hedge Fund Industry, and Title IV of the Dodd-Frank Act for U.S. and Global Financial Systems*, 31 NW. J. INT'L L. & BUS. 637, 683 (2011).

[88] Dodd-Frank Act, § 404(2);17 C.F.R. § 275.204(b)-1 (2012); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128, 71,140 (Nov. 16, 2011) (codified as amended at 17 C.F.R. pts. 275 & 279)(the Dodd-Frank Act amended section 204(b) of the Advisers Act in effect requiring the SEC to establish reporting and recordkeeping requirements for private fund advisers); *see also* Dodd-Frank Act § 112; EDWARD V. MURPHY & MICHAEL B. BERNIER, CONG. RESEARCH SERV., EDWARD V. MURPHY & MICHAEL B. BERNIER, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK (2011), *available at* http://www.llsdc.org/assets/DoddFrankdocs/crs-r42083.pdf (describing the mission, membership, and scope of the FSOC and providing an analysis of FSOC-related policy issues Congress may face).

[89] *Securities/Section 20/Broker-Dealer*, 40 BANKING & FIN. SERVICES POL'Y REP 26 (Dec. 2011); 17 C.F.R. § 275.204(b)-1 (2014) (requiring private fund advisers to file Form PF with the SEC periodically); 17 C.F.R. § 4.27(d) (2014) (requiring private fund advisers to file Form PF if they are registered as commodity pool operators or commodity trading advisers).

and drafted for the use of the FSOC.[90] Form PF provides the FSOC with information about the private fund industry in order to assess the risks in the financial system and support FSOC's mandate of designating systemically significant financial institutions.[91] Additionally, Form PF filings can be utilized by the SEC and the CFTC for investigations and examinations.[92] Although Form PF information contains private fund advisers' proprietary information and is considered confidential, the Dodd-Frank Act authorized the SEC, upon request, to share Form PF data with institutions that are also required to maintain confidentiality of Form PF data, including the FSOC, Congress, courts, federal departments, and self-regulated organizations upon request.[93]

The SEC had broad expectations for the use of Form PF data. The SEC expected Form PF data to help more fully evaluate and anticipate issues with potential regulatory actions, allocate and reallocate resources, and anticipate regulatory problems.[94] The SEC also anticipated that Form PF data would enhance its ability to develop and frame regulatory policies pertaining to the private fund industry, private fund investment advisers, and the markets in which they participate.[95] Additionally, the SEC believed that Form PF data would help discern relationships between private fund's investment activities and regulatory actions.[96]

Form PF filing requirements apply to registered investment advisers that hold $150 million RAUM or more attributable to private funds at the end of their most recently completed fiscal year, are registered or are required to register with the SEC, and advise a single private fund or several private funds.[97] To take account of the relative risks of each

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[90] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,129-71,130

[91] *Id*.

[92] "In addition to the primary purpose to assist FSOC in its assessment of systemic risk, the Commission stated that it would use the information collected on Form PF in its regulatory programs, including examinations, investigations, and investor protection efforts." SEC, ANNUAL STAFF REPORT RELATING TO THE USE OF DATA COLLECTED FROM PRIVATE FUND SYSTEMIC RISK REPORTS 3 (2013) [HEREINAFTER SEC 2013], *available at* http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.; *see also* Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1, 27 (2011); Cheryl Nichols, *Addressing Inept SEC Enforcement Efforts: Lessons from Madoff, the Hedge Fund Industry, and Title IV of the Dodd-Frank Act for U.S. and Global Financial Systems*, 31 NW. J. INT'L L. & BUS. 637, 683 (2011).

[93] Barbara Crutchfield George & Lynn Vivian Dymally, *The End of an Era of Limited Oversight: The Restructured Regulatory Landscape of Private Investment Funds Through the U.S. Dodd-Frank Act and the E.U. Alternative Investment Fund Managers Directive*, 25 FLA. J. INT'L L. 207, 236 (2013).

[94] *Id.*

[95] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,142.

[96] *Id.*

[97] 17 C.F.R. § 275.204(b)-1 (2014); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,132 (listing three criteria for filing Form PF that represent an initial threshold for the minimal Form PF requirements). Most private fund advisers who meet these three criteria will only be required to file Section 1 of Form PF. *Id*. at 71,132. Remaining sections of Form PF will be filed by "Large Private Fund Advisers." *Id.* at 71,132–33. There are three types of Large Private Fund Advisers: (1) "[a]ny adviser having at least $1.5 billion in [RAUM] attributable to hedge funds as of the end of any month in the prior fiscal quarter;" (2) "[a]ny adviser managing a liquidity fund having at least $1 billion in combined [RAUM] attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter;"

type of private fund, the SEC takes a tiered approach to Form PF filing requirements.[98] While smaller private fund advisers – those with less than $1.5 billion regulatory assets under Management (RAUM) attributable to hedge funds - are required to complete and file Form PF annually,[99] large private fund advisers - those with at least $1.5 billion RAUM attributable to hedge funds[100] - have to update their Form PF filings quarterly.[101]

