The Post Dodd-Frank Act Evolution of the Private Fund Industry: Comparative Evidence from 2012 and 2015

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This comparative survey study examines the private fund industry's reactions and adjustments to a rapidly evolving regulatory framework, three years after the first application of mandatory registration and disclosure rules for private fund advisers under the Dodd-Frank Act. Using two datasets (2012: N = 94; 2015: N = 69) for a population of 1267 registered investment advisers to add an historical time series perspective, the author analyzes and compares survey respondents' short- and long-term estimations of industry effects. The data suggest that immediate and short-term concerns have given way to adaptation to the changes.

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INTRODUCTION

Surveys conducted in the immediate aftermath of the enactment of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] suggested that private fund advisers successfully addressed the compliance demands associated with the Dodd-Frank Act and absorbed the increased compliance costs of the registration and disclosure rules relatively quickly after registration.[2] Despite industry concerns about the effects of the Dodd-Frank Act,[3] the author demonstrated in a 2012 survey that the private fund industry adjusted well to the post-

1. Pub. L. No. 111-203, tit. IV, 124 Stat. 1376, 1570 (2010) (codified as amended at 15 U.S.C. §§ 80b-2, -3 (2012)) [hereinafter Dodd-Frank Act].

2. Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243 (2013); KPMG, ALT. INV. MGMT. ASS'N & MANAGED FUNDS ASS'N, THE COST OF COMPLIANCE: 2013 KPMG/AIMA/MFA GLOBAL HEDGE FUND SURVEY (2013), https://goo.gl/MB1PPE [hereinafter THE COST OF COMPLIANCE]; EISNERAMPER & HOFSTRA UNIV. FRANK G. ZARB SCH. OF BUS., DODD-FRANK BILL—A YEAR AND A HALF LATER: VIEWS FROM THE HEDGE FUND INDUSTRY 2–3 (2012), http://goo.gl/QN2gGb [hereinafter EISNERAMPER SURVEY]; Press Release, Hofstra Univ., Dodd-Frank Drives Investor Acceptance of Hedge Fund Model, New Survey Reports (Apr. 12, 2012), http://www.hofstra.edu/home/news/pressreleases/archive/041212_doddfrank.html ("[M]ost hedge funds surveyed expect their operational cost will rise due to increased costs of the regulations found in the Dodd-Frank bill."); CITI PRIME FIN., HEDGE FUND BUSINESS EXPENSE SURVEY: INDUSTRY-WIDE BENCHMARKS FOR MANAGING A HEDGE FUND ORGANIZATION (2012), http://goo.gl/SO2iDe; Jón Daníelsson et al., *Highwaymen or Heroes: Should Hedge Funds Be Regulated?: A Survey*, 1 J. FIN. STABILITY 522, 523 (2005) (expressing concern over the potential effects of regulation).

3. *Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 26 (1998) (statement of Alan Greenspan, Chairman, Fed. Reserve Bd.) (repeating Greenspan's support for continued loose regulation of the hedge fund industry); U.S. SEC. & EXCH. COMM'N, STAFF REPORT: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 90 (2003) [hereinafter 2003 SEC HEDGE FUND REPORT], http://www.sec.gov/news/studies/hedgefunds0903.pdf ("Many of those opposing required registration expressed a strong preference for leaving the hedge fund industry 'unregulated.' They argued that the incidence of fraud among hedge fund advisers is low, and that hedge funds are adequately supervised by prime brokers, auditors and lenders. Some asserted that there would be no purpose in requiring registration, arguing that the types of clients investing in hedge funds are able to take steps to protect themselves without the assistance of the Commission." (footnotes omitted)); MANAGED FUNDS ASS'N, WHITE PAPER ON REGISTRATION OF HEDGE FUND ADVISERS UNDER THE INVESTMENT ADVISERS ACT OF 1940 (July 7, 2003), https://www.sec.gov/spotlight/hedgefunds/hedge-mfa2.htm#wpaper1.htm ("We do not believe, however, that mandatory registration of all hedge fund managers under the Investment Advisers Act of 1940 is merited. Sophisticated investors that today invest in hedge funds are able to evaluate the merits of investments in such funds and therefore do not need the additional protection that registration would provide."); Stephen Brown et al., *Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration*, 63 J. FIN. 2785, 2789 (2008) (stating that when the SEC tried to change registration rules in 2004, the changes were strongly opposed by hedge fund managers, "who argued that completing the 35-page form was unnecessarily costly and burdensome"); Carol J. Loomis, *Hard Times Come to the Hedge Funds*, FORTUNE, Jan. 1970, at 100, 100 (stating that the threat of SEC action was viewed as a deterrent to growth, and hedge fund managers in the 1960s and 1970s disliked the thought of SEC regulation, dreading the "prospect of an SEC move that would prevent them from earning their compensation in the traditional way").