Categories of required disclosures under Form PF include information on the investment adviser, the funds managed by the investment adviser, and information about individual investors,[102] financing information, the products used by the investment adviser, performance and changes in performance, risks metrics, strategies used, credit exposure, and positions held by the investment adviser, among others.[103] Form PF disclosure requirements pertaining to the investment advisers' reporting funds advised by investment advisers require a breakdown of Net Asset Value (NAV) managed by the adviser by hedge fund strategy,[104] and the percentage of the reporting fund's NAV managed by using computer-driven trading algorithms.[105] Form PF also requires hedge fund advisers to disclose the five trading counterparties to which the reporting fund has the greatest net counterparty credit exposure,[106] the name of the creditor, and the dollar amount owed to each creditor.[107] Other information required in this context includes information about the collateral and other credit support counterparties posted to the respective reporting funds[108] and changes in market factors and their effect on the long and short components of the portfolio as a percentage of NAV.[109]

To enable the SEC to understand the exposure of the advisers' reporting funds and their assets, Form PF requires disclosure pertaining to the value of turnover by asset class in the respective reporting month[110] and the exposure of long and short positions.[111] Similarly, to help the SEC understand the liquidity of the reporting

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and (3) "[a]ny adviser having at least $2 billion in [RAUM] attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year." *Id.* (footnotes omitted).

[98] *Id.* at 71,136.

[99] *See Id.*; *see also* FORM PF, *supra* note 14, at General Instruction 9 (providing different filing periods for different types of advisers).

[100] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128, 71,132–33 (Nov. 16, 2011) (codified as amended 17 C.F.R. pts. 275 & 279) (defining "large private fund adviser").

[101] *Id.* at 71,140; FORM PF, *supra* note 14, at General Instruction 9 ("[Y]ou [large hedge fund advisers] must file a *quarterly update* that updates the answers to all Items in this Form PF relating to the *hedge funds* that you advise.").

[102] *See* 17 C.F.R. § 279.9 (2014) (establishing filing requirements for Form PF); FORM PF, *supra* note 18, § 1a–b.

[103] *See* FORM PF, *supra* note 14, at 1b-c.

[104] *Id.* § 1a, Item B.3 (including the following private fund categories: (a) hedge funds, (b) liquidity funds, (c) private equity funds, (d) real estate funds, (e) securitized asset funds, (f) venture capital funds, (g) other private funds, (h) funds and accounts other than private funds).

[105] *Id.* § 1c, Item B.21.

[106] *Id.* § 1c, Items B.22–23.

[107] *Id.* § 2b, Item D.47.

[108] *Id.* § 2b, Item B.36.

[109] *Id.* § 2b, Item C.42.

[110] *Id.* § 2a, Item B.27.

[111] *Id.* § 2a, Item B.26; *Id.* § 2b, Item B.30 (pertaining to investment advisers that advise more than one hedge fund).

fund's portfolios, Form PF requires the investment adviser to disclose the reporting fund's positions and the time it would take to liquidate them.[112] Form PF also requires the disclosure of information regarding the investment adviser's use of trading and clearing mechanisms.[113] In addition, investment advisers have to disclose information regarding the value of each of the advised funds' borrowings and the types of creditors[114] and the aggregate value of all derivative positions for each advised fund.[115] Finally, Form PF requires disclosure of information pertaining to investor liquidity—time period and percentage of NAV locked[116]—and the reporting fund's restrictions of investor withdrawals and redemptions.[117]

IV. Financial Stability Oversight Council

In an attempt to correct perceived regulatory weaknesses that may have contributed to the financial crisis of 2008-09, the Dodd-Frank Act created the FSOC.[118] With the FSOC, Congress created a common forum that enabled financial regulators to assess and address systemic risks that could develop in less or unregulated non-bank financial institutions.[119]

The FSOC's mandate and primary purpose includes the identification and remedying insufficient supervision of large non-bank financial institutions, the promotion of market discipline, and responding to emerging threats to the stability of the U.S. financial system.[120] It is also tasked with curtailing the complexity of financial institutions and improving the coordination among financial regulators[121] and its supervisory responsibilities include evaluation and implementation of supervisory priorities and principles.[122] Its core duties include: regulatory recommendations for financial regulators; the identification of regulatory shortcomings that could pose

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[112] *Id.* § 2b, Item B.32.
[113] *Id.* § 1c, Item B.24.
[114] *Id.* § 2d, Item D.43.
[115] *Id.* § 2b, Item D.45.
[116] *Id.* § 2b, Item E.50.
[117] *Id.* § 2b, Item E.49.
[118] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 111-112, 124 Stat. 1376, 1392 (2010) (codified as amended in 12 U.S.C. 5321,5322).
[119] *Id.*
[120] FIN. STABILITY OVERSIGHT COUNCIL, 2013 ANNUAL REPORT (2013), *available at* http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2013-Annual-Report.aspx; Amanda Risch, *The Financial Stability Oversight Council*, 31 REV. BANKING & FIN. L. 521, 522-523 (2012).
[121] EDWARD V. MURPHY, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK 1-2 (2013), *available at* http://www.fas.org/sgp/crs/misc/R42083.pdf; Ben S. Bernanke, Chairman, Bd. Of Governors of the U.S. Fed. Reserve Sys., Speech at the 47th Annual Conference on Bank Structure and Competition: Implementing a Macroprudential Approach to Supervision and Regulation (May 5, 2011) [hereinafter Bernanke Speech 2011], *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm; *See generally* Emerich Gutter, *Too-Big-to-Fail and the Financial Stability Oversight Council*, 30 REV. BANKING & FIN. L. 73 (2010); Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CAL. L. REV. 327, 369-70 (2013); EDWARD V. MURPHY, CONG. RESEARCH SERV., R43087, WHO REGULATES WHOM AND HOW? AN OVERVIEW OF U.S. FINANCIAL REGULATORY POLICY FOR BANKING AND SECURITIES MARKETS (2013), at 16-17, *available at* http://www.fas.org/sgp/crs/misc/R43087.pdf.
[122] *See* Emerich Gutter, Too-Big-to-Fail and the Financial Stability Oversight Council, 30 REV. BANKING & FIN. L. 73, 74 (2010).

systemic risk; collection of information on financial firms; monitoring the financial system for potential systemic risks; facilitating the sharing of information and coordination among financial regulators; suggesting regulatory changes to Congress for the promotion of efficiency, competitiveness, and stability; and providing a forum for the resolution of jurisdictional disputes among council members.[123]

The governance structure of the FSOC facilitates its coordination tasks and enables it to fulfil its mandate of addressing systemic risks. As a collaborative body chaired by the Secretary of the Treasury, the FSOC consists of ten voting members[124] and five nonvoting members[125] and brings together the expertise of federal regulators and state regulators.[126] For the purpose of identifying emerging risks to financial stability, the FSOC can request data and analyses from the OFR and provide direction to the OFR.[127] The FSOC's systemic risk committee and two sub-committees provide structure for analysing potential emerging systemic risks.[128] In addition to the systemic risk

[123] EDWARD V. MURPHY, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK 4-9 (2013).

[124] EDWARD V. MURPHY, CONG. RESEARCH SERV., R43087, WHO REGULATES WHOM AND HOW? AN OVERVIEW OF U.S. FINANCIAL REGULATORY POLICY FOR BANKING AND SECURITIES MARKETS 33-34 (2013) ("The council is chaired by the Secretary of the Treasury and the other voting members consist of the heads of the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Housing Finance Administration, Consumer Financial Protection Bureau and a member with insurance expertise appointed by the President.").

[125] *Id*. at 33-34 ("The five nonvoting members who serve in an advisory capacity are the director of the Office of Financial Research (created in conjunction with FSOC to support its efforts), the head of the Federal Insurance Office (created by Title V of DFA), a state banking supervisor, state insurance commissioner, and a state securities commissioner.")

[126] *FAQs about FSOC*, U.S. DEP'T OF THE TREASURY (Apr. 10, 2013), http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx ("The Financial Stability Oversight Council has a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury that brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the President, and state regulators")

[127] Financial Stability Oversight Council, DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx (Apr. 10, 2013, 12:00PM), ("Additionally, to help with the identification of emerging risks to financial stability, the FSOC can provide direction to, and request data and analyses from, the newly created Office of Financial Research (OFR) housed within Treasury.");

[128] *Continuing Oversight of the Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Focusing on Provisions Related to Monitoring Systemic Risk and Promoting Financial Stability*: *Hearing Before the S. Comm. on Banking, Housing, and Urb. Affairs*, 112th Cong. 65 (2011) (statement of Mary L. Schapiro, Chairman, U.S. Securities & Exchange Commission) ("FSOC has established a Systemic Risk Committee that seeks to identify, highlight and review possible risks that could develop across the financial system." *available at* https://www.sec.gov/news/testimony/2011/ts051211mls.htm; *FAQs about FSOC*, U.S. DEP'T OF THE TREASURY (Apr. 10, 2013), http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx ("The structure is intended to balance the need for an interdisciplinary and cross-cutting approach with the need to leverage existing expertise and experience. The systemic risk committee will include senior staff and report to the Deputies committee.") *Id.* ("Systemic Risk Committee: This committee is accountable for monitoring systemic risk and will play a role in prioritizing the review of sources of systemic risk and guiding the work of both the staff and systemic risk subcommitte*es").*

committees, FSOC has its own permanent staff at the OFR, tasked with providing information, technical expertise and collecting required data on the financial system.[129]