Dodd-Frank regulatory landscape.[4] For example, the 2012 survey found that private fund investors' rate of return was not adversely impacted by the registration and disclosure requirements. Private fund adviser firms that planned a strategic response were smaller than those firms that did not plan a strategic response; however, both large and small firms, for the most part, did not take the Dodd-Frank Act changes into account in determining the assets under management ("AUM") of their funds.[5] Moreover, compliance cost estimates in the 2012 survey were equally moderate, suggesting total compliance costs for the majority of advisers would range from $50,000 to $200,000.[6] At the time of the 2012 survey, the long-term implications of Title IV's unprecedented registration and reporting obligations for the private fund industry remained largely unclear.[7]

Investor-driven market factors and expanding regulation suggest that the long-term implications of the private fund manager registration and mandated disclosures under the Dodd-Frank Act may be different than the initial survey studies suggested. The private fund industry has been subject to significant changes since the Dodd-Frank Act rules became effective for private funds in 2012. Between 2013 and 2015, the private fund industry grew by 26%, increasing from just over $2 trillion AUM in 2013 to $2.7 trillion AUM through 2015.[8] In the same time frame, investor-driven factors, such as the emergence and proliferation of so-called retail alternatives or hybrid funds,[9] including hedged mutual

4. Kaal, *supra* note 2, at 311–12. Despite the overall mild effect of the Dodd-Frank Act, the results of the 2012 survey highlighted several core areas of industry concern over the Dodd-Frank Act mandate as it pertains to the private fund industry. Respondents in the 2012 survey (46.34% of respondents) indicated that the Dodd-Frank registration and disclosure rules create higher costs that affect the funds they manage and the profits of their investment management companies (78.26% of respondents). To address heightened Dodd-Frank Act compliance requirements, respondents outsourced compliance work, hired additional counsel, instituted new recordkeeping policies, hired additional staff, changed marketing materials, and improved communications with investors.

5. *Id.* at 316. A majority of respondents in the 2012 survey did not feel the need to change the size of their AUM, and Dodd-Frank Act regulations were not factors a majority of respondents considered if they did change the AUM size of their funds. The SEC Form PF threshold for quarterly reporting of $1.5 billion AUM was not taken into account in determining the appropriate size of AUM for the funds they manage (80.46% of respondents).

6. *Id.*

7. Existing studies (*see supra* note 2) show trends and perceptions within the industry but do not provide insights on the long-term implications of the registration and disclosure requirements. The data in such studies were collected within a relatively short time period after the registration requirements under the Dodd-Frank Act became effective. For instance, the data for the Kaal study, *supra* note 2, were collected within three months of the SEC's registration effective date, March 30, 2012. Most recent attempts to assess impact rely on anecdotal evidence or small surveys. *See* Arleen Jacobius et al., *Assessing the Impact of Dodd-Frank 5 Years Later*, PENSIONS & INV. (July 27, 2015), http://goo.gl/c0aIu0.

8. *Hedge Fund Industry—Assets Under Management*, BARCLAY HEDGE, http://goo.gl/PB3P86 (last visited Feb. 15, 2016) (hedge fund industry had $2.508 trillion AUM for the year ending in 2014).

9. Retail alternatives are investment vehicles that offer the attractive features of mutual funds, such as significant diversification, relative stability, and transparency, with the more aggressive strategies and the corresponding prospect of absolute returns of private funds. *See* SEI, THE RETAIL ALTERNATIVES PHENOMENON: WHAT ENTERPRISING PRIVATE FUND MANAGERS NEED TO KNOW (2013), http://goo.gl/orKIKD. Net assets of mutual funds employing alternative strategies have increased 192% from 2009 to 2014. Calculation (Rate of Growth) was done using the Investment Company Institute data. INV. CO. INST., 2015 INVESTMENT COMPANY FACT BOOK 214 tbl. 42 (2015), https://www.ici.org/pdf/2015_factbook.pdf

funds and synthetic hedge funds; increasing side-by-side management of mutual funds and hedge funds; and public offerings of alternative asset managers—alongside other changes—transformed the private fund industry. In addition to investor-driven factors, changing regulations also have affected the industry. The U.S. Securities and Exchange Commission ("SEC") continues to refine and expand the regulatory landscape for the private fund industry in the aftermath of the Dodd-Frank Act and the Jumpstart Our Business Startups Act ("JOBS Act"),[10] and it continues to amend rules and SEC reporting forms that apply to the industry.[11]

This survey study examines the industry's adjustment to the unprecedented compliance requirements three years after the first application of the Dodd-Frank Act rules. Based on identical survey instruments, this study provides a comparison of survey data, contrasting the results of a 2012 survey[12] with the findings of a 2015/2016 follow-up study. The population for both surveys consisted of 1267 private fund advisers that registered before the SEC's registration effective date for private funds—March 30, 2012. Respondents (2012: N = 94; 2015: N = 69) answered questions in several categories[13] designed to identify the effects of Title IV of the Dodd-Frank Act. The decline in response rate may itself be suggestive of the relatively rapid adaptation to changes brought about by the new statutory and regulatory regime.

This article consists of five parts. After an introduction that highlights the historical evolution of the regulatory framework for the private fund industry, Part I introduces the tectonic shift in the regulatory framework for private funds under Title IV. Over fifty years of low-level regulatory oversight for the hedge fund industry ended with Title IV. Part II introduces the reader to investor-driven and regulatory changes in the private fund industry since the enactment of Title IV, including SEC rulemaking, examinations, enforcements, and settlements. Part III outlines the methodological approach of the survey study. It introduces the survey instrument, data sources, sampling and coding constraints, and possible selection bias issues. Part IV discusses the results of the survey study with descriptive statistics and presents the substantive results of the study in comparison graphs, highlighting and evaluating trends and analyzing dissimilar responses by survey participants. Part V summarizes key findings and discusses implications for hedge fund policy.

("Alternative Strategies Mutual Funds: Total Net Assets, Net New Cash Flow, Number of Funds, and Number of Share Classes").