1. Procedure for Systemic Risk Assessment of Private Funds

The FSOC's powers over nonbank financial institutions are broad and unprecedented in U.S. financial regulation.[130] The Dodd-Frank Act gave FSOC the power to subject a nonbank financial company to extensive supervision by the Federal Reserve.[131] While the FSOC has to consider several quantitative metrics in its systemic risk assessment of non-bank financial institutions,[132] the Dodd-Frank Act allowed FSOC to consider any other risk-related factors it may deem appropriate,[133] underscoring its broad powers. Moreover, the Dodd-Frank Act specifically prohibits "antievasion" by nonbank financial institutions,[134] further extending FSOC's powers. On its own initiative, the FSOC may determine with a two-thirds vote if a nonbank financial institution is systemically important.[135] While Dodd-Frank proscribes several considerations that the Council must take into account in its determination of what entities qualify as Systemically Important Financial Institution (SIFI), the quantitative systemic risk assessment measures are not specifically codified and the FSOC can change thresholds and analysis via the rule making process.[136]

The FSOC applied two broad standards to the designation of the non-bank financial institution as a Systemically Important Financial Institution. First, FSOC assesses whether the "material financial distress" at a nonbank financial institution could pose a threat to the stability of the financial system.[137] Secondly, FSOC takes into

[129] EDWARD V. MURPHY, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK 1-2 (2013).

[130] *See generally* D. Jean Veta & Michael Nonaka, *Assessment of the Act's Systemic Risk Regulation* Provisions, *in* 6 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW: RESTORING FINANCIAL STABILITY 71 (International Monetary Fund, 2012).

[131] Section 111-113 of the Dodd-Frank Act outlines the purpose of the FSOC, which is to determine the material financial distress of nonbank financial companies and to bring such entities under the prudential supervision of the Federal Reserve. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 111-113, 124 Stat. 1376, 1392 (2010) (codified as amended in 12 U.S.C. 5321-5323); *Id*. at § 113 (authorizing the FSOC to designate a nonbank financial institution for enhanced prudential standards and consolidated supervision by the Fed); *Id*. at § 165 (instructing the Board of Governors of the Federal Reserve to develop special prudential standards that are to be applied to any bank holding company holding assets of more than $50 billion, as well as to any firms designated by the FSOC); EDWARD V. MURPHY, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK 1-2 (2013); *see further Nonbank Financial Company Designations*, U.S. DEP'T OF TREASURY (DEC. 17, 2013), http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx

[132] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 113(a)(2), 124 Stat. 1376, 1392 (2010) (codified as amended in 12 U.S.C. 5321)

[133] *Id*. at § 113(a)(2)(K). The FSOC "has authority to assess nonbank financial companies, and their relationships with other nonbank financial companies and market participants in a manner that addresses the statutory considerations and such other factors the Council deems appropriate." 12 C.F.R. § 1310 app. A(III)(a) (2014).

[134] Dodd-Frank Act at § 113(c).

[135] *Id*. at § 113(a)(1)

[136] *Id*. at § 113(a)(1) & (a)(2)(K); 12 C.F.R. § 1310 app. A (2014).

[137] 12 C.F.R. § 1310 app. A(II) ("A threat to the financial stability of the United States [….] exist[s] if there would be an impairment of financial intermediation or of financial market functioning that would be

account in its assessment the nature, size, scope, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial institution as possible threats to the financial system.[138] Commonly managed investment funds that manage $50 billion or more in the aggregate of total consolidated assets could be designated a SIFI, particularly if such funds all follow a similar investment strategy.[139]

The Dodd-Frank Act requires certain statutory considerations to determine whether or not a nonbank financial institution meets either of the two standards.[140] The

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sufficiently severe to inflict significant damage on the broader economy.") *Id. ("*An impairment of financial intermediation and financial market functioning, in turn, can be established through several channels including exposure, asset liquidation, or critical function or service"); *see generally* TOBIAS ADRIAN, DANIEL COVITZ & NELLIE J. LIANG, FINANCIAL STABILITY MONITORING (2013). Whether a nonbank financial institution is in "material financial distress" will be assessed by FSOC as if the financial industry as a whole were in a period of overall stress and in a weak market environment, similar to bank stress tests conducted by the Fed under Section 165(i)(2) of Dodd-Frank Act. Dodd-Frank §165(i)(2).

[138] 12 C.F.R. § 1310 app. A(II)(c) (2014). This standard will be met if the "nature of a nonbank financial company's business practices, conduct, or operations could pose a threat to the stability of the financial system, regardless of whether or not the nonbank financial company is experiencing any financial distress." *Id.* Because large nonbank financial companies that experience financial distress often impact the broader financial industry there will be significant overlap between the two FSOC determination standards for SIFI status of nonbank financial institutions. *Id.* Dodd-Frank Act Section 113 lists 10 considerations that the FSOC must take into account in making a SIFI determination. Dodd-Frank Act at § 115(b)(1).

[139] 12 C.F.R. § 1310 app. A(III)(a) (2014). (A nonbank financial company will be evaluated further in Stage 2 if it meets both the total consolidated assets threshold and any one of the other thresholds. The thresholds are: *Total Consolidated Assets.* The Council intends to apply a size threshold of $50 billion in total consolidated assets……*Credit Default Swaps Outstanding. T*he Council intends to apply a threshold of $30 billion in gross notional credit default swaps ("CDS") outstanding for which a nonbank financial company is the reference entity…..*Derivative Liabilities.* The Council intends to apply a threshold of $3.5 billion of derivative liabilities….*Total Debt Outstanding.* The Council intends to apply a threshold of $20 billion in total debt outstanding…..*Leverage Ratio.* The Council intends to apply a threshold leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1…..*Short-Term Debt Ratio.* The Council intends to apply a threshold ratio of total debt outstanding (as defined above) with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent….); *see also* Joseph P. Vitale & Marc E. Elovitz, *FSOC Issues Final Rule on Designating Nonbanks as "Systemically Important" — What Private Fund Managers Need to Know*, SCHULTE ROTH & ZABEL (Apr. 12, 2012), http://www.srz.com/FSOC_Issues_Final_Rule_on_Designating_Nonbanks_as_Systemically_Important/

[140] Dodd-Frank Act at §113(a)(2). (2) CONSIDERATIONS.—In making a determination under paragraph (1), the Council shall consider—

> (A) the extent of the leverage of the company;
> (B) the extent and nature of the off-balance-sheet exposures of the company;
> (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
> (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
> (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

FSOC organized these statutory considerations into a six-category framework, each category reflecting a different dimension of the nonbank financial institution's potential threat to financial stability: leverage, liquidity risk and maturity mismatch, size, interconnectedness, substitutability, and existing regulatory scrutiny.[141]

Based on its six-category analytical framework, FSOC employs a three-stage process of increasing in-depth evaluation and analysis to determine whether a nonbank financial institution creates a threat to the financial stability of the United States.[142] In stage one, applying six quantitative thresholds, FSOC uses a mechanical screening process to eliminate those nonbank financial institutions from review that are unlikely to pose significant systemic risk and may not merit SIFI designation.[143] Only those nonbank financial institutions that raised systemic concerns in stage one will be subject to more institution-specific and qualitative evaluation in stage two and thereafter possibly stage three.[144] In stage two FSOC prioritizes those nonbank financial institutions identified in stage one based on quantitative and qualitative public and regulatory sources of information and initiates the consultation process with the primary financial regulatory agencies.[145] In stage three, FSOC contacts each identified nonbank financial institution to collect additional information that was not available in stages one and two[146]. The combined information from all three stages is then evaluated.[147] Should the FSOC

> (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
> (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
> (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies;
> (I) the amount and nature of the financial assets of the company;
> (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
> (K) any other risk-related factors that the Council deems appropriate; *see also*

12 C.F.R. § 1310 app. A(II)(c) (2014).

[141] 12 C.F.R. § 1310 app. A(III)(c) (2014).

[142] *Id* at (III). *See generally* Gregory S. Rowland, *Designation of Asset Managers and Funds as Systemically Important Non-Bank Financial Institutions: Process and Industry Implications*, 20 INVESTMENT LAW. 1, 1-2 (2013), *available at* http://www.davispolk.com/sites/default/files/files/Publication/496c5f23-8c9a-48ae-bd95-078e31e4b632/Preview/PublicationAttachment/5585c767-083c-48ed-b549-0d07d4cc1515/IL_April_2013_Rowland_article.pdf.

[143] 12 C.F.R. § 1310 app. A(III)(a) (2014); *see generally* Joseph P. Vitale & Marc E. Elovitz, *FSOC Issues Final Rule on Designating Nonbanks as "Systemically Important" — What Private Fund Managers Need to Know*, SCHULTE ROTH & ZABEL, (Apr. 12, 2012), http://www.srz.com/FSOC_Issues_Final_Rule_on_Designating_Nonbanks_as_Systemically_Important/

[144] *See generally* Press Release, Financial Stability Oversight Council, Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability (Jul. 9, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx.

[145] 12 C.F.R. § 1310 app. A(III)(b) (2014).

[146] *Id*. at (III)(c).