10. Pub. L. No. 112-106, 126 Stat. 306 (2012).

11. *See* Money Market Fund Reform, Amendments to Form PF, Investment Company Act Release No. 31166, 79 Fed. Reg. 47735, 47863 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 274 & 279); *Form PF Frequently Asked Questions*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml (last visited Feb. 15, 2016).

12. Kaal, *supra* note 2.

13. The categories included, among others, long-term effect of reporting and disclosure rules on private funds, cost of compliance, compliance measures, strategic responses, long-term effect of reporting and disclosure rules on the private fund industry, effect of the regulatory regime on AUM, and effect of the regulatory regime on profitability.

I. Private Fund Oversight Under the Dodd-Frank Act

The private fund industry is continuously evolving and subject to regulatory change. Historically, private funds were characterized by their ability to remain unregistered and exempt from federal securities regulation. Private fund advisers and promoters designed the funds to operate within the exceptions and exemptions of various acts, including the Securities Act of 1933 ("Securities Act") (there is no public offering), the Securities and Exchange Act of 1934 ("Exchange Act") (they are not publicly traded companies), the Investment Company Act of 1940 ("Investment Company Act") (they are not mutual funds), and, until 2012, the Investment Advisers Act of 1940 ("Investment Advisers Act") (they are not public investment advisers).[14] These exemptions gave private fund advisers substantial freedom in their investment activities.[15]

With increasing investor demand and the growth of the hedge fund industry, the SEC sought to strengthen the regulatory framework applicable to private funds.[16] Historically, courts provided limited and sometimes contradictory guidance.[17] Because of private funds' alleged impact in the 1969 bear market,[18] the

14. For the pre-Dodd-Frank Act law on advisers, see Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 789. The most important regulatory exemption for hedge funds is found in the Investment Company Act of 1940, an act that regulates mutual funds. Hedge funds rely on one of two statutory exclusions in the definition of an investment company. Hedge funds either have fewer than 100 investors, or have only investors that are "qualified purchasers" (i.e., individuals who own over $5 million in investments or companies with over $25 million in investments). 15 U.S.C. § 80a-3(c) (2012). A hedge fund may use investment techniques that are forbidden to registered investment companies. The most notable strategies more freely available to these hedge funds than other specifically regulated financial entities involve the use of derivatives, leverage, and "shorting," which is betting on decreases in value in asset classes.

15. Pre-Dodd-Frank Act, hedge funds could qualify for the section 80b-3(b) exemption in the Investment Advisers Act to avoid registration. *See* 15 U.S.C. § 80b-3(b)(3) (2006) ("[A]ny investment adviser [was exempted] who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act]."), *repealed by* Dodd-Frank Act, *supra* note 1, § 403, 124 Stat. at 1570. They also avoided the general public investment company regulatory scheme under the private offering exemptions in the Investment Company Act. *See* Investment Company Act § 3(c)(1), (7), 15 U.S.C. § 80a-3(c)(1), (7) (2012).

Despite the broad application of exemptions for private funds, the general antifraud provisions of the Securities Act and Exchange Act apply to the activities of private funds, and so does state law against investor fraud. Accordingly, private fund managers cannot make false and misleading statements of material information (or use misleading material half-truths) when dealing with investors or counterparties in trades. Banking laws equally restrict the activities of private fund lenders—banks—in significant respects.

16. *See* Wulf A. Kaal, *Confluence of Private and Mutual Funds* (U. of St. Thomas (Minn.) Legal Stud. Research Paper No. 16-06, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715083.

17. Managed Funds Ass'n, *supra* note 3 ("In *SEC v. Ralston Purina & Co.*, the Court decided that an offering of stock by a company to its employees—regardless of how many employees received the offer—was a public offering because some of the employees needed the protection of the Securities Act. Following the *Ralston* decision, uncertainty prevailed. As a result, for twenty years, the private capital markets were of little use to the U.S. economy, issuers or investors." (italics added)).

18. Sebastian Mallaby, More Money than God: Hedge Funds and the Making of the New Elite 40–41 (2010) ("The turbulence put an end to the first hedge-fund era. Between the close of 1968 and September 30, 1970, the 28 largest hedge funds lost two thirds of their capital. Their claim to be hedged turned out to be a bald-faced lie; they had racked up hot performance numbers by borrowing

SEC started to consider ways to bring them under its regulatory authority.[19] With the growth of the hedge fund industry in the 1980s, the SEC repeatedly attempted to register private fund advisers, while defining a safe harbor from registration. First, in 1985, the SEC adopted the investment adviser registration safe harbor in Rule 203(b)(3) under the Investment Advisers Act,[20] allowing investment advisers to count each partnership, trust, or corporation in their funds as a single client.[21] In 1997, the SEC broadened the scope of the rule by including other entities used by investment advisers to pool client assets.[22] In December 2004, after the consequences of Long Term Capital Management ("LTCM"),[23] the SEC, using its rulemaking authority under the Investment Advisers Act, issued a final rule that required hedge fund advisers to register under the Investment Advisers Act.[24]

hard and riding the bull market. By January 1970, there were said to be only 150 hedge funds, down from between 200 and 500 one year before . . . .").