[147] FIN. STABILITY OVERSIGHT COUNCIL, 2013 ANNUAL REPORT (2013) available at http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2013-Annual-Report.aspx; Press Release, Financial Stability Oversight Council, Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability (Jul. 9, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx ("Each nonbank

conclude at the conclusion of stage three that the nonbank financial company creates a threat to the stability of the U.S. financial system, FSOC will request a hearing in accordance with section 113(e) of the Dodd-Frank Act.[148]

Designation as a systemically important financial institution (SIFI) would change the nature of the regulation for the respective nonbank financial institution and subject such entity to substantial additional regulations,[149] requiring the respective entity to change the way it does business. This change in the way a nonbank does business could impact its growth as such entity may be required to bolster its balance sheet and curtail risk.[150]

2. Data Analysis

The design of Form PF is intended to provide the FSOC with the required empirical data to determine the extent to which the activities of private funds and/or their advisers pose a systemic risk.[151] Of particular interest for FSOC's systemic risk analysis via Form PF data are the concentration of fund investments by geography and industry, the systemic exposure to specific financial institutions and credit counterparties, and the concentration of the respective private funds' investor base.[152]

FSOC's three-stage review process for SIFI designation[153] depends heavily on the information provided by private fund investment advisers in Form PF.[154] A large proportion of the information provided in Form PF also relates directly to the six-category framework the FSOC uses throughout is SIFI designation process. The six-category framework is organized in accordance with the statutory considerations set out by the Dodd-Frank Act and is designed to determine whether or not a nonbank financial

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financial company that is reviewed in Stage 3 is notified that it is under consideration and is provided an opportunity to submit written materials related to the Council's consideration of the company for a proposed designation.").

148 12 C.F.R. § 1310 app. A(III)(2014).

149 Once designated as a SIFI, the respective entity will be subject to extensive regulation and supervision by the Federal Reserve Board under Title I of the Dodd-Frank Act. Dodd-Frank Act at § 115(a)(1); EDWARD V. MURPHY, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK (2013) at 1-2. The Dodd-Frank Act requires that the regulatory standards for non-bank financial firms under Fed supervision are more stringent than the standard for non-bank financial firms outside of Fed supervision. Dodd-Frank Act at § 115(a). The Fed has the authority to require such non-bank financial institutions to comply with the following prudential standards: leverage limits, liquidity requirements, enhanced public disclosures, concentration limits, risk-based capital requirements, resolution plan and credit exposure report requirements, a contingent capital requirement, short-term debt limits, and overall risk management requirements. *See* Dodd-Frank Act at § 115(b)(1).

150 Douglas J. Elliot, *Regulating Systemically Important Financial Institutions That Are Not Banks,* INITIATIVE ON BUS. AND PUB. POL'Y AT BROOKINGS, 1 (May 9, 2013) http://www.brookings.edu/~/media/research/files/papers/2013/05/09%20regulating%20financial%20institutions%20elliott/09%20regulating%20financial%20institutions%20elliott.pdf.

151 Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,129.

152 FORM PF, *supra* note 14, at §2a.

153 *See supra* notes 137-140 and accompanying text; 12 C.F.R. § 1310 app. A(III) (2014).

154 Rowland, *supra* note 141, at 2. Except for the Stage 1 threshold relating to the credit default swaps written on the nonbank financial company. *Id.* "Stage 2 analysis is more company specific, and will move beyond the scope of the metrics collected by Form PF for Stage 1, but will likely be used as a reference." *Id* at 3.

institution merits a SIFI designation.[155] Each category reflects a different dimension of the nonbank financial institution's potential threat to financial stability: leverage, liquidity risk and maturity mismatch, size, interconnectedness, substitutability, and existing regulatory scrutiny.[156]

The information in Form PF either directly or indirectly addresses most of FSOC's stage one thresholds.[157] More specifically, the following Form PF Questions provide specific information for FSOC's stage one threshold assessment: Form PF Question 8 (gross asset value of reporting fund) is directly relevant for FSOC's stage one threshold for $50 billion in total consolidated assets; Form PF Questions 13, 44 (value of derivative positions) help assess the threshold of $3.5 billion in derivative liabilities; Form PF Questions 46 (financing liquidity) and 58 (financing information) inform the $20 billion threshold in stage one for total debt outstanding; and Form PF Questions 8 (gross assets value of reporting fund) and 9 (net asset value of reporting fund) help determine the 15 to 1 leverage ratio in FSOC's stage one assessment.[158]

Form PF data is also used in FSOC's stage two SIFI designation analysis. Several Form PF Questions provide directly relevant information for the six criteria considered by FSOC in its stage two analysis and beyond: Form PF Questions 22, 23, 36 and 37 (five counterparties to which the *reporting fund* has the greatest mark-to-market net counterparty credit exposure) provides highly relevant information to determine the interconnectedness of private funds; Form PF Question 8 (gross assets value of reporting fund) helps the FSOC assess the size of private funds/advisers; Form PF Questions 30 (reporting fund exposure) and 56 (product exposures) help the FSOC in assessing the fund substitutability; Form PF Questions 32 (liquidity of reporting funds' portfolio) and 55 (reporting fund assets) can help FSOC compare the liquidity of a funds' assets with the liquidity of investors in Questions 50 (investor liquidity) and 64 (investor liquidity in percent) to analyse funds' liquidity and maturity mismatch risk; Form PF Questions 8, 9, 43, 44, 46, 58, and 66 can help FSOC assess the reporting fund's leverage; finally Form PF Questions 40 (reporting fund's VaR) and 42 (effect of market factors on portfolio) can help FSOC assess the overall riskiness of private funds advisers' investments.[159]