19. SEC Commissioner Hugh F. Owens started raising questions about what to do about hedge funds following the 1969 crash. *See* Hugh F. Owens, Comm'r, U.S. Sec. & Exch. Comm'n, A Regulator Looks at Some Unregulated Investment Companies: The Exotic Funds (Oct. 21, 1969), https://www.sec.gov/news/speech/1969/102169owens.pdf ("After all, the Commission is by law the guardian of the marketplace and is, consequently, responsible for supplying the protections of the securities laws to persons who invest in an entity which itself invests in securities. Suffice it to say, therefore, that the Commission is taking a long and hard look at such investing vehicles in this light."). Initially, the SEC claimed that hedge funds are "dealers" in securities, which could require registration under the Exchange Act. However, the SEC continued to provide guidance, mostly in the form of no-action letters, to help investment advisers determine how to counsel clients to stay exempt from securities regulation.

20. *See* Definition of "Client" of an Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 983, 50 Fed. Reg. 29206 (July 18, 1985) (to be codified at 17 C.F.R. pt. 275). The rule intended to provide investment advisers with greater certainty in determining when they might rely on the safe harbor. For purposes of an exemption from registration under that act, the safe harbor allowed a limited partnership, rather than each of its limited partners, to be counted as a "client" of a general partner acting as investment adviser to the partnership. Justifying the rule, the SEC reasoned that if an investment adviser manages an investment pool on the basis of the investment objectives of its participants, the entire pool should be viewed as the adviser's client rather than each participant.

21. *Id.*

22. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28112 (May 22, 1997) (to be codified at 17 C.F.R. pts. 275 & 279). Specifically, investment advisers were allowed to count a legal organization as a single client, provided they based investment advice on the objectives of the legal organization, rather than the individual investment objectives of any owners of the legal organization. This safe harbor allowed investment advisers to manage large amounts of securities indirectly for several hundreds of investors in several hedge funds.

23. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001). After the fall of LTCM in 1998 and its bailout orchestrated by the New York Federal Reserve Bank, it became increasingly apparent that hedge funds could pose risks that might affect international markets. Concerns over excessive leverage by hedge funds and a lack of transparency led to increasing demands for new regulation.

24. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72054 (Dec. 20, 2004) (to be codified at 17 C.F.R. pts. 275 & 279). The rule was issued by a rare three-to-two vote of the SEC Commissioners. The SEC justified its rulemaking with reference to the growth of the hedge fund industry in combination with the retailization of the hedge fund sector, increased hedge fund risk, and financial loss to investors caused by instances of fraud by hedge fund advisers. The SEC cited among the benefits of this rule more information about hedge fund advisers, the deterrence of fraud, the curtailment of losses, and improved

The registration requirement provoked significant opposition from the private fund industry.[25] Eventually, the United States Court of Appeals for the District of Columbia Circuit vacated the SEC's registration rule in *Goldstein v. SEC*.[26] Highlighting the significant opposition of the private fund industry to the rule, the overwhelming majority of private fund advisers that had registered under the SEC's 2004 registration requirements deregistered after *Goldstein*.[27] In the aftermath of *Goldstein*, the SEC proposed an increase in the scope of an accredited investor[28] under Regulation D and dramatically expanded investor antifraud protection.[29]

Resolving the prior controversy about the extent of permissible regulatory oversight—and, in effect, overruling *Goldstein*—for the first time in the history of the private fund industry, Title IV of the Dodd-Frank Act[30] authorized the

compliance controls. The SEC argued that these positive aspects of its rulemaking would benefit mutual fund investors, other investors and markets, regulatory policy, and hedge fund advisers. The rule was controversial and strongly opposed by hedge fund advisers. Without the private adviser exemption, investment advisers were subject to SEC inspections and bookkeeping and recordkeeping requirements. Without the private adviser exemption, hedge funds also faced disclosure and code of ethics requirements, resulting in significantly higher legal fees. The industry argued that completing the thirty-five-page Form ADV was unnecessarily costly and burdensome. Registration also allowed the SEC to screen hedge fund advisers for prior convictions or other professional misconduct. *See also* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 976.

25. *See, e.g.*, Laura Edwards, Note, *Looking Through the Hedges: How the SEC Justified Its Decision to Require Registration of Hedge Fund Advisers*, 83 WASH. U. L.Q. 603, 622 (2005) ("According to the MFA, the SEC received 156 letters as of October 13, and 124 of the letters specifically stated the author's position on the proposal. . . . Of the 124 letters, the Managed Funds Association classified 91 letters, or 73% of the letters, as being against the proposal, while 33 letters were in favor of the proposal."); Letter from John G. Gaine, President, Managed Funds Ass'n, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 1–2 (Sept. 15, 2004), http://www.sec.gov/rules/proposed/s73004/jggaine091504.pdf ("However, it remains MFA's position that the imposition on hedge fund advisers of the proposed regulatory regime contemplated by the SEC Proposal will not work to benefit investors or the global financial markets, and that other, more efficacious means may be employed to achieve the ends desired.").

26. 451 F.3d 873 (D.C. Cir. 2006). The D.C. Circuit in *Goldstein* vacated the hedge fund rule as an instance of arbitrary rulemaking by the SEC. Because the term "client" had not otherwise been defined in the Investment Advisers Act, the SEC had no authority to determine the term's meaning.

27. *See* Karen L. Anderberg, *Is Deregistration as an Adviser with U.S. SEC an Option?: 1 February 2007 Deadline Approaches*, DECHERT ON POINT (Dechert LLP), Jan. 2007, at 1, 1 ("[M]any hedge fund advisers that registered with the SEC have already deregistered, and others are now contemplating deregistration.").

28. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 400 (proposed Jan. 4, 2007) (attempting to define a new category of accredited investor—accredited natural person—owning not less than $2.5 million in investments at the time of purchase of securities). This was ultimately deferred in the final rule. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44756, 44756 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275) ("We plan to defer consideration of our proposal to define the term accredited natural person until we have had the opportunity to evaluate fully the comments we received on that proposal together with those we receive on our May 2007 proposal.").

29. *See, e.g.*, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44756, 44757 (Aug. 9, 2007) ("In its opinion, the Court of Appeals distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which is not limited to conduct aimed at clients or prospective clients of investment advisers. Section 206(4) provides us with rulemaking authority to define, and prescribe means reasonably designed to prevent, fraud by advisers.").

30. Dodd-Frank Act, *supra* note 1, § 401, 124 Stat. at 1570.

SEC to promulgate rules requiring registration and enhanced disclosure from private fund advisers.[31] Following its Title IV mandate,[32] the SEC introduced a controversial new form, Form PF (Private Funds), that required the disclosure of counterparties and credit exposure, performance and changes in performance, the percentage of equity and debt, strategies and products used by the investment adviser and its funds, risk metrics, positions held by the investment adviser, percentage of assets traded using algorithms, and financing information, among other information.[33]

1. Private Fund Adviser Registration

Title IV requires private fund advisers with more than $150 million AUM to register with the SEC as investment advisers.[34] In addition to exempting private fund advisers with less than $150 million AUM from registration,[35] Title IV also

31. Dodd-Frank Act, *supra* note 1, §§ 402–408, 124 Stat. at 1570–74. The drafting process for the Dodd-Frank Act was divisive. The legislators supporting the act wanted the SEC to be able to obtain sufficient information to protect against systemic risk, prevent fraud, and provide investors with useful information about hedge funds—even funds that are exempt from registration. Representatives supporting the new hedge fund requirements maintained that years without regulation had ushered in the financial crisis. Others were concerned that the exemptions in Title IV might make hedge fund regulation less effective. Legislators opposed to the act alleged that the SEC failed to sufficiently curtail hedge funds under existing law and argued that hedge funds did not create systemic risk, played no role in the financial crisis, and were irrelevant to the financial system as a whole.

32. The act mandates hedge fund adviser registration to increase recordkeeping and disclosure. *See* Dodd-Frank Act, *supra* note 1, § 408, 124 Stat. at 1575 ("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.").

33. U.S. 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 (2014) [hereinafter Form PF], http://www.sec.gov/about/forms/formpf.pdf; U.S. Sec. & Exch. Comm'n, OMB No. 3235-0049, Form ADV, Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers (2011) [hereinafter Form ADV], http://www.sec.gov/about/forms/formadv.pdf.

34. *See* Dodd-Frank Act, *supra* note 1, § 408, 124 Stat. at 1575 ("The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each 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, *supra* note 1, § 403, 124 Stat. at 1575 (striking private adviser exemption under section 203(b)(3) of the Investment Advisers Act, thereby precluding many private fund advisers from avoiding registration); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42950, 42955 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275 & 279) ("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, Investment Advisers Act Release No. 3222, 76 Fed. Reg. 39646, 39666 (July 6, 2011) (to be codified at 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); Form ADV, *supra* note 33, pt. 1A, at 6–9 (explaining how to calculate regulatory assets under management); Form ADV, *supra* note 33, 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").

35. Dodd-Frank Act, *supra* note 1, § 408, 124 Stat. at 1575.

exempts advisers with less than $100 million AUM that provide advice to foreign private advisers that have fewer than fifteen clients and investors in the United States,[36] advice to clients on investments other than private funds,[37] and venture capital fund advisers.[38] While private fund advisers with less than $150 million AUM are not per se required to register, they must maintain records and provide the SEC with annual reports as well as any other reports that the SEC deems appropriate or necessary to protect investors.[39]

The Dodd-Frank Act transfers responsibility for midsized investment advisers from the SEC to state regulatory authorities.[40] Midsized advisers that do not meet the SEC registration requirements are instead required to register with either the state securities commissioner or a similar agency in the state of their principal place of business.[41] In those states that do not provide appropriate oversight, the SEC oversees midsized advisers.[42]

2. Disclosure

In addition to mandating the registration of private investment fund advisers, Title IV requires registered investment advisers to maintain records as well as any other information the SEC requires to evaluate the private fund industry, maintain appropriate oversight, and avoid systemic risk. To attain these objectives, the SEC amended its Form ADV and introduced Form PF.

a) Form ADV

SEC Form ADV is a disclosure document that the SEC amended to reflect the new registration requirements under the Dodd-Frank Act. Any investment ad-

36. Dodd-Frank Act, *supra* note 1, §§ 402–403, 124 Stat. at 1570–71 (stating that to qualify for the exemption, foreign private advisers cannot have a place of business in the United States, cannot hold themselves out to the U.S. public as an investment adviser, and cannot have more than $25 million AUM attributed solely to U.S. clients and investors). *But see* Dodd-Frank Act, *supra* note 1, § 402(a), 124 Stat. at 1570 (allowing the SEC to exercise its rulemaking powers and raise this amount).

37. Dodd-Frank Act, *supra* note 1, § 410, 124 Stat. at 1576–77.

38. Dodd-Frank Act, *supra* note 1, § 407, 124 Stat. at 1574–75.

39. Dodd-Frank Act, *supra* note 1, § 408, 124 Stat. at 1575.

40. Dodd-Frank Act, *supra* note 1, § 408, 124 Stat. at 1575 (amending section 203A(a)(2) of the Investment Advisers Act). Midsized advisers are generally defined as investment advisers with between $25 and $100 million in AUM that are subject to registration and examinations with the state in which they maintain their principal office and place of business.

41. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42952 (stating that a midsized adviser should determine whether she is "required to be registered" or "subject to examination" by a state securities authority, by consulting Item 2.b of the Instructions for Part 1A of Form ADV); *Frequently Asked Questions Regarding Mid-Sized Advisers*, U.S. Sec. & Exchange Commission, https://www.sec.gov/divisions/investment/midsizedadviserinfo.htm (last modified June 28, 2011) (stating that all state securities authorities other than New York and Wyoming have advised the SEC that advisers registered with them are subject to examination). This is no longer true for Minnesota. *See* Minn. Stat. § 80A.61 (2014).

42. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42952 & n.22 (citing data from the Investment Adviser Registration Depository and estimating that "approximately 3,200 SEC-registered advisers will be required to withdraw their registration and register with one or more state securities authorities").

viser registering with the SEC is required to file Form ADV.[43] Under amended Form ADV, registered investment advisers and exempt reporting advisers[44] are required to report to the SEC any information regarding the private funds they manage;[45] the required disclosures include information regarding investment strategy, fund structure, ownership, gross asset value, scope of provided services, and the fund's use of consultants and other gatekeepers.[46]

Under amended Form ADV, advisers must report their gross Regulatory Assets Under Management ("RAUM"), which impacts the adviser in several ways. RAUM is a key concept for the registration of investment advisers. The AUM managed by an adviser determines whether the adviser must register with the SEC.[47] The Investment Advisers Act defines RAUM as "the 'securities portfolios' with respect to which an adviser provides 'continuous and regular supervisory or management services.'"[48] On revised Form ADV, advisers will no longer be able to deduct outstanding debt or other accrued but unpaid liabilities from their totals because they must report their gross RAUM, rather than their net.[49] To increase consistency, revised Form ADV also reduces the ability of investment

43. 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) (2016); *id.* § 279.1 (establishing filing requirements for Form ADV); *see also* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42953–54; 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*, MICH. BUS. L.J., Spring 2011, at 19, 19 ("The SEC requires all investment advisers . . . registered with the SEC to complete and file a Form ADV with the SEC . . . ."); 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) (explaining how the rules require private fund advisers to mail additional disclosures to the SEC); Marybeth Sorady et al., *Summary and Analysis of Dodd-Frank Rules for Investment Advisers: Registration Requirements, Exemptions, Family Offices, Performance Fee Eligibility*, 12 J. INV. COMPLIANCE 4, 4 (2011) (explaining the rules recently adopted by the SEC under the provisions of the Dodd-Frank Act that are related to the increased asset threshold for federal registration as an investment adviser and "focusing in particular on analyzing the impact of the Rules on U.S. and non-U.S. advisers to private funds").

44. FORM ADV, *supra* note 33, pt. 1A, at 5–6 (requiring exempt reporting advisers to disclose only a limited subset of items on Form ADV).

45. FORM ADV, *supra* note 33, pt. 1A, at 5–6.

46. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42965–66 (requiring advisers to complete section 7.B.(1) of Schedule D for any private fund that the adviser manages when, previously, Item 7 required only that advisers 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 42965. 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'"—this will both identify gatekeepers and give investors an idea of what kinds of roles particular gatekeepers play. *Id.* at 42968. 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 42965.

47. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42955.

48. *Id.* (quoting Investment Advisers Act § 203A(a)(3)).

49. *Id.* at 42956.

advisers to exercise discretion in either counting or excluding assets from RAUM.[50]

The SEC also amended Form ADV to ensure the appropriate identification of entities and individuals with exposure to hedge fund investments. Accordingly, amended Form ADV requires that investment advisers disclose the types of services they provide, including financial planning, portfolio management, pension consultation, security rating, and educational seminars.[51] Advisers must also identify their clients by type (examples include low and high net worth individuals, investment companies, banks, charities, and insurance companies).[52] Advisers must also identify what percentage of the adviser's total RAUM is owned by each type of client[53] and what compensation arrangements the adviser uses.[54]

The SEC also intends to ensure the availability of sufficient data, which are required to understand an adviser's business and prepare for on-site examinations. Accordingly, revised Form ADV requires advisers to disclose their clients, employees, compensation arrangements, and advisory activities.[55] Required disclosures include total number of employees[56] as well as the number of nonemployees who solicit advisory clients on the adviser's behalf.[57] Those nonemployees are further categorized by those who perform advisory functions, who act as registered representatives of broker-dealers, who are registered with state authorities as investment adviser representatives, and who are insurance agents.[58]

Amended Form ADV allows the SEC to address conflicts of interest in various ways. Advisers are required to disclose transactions involving a conflict of interest that may arise in direct transactions between advisers or related persons and clients.[59] Form ADV requires advisers to identify their types of business

50. *Id.*; *see also id.* at 42955 (precluding advisers from excluding family assets, proprietary assets, assets managed without compensation, and assets of foreign clients when calculating RAUM). The Dodd-Frank Act gives the SEC authority to require reporting and recordkeeping for assets carrying systemic risk. Dodd-Frank Act, *supra* note 1, § 410, 124 Stat. at 1576–77; Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42955.

51. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42970 (Item 5.G); *see also id.* (Item 5.H) (requiring disclosures pertaining to the number of clients the adviser provided with financial planning services); *id.* (Item 5.I) (asking whether the adviser participates in a wrap fee program); *id.* (Item 5.J) (asking whether the adviser previously indicated that it provides investment advice only with respect to limited types of investments).

52. *Id.* (Item 5.D.(1)).

53. *Id.* (Item 5.D.(2)).

54. *Id.* (Item 5.E).

55. Form ADV, *supra* note 33, pt. 1A, at 7–11 (Item 5); *see* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42970 (adopting amendments to Item 5 largely as they were originally proposed, with only a few minor changes).

56. Form ADV, *supra* note 33, pt. 1A, at 7 (Item 5.A).

57. Form ADV, *supra* note 33, pt. 1A, at 17 (Item 5.A); *see also* Form ADV, *supra* note 33, pt. 1A, at 8–10 (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.* (Item 5.C.(1)–(2)) (asking for the number of clients and what percentage are non-U.S. persons).

58. Form ADV, *supra* note 33, pt. 1A, at 7 (Item 5.B).

59. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42971; Form ADV, *supra* note 33, pt. 1A, at 13 (Item 8.A) (requiring disclosure as to whether the adviser or related person buys 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

activity,[60] whether one of those businesses is the adviser's primary business,[61] and whether the adviser provides any service other than investment advice to advisory clients.[62] Such disclosures are intended to avoid potential conflicts of interest between the different types of businesses and services the adviser may engage in.[63] Other disclosures in this context include related-person status of brokers and dealers;[64] soft dollar benefits, which describe other research, products, and services associated with client transactions;[65] and compensation for client referrals.[66]

Custodial practices represented another major emphasis for the SEC in amending Form ADV. The adviser must disclose the number of persons who act as qualified custodians for clients in connection with the advisory services provided those clients.[67] Revised Form ADV also requires disclosure of the custody of client assets,[68] cash, bank accounts, and securities.[69] The adviser must

the adviser or related person has a proprietary ownership interest other than the two described immediately above); Form ADV, *supra* note 33, pt. 1A, at 13 (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); Form ADV, *supra* note 33, pt. 1A, at 13 (Item 8.C.) (requiring disclosure, including 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 determine the broker or dealer to be used for purchases or sales for the account, or to determine the commission rates to be paid to a broker or dealer for the account).

60. Form ADV, *supra* note 33, pt. 1A, at 11 (Item 6.A) (providing that business activities include broker-dealer, futures commission merchant, real estate broker, banking, legal work, or accounting).

61. Form ADV, *supra* note 33, pt. 1A, at 11 (Item 6.B.(1)–(2)).

62. Form ADV, *supra* note 33, pt. 1A, at 11 (Item 6.B.(3)) (asking the adviser to describe other products and services).

63. Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42970.

64. Form ADV, *supra* note 33, pt. 1A, at 13–14 (Items 8.D, 8.F).

65. Form ADV, *supra* note 33, pt. 1A, at 14 (Item 8.G).

66. Form ADV, *supra* note 33, pt. 1A, at 14 (Items 8.H–I); *see* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42971–72 (adopting three amendments to Item 8: (1) an adviser who indicates that he or she 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 section 28(e) of the Exchange Act's safe harbor; and (3) an adviser must report whether his or her related person receives direct or indirect compensation for client referrals); *see also* Form ADV, *supra* note 33, pt. 1A, at 13–14 (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. 54165, 71 Fed. Reg. 41978, 41981–82 (July 24, 2006) (to be codified at 17 C.F.R. pt. 241) (providing interpretive guidance in determining whether soft dollar benefits fit under the safe harbor of section 28(e) of the Exchange Act).

67. Form ADV, *supra* note 33, pt. 1A, at 15 (Item 9.D) (asking whether the adviser or a related person acts as a "qualified custodian" for clients in connection with advisory activities provided to clients and requiring the adviser to identify any related person who acts as a qualified custodian in section 7.A of Schedule D, regardless of whether the person is operationally independent under Rule 206(4)-2 of the Advisers Act).

68. Form ADV, *supra* note 33, pt. 1A, at 14–16 (Item 9); *see* Form ADV, *supra* note 33, pt. 1A, at 2 (Appendix C: Glossary of Terms) ("[An adviser has] custody if a *related person* holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [the adviser] provides to clients.").

69. Form ADV, *supra* note 33, pt. 1A, at 14–15 (Items 9.A–B).

indicate the total U.S. dollar amount held in custody as well as the total amount of clients' cash, bank accounts, and securities subject to adviser or related-person custody.[70] If the adviser or a related person has custody of client assets, revised Form ADV requires disclosure of any irregularities to prevent fraud or mistakes.[71]

b) Form PF

Reporting obligations on Form PF[72] increase the regulatory oversight of private funds to unprecedented levels.[73] Form PF requires investment managers to disclose information about themselves, their managed funds, and their investors.[74] This includes products used by the investment adviser, performance—or changes in performance—of the products, financing information, risk metrics, strategies used, credit exposure, and positions held by the investment adviser among other categories of information.[75]

Important Form PF disclosure requirements include the five trading counterparties to which the reporting fund has the greatest net counterparty credit exposure;[76] this includes the dollar amount owed to each creditor[77] and a breakdown of the net asset value ("NAV") the investment manager oversees,[78] including the percentage of the reporting fund's NAV that was managed using high-frequency trading strategies.[79] Other important Form PF disclosures include the requirement that the manager identify changes in market factors and their effect on the long and short components of the portfolio as a percentage of NAV,[80] any information about counterparties' collateral, other credit support

70. Form ADV, *supra* note 33, pt. 1A, at 14–15 (Items 9.A–B).

71. Form ADV, *supra* note 33, pt. 1A, at 15 (Item 9.C) (requiring advisers to disclose whether clients with assets under custody receive statements, whether an independent public accountant audits client accounts, and whether an independent public accountant prepares an internal control report with respect to custodial services).