V. Private Fund Data and Systemic Risk Assessment

The analysis in this article suggests that the evidence provided by the SEC[160] and the FSOC[161] in combination with data analysis from a prior study[162] seem to confirm

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[155] Dodd-Frank Act at § 113(a)(2); 12 C.F.R. § 1310 app. A(II)(d)(2) (2014).
[156] 12 C.F.R. § 1310 app. A(II)(d)(2) (2014).
[157] Rowland, *supra* note 141, at 2. Except for the Stage 1 threshold relating to the credit default swaps written on the nonbank financial company. *Id.* "Stage 2 analysis is more company specific, and will move beyond the scope of the metrics collected by Form PF for Stage 1, but will likely be used as a reference." *Id.* at 3.
[158] Compare FSOC's Stage 1 thresholds in 12 C.F.R. § 1310 app. A(III)(a) (2014) with the information filed by private fund investment advisers in Form PF - Form PF, *supra* note 14, at §2a; *see also* Rowland, *supra* note 141, at 5-7.
[159] Form PF, *supra* note 14, at §2a; Compare FSOC's Stage 1 thresholds in 12 C.F.R. § 1310 app. A(III)(a) (2014) with the information filed by private fund investment advisers in Form PF; *see also* Rowland, *supra* note 141, at 5-7.
[160] *See infra* Fn. 163 to 167.
[161] *See infra* Fn. 171 to 172.
[162] Kaal Registration, *supra* note 22, at 316-317.

concerns over Form PF data insufficiency and possible inaccuracies. These challenges for Form PF data could have an effect on FSOC's systemic risk assessment of private fund advisers.

1. Sub-optimality of Systemic Risk Data

The analysis of the data collected in Form PF presents several key challenges. The SEC suggests that the consistency of investment adviser's responses on Form PF is not ensured and could be questionable.[163] Other challenges with Form PF identified by the SEC include the differences in approaches taken by investment advisers in completing Form PF and differences in assumptions made by investment advisers in completing Form PF.[164] Upon initial analysis of Form PF data, the SEC identified data anomalies deemed to be attributable to filer error[165] which precipitated SEC concerns about the quality of the information provided by private fund advisers. [166] While the SEC is making a concerted effort to improve Form PF data quality by issuing FAQs on interpretive issues and requesting curative amendments of Form PF filings from filers,[167] expanding the utility of Form PF data without sufficient confidence in the accuracy of the information provided by investment advisers on Form PF remains difficult. On the upside, the SEC's experience with Form PF data is in its early stages and the data quality and utility is likely to evolve over time as filers become more familiar with the requirements of Form PF and the methods of calculation.[168]

The SEC also appears to be aware of possible data quality shortcomings[169] because it continues to assess Form PF data quality.[170] Similarly, in its attempt to identify activities of twenty of the largest U.S. fund managers as possible sources of systemic risk,[171] the FSOC acknowledged that the available data was insufficient – at least in the

[163] SEC, ANNUAL STAFF REPORT RELATING TO THE USE OF DATA COLLECTED FROM PRIVATE FUND SYSTEMIC RISK REPORTS 1 (2013) [HEREINAFTER SEC 2013], *available at* http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.
[164] *Id*.
[165] Section 207 of the Investment Advisers Act makes any willful misstatements or omission of a material fact in any report filed with the SEC pursuant to the Investment Advisers Act unlawful.
[166] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71,129.
[167] *See* Form PF: Frequently Asked Questions, U.S. SEC. & EXCH. COMM'N (last visited Jan. 12, 2014), , http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml.
[168] Kaal Disclosure, *supra* note 22, at [__].
[169] OFFICE OF FIN. RESEARCH, ASSET MANAGEMENT AND FINANCIAL STABILITY 2 (2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf ("Unfortunately, there are limitations to the data currently available to measure, analyze, and monitor asset management firms and their diverse activities, and to evaluate their implications for financial stability. These data gaps are not broadly recognized"); Yin Wilczek, Report: 'Data Gaps' About Asset Managers Stymies Analysis of Risks Posed by Industry, BNA BANKING REPORT, Sept. 30, 2013 ("There are "significant data gaps" regarding the activities of asset managers that make it difficult to fully analyze or measure the threat posed by the industry to financial stability, the Office of Financial Research said Sept. 30.")
[170] SEC 2013, *supra* note 163, at 1.
[171] FIN. STABILITY OVERSIGHT COUNCIL, 2013 ANNUAL REPORT (2013) *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf. ELABORATE ON FINDINGS IN FN.

context of counterparty risks and leverage, including the repo market and securities lending and in the context of separate fund accounts.[172]

The data collected via Form PF has several core shortcomings.[173] Core substantive issues with Form PF include: the ambiguity of several key questions on Form PF, the inaccuracy of Form PF definitions and corresponding insufficiency of SEC guidance for Form PF, and difficulties in aggregating the required Form PF information.[174] Over forty percent of respondents in a prior study suggested that they disagreed with definitions or instructions in Form PF.[175] Especially the definition of Regulatory Assets under Management (RAUM), as required by Form PF, required filers to interpret what they were required to report.[176] The level of interpretation required to answer Form PF precipitated particular concerns among filers pertaining to the definition of counterparties and performance measures for counterparties in Form PF. There is also evidence that Form PF questions and definitions had to be optimized, including performance information required by Form PF.[177] Form PF instructions generally needs clarification and the definitions for RAUM/AUM in Form PF, among others, have to be improved.[178]

2. *Impact on Systemic Risk Assessment*

Given the identified shortcomings of Form PF data, the systemic risk assessment process employed by the FSOC could be compromised. Several core Form PF questions that provide specific information for FSOC's stage one threshold assessment encounter problems. More specifically, the definition of RAUM required a level of interpretation by filers.[179] FSOC is using asset valuations in Form PF that are associated with RAUM, such as gross asset value of reporting fund (Form PF Question 8), the value of derivative positions (Form PF Questions 13, 44), financing information and financing liquidity (Form PF Questions 46 and 58), as well as gross and net assets value of reporting fund (Form PF Questions 8 and 9) to determine various stage one thresholds.[180] Given FSOC's direct or indirect use of RAUM related data (and FSOC's emphasis on such data), in combination with the author's prior study suggesting that RAUM requires substantial interpretation,[181] it seems at least questionable if FSOC will be able to use the related Form PF data effectively and sustainably for its systemic risk evaluations and the designation of non-bank financial companies as systemically risky.

FSOC's stage two assessment process could be equally affected. Form PF questions that provide specific information for FSOC's stage two threshold assessment also encounter problems. The determination of a private fund's size and leverage in

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172 *Id.* at 13.
173 *Id.*; Kaal Disclosure, *supra* note 22, at [__].
174 Kaal Disclosure, *supra* note 22, at [__].
175 *Id.*
176 *Id.*
177 *Id.*
178 *Id.*
179 *Id.*
180 FSOC's stage one thresholds that can be determined by use of Form PF RAUM data include: $50 billion in total consolidated assets, $3.5 billion in derivative liabilities, $20 billion of total debt outstanding, 15 to 1 leverage ratio of total consolidated assets to total equity, the leverage ration of private funds. For further analysis of relevance of Form PF data in FSOC's stage one evaluation see *supra* Fn. 143-144.
181 Kaal Disclosure, *supra* note 22, at [__].

FSOC's stage two also relies on Form PF RAUM data[182] and could be subject to inaccuracies because the RAUM measures reported by private funds can required a level of interpretation by the filers, as identified in the author's prior study.[183] The level of interpretation required to answer Form PF affects performance measures in Form PF Question 17, counterparties and definitions of counterparties in Form PF Questions 22 and 23.[184] Form PF questions 22 and 23 are directly used in FSOC's stage two analysis to determine the interconnectedness of private funds.

In addition to the specific matching of Form PF data issues with FSOC's uses of Form PF data, Form PF data may also present several more generic areas of concern for FSOC's systemic risk evaluation. Over forty percent of respondents in a prior study suggested that they disagreed with definitions or instructions in Form PF.[185] This suggests that a large proportion of filers are uncertain as to how Form PF questions are to be answered. This uncertainty at least raises the possibility that the filers are using estimates and a variety of assumptions to complete Form PF. If FSOC relies on Form PF data in its systemic risk assessment that is subject to inaccuracies, it appears possible that FSOC's work pertaining to private funds could in turn be subject to errors.

VI. Conclusion

The article suggests that private fund advisers who reported data as required by SEC Form PF encountered issues that could affect FSOC's systemic risk assessment of private funds. The author does not suggest that the FSOC is unable to fulfill Congress's mandate. The observations in this article pertaining to the suboptimality of Form PF data are primarily based on the quantifications and evaluations of the author's prior survey study. The author identified and matched the relevance of purported Form PF data issues with the respective use and emphasis of Form PF data in FSOC's systemic risk assessment. The matching of identified Form PF issues with FSOC's respective use of such suboptimal Form PF data suggests that possible inaccuracies may exist in FSOC's systemic risk assessment process. The author does not claim scientific and/or empirical precision in the analysis. Addressing the identified problems with Form PF data could help optimize FSOC's systemic risk assessment of private funds.

[182] *See supra* Fn 145.
[183] Kaal Disclosure, *supra* note 22, at [__].
[184] *Id.*
[185] *Id.*