72. Form PF, *supra* note 33, at 2; *see also* 17 C.F.R. § 275.204(b)-1 (2016) (requiring private fund advisers to file Form PF with the SEC periodically); *id.* § 4.27 (requiring private fund advisers to file Form PF if they are registered as commodity pool operators or commodity trading advisers); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 76 Fed. Reg. 71128, 71239 (Nov. 16, 2011) (to be codified at 17 C.F.R. pts. 275 & 279).

73. *See supra* note 72; *see also* Dodd-Frank Act, *supra* note 1, tit. IV, 124 Stat. at 1570 (incorporating the Private Fund Investment Adviser Registration Act (PFIARA) in Title IV); *see also Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/. . ./EC*, COM (2009) 207 final (Apr. 30, 2009).

74. *See* 17 C.F.R. § 279.9 (2016) (establishing filing requirements for Form PF); Form PF, *supra* note 33, § 1a–b.

75. *See* Form PF, *supra* note 33.

76. Form PF, *supra* note 33, § 1c (Items B.22–23).

77. Form PF, *supra* note 33, § 2b (Item D.47).

78. Form PF, *supra* note 33, § 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, and (h) funds and accounts other than private funds).

79. Form PF, *supra* note 33, § 1c (Item B.21).

80. Form PF, *supra* note 33, § 2b (Item C.42).

posted to the respective reporting funds,[81] and trading and clearing mechanisms subject to liquidity constraints and the duration of those constraints.[82]

The SEC intended Form PF to improve its understanding of reporting funds' liquidity, exposure, and assets. To help the SEC understand reporting funds' liquidity, exposure, and assets, Form PF requires investment advisers to disclose the time increments it would take to liquidate a certain percentage of the reporting funds' portfolio,[83] the dollar value of long and short positions in each asset class,[84] the value of turnover by asset class,[85] the market value of each of the advised funds' borrowings, the types of their creditors,[86] and the aggregate value of all derivative positions for each advised fund.[87] Finally, Form PF requires disclosure, if applicable, of the reporting funds' restrictions on investor withdrawals and redemptions,[88] and other information pertinent to investor liquidity, such as the percentage of NAV.[89]

The RAUM of the investment adviser dictates the required frequency of Form PF filings. The SEC uses a tiered approach intended to reflect the relative risks of each type of fund.[90] Large hedge fund advisers, defined as those with at least $1.5 billion RAUM attributable to hedge funds,[91] must update their Form PF filings quarterly.[92] In contrast, private fund advisers with less than $1.5 billion RAUM attributable to private funds file Form PF on an annual basis.[93]

Considering the highly sensitive nature of these required disclosures and the complexity of the reporting requirements, Form PF created substantial challenges for the hedge fund industry. Some of the most controversial disclosure requirements on Form PF include the reporting of risk metrics, strategies and products used by the investment adviser and its funds, counterparties and credit exposure, performance and changes in performance, financing information, percentage of assets traded using algorithms, and the percentage of fund assets held in equity and debt instruments.

81. Form PF, *supra* note 33, § 2b (Item B.36).
82. Form PF, *supra* note 33, § 1c (Item B.24).
83. Form PF, *supra* note 33, § 2b (Item B.32).
84. Form PF, *supra* note 33, § 2a (Item B.26); Form PF, *supra* note 33, § 2b (Item B.30) (pertaining to investment advisers that advise more than one private fund).
85. Form PF, *supra* note 33, § 2a (Item B.27).
86. Form PF, *supra* note 33, § 2d (Item D.43).
87. Form PF, *supra* note 33, § 2b (Item D.44).
88. Form PF, *supra* note 33, § 2b (Item E.49).
89. Form PF, *supra* note 33, § 2b (Item E.50).
90. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 76 Fed. Reg. 71128, 71136 (Nov. 16, 2011) (to be codified at 17 C.F.R. pts. 275 & 279).
91. *Id.* at 71132–33 (defining "large private fund adviser").
92. *Id.* at 71140; Form PF, *supra* note 33 (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.").
93. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. at 71140; *see also* Form PF, *supra* note 33 (Instruction 9) (providing different filing periods for different types of advisers).

Despite these apparent challenges, prior surveys suggest that the impact of Form PF has been absorbed relatively quickly by the hedge fund industry.[94] The majority of private fund advisers responding to a 2012 survey incurred costs of less than $10,000 to prepare their initial data reports for the SEC, with the cost of subsequent annual Form PF filings falling to about half the initial cost.[95] Larger hedge fund advisers, that must file quarterly, face substantially higher compliance costs—both for their initial data reporting and for subsequent quarterly filings. However, according to the survey, the reporting obligations for private fund advisers on Form PF and the corresponding SEC forms may be further improved.[96] The majority of SEC-registered hedge fund advisers identified the ambiguity of Form PF data reporting requirements as the most pressing issue. In summary, prior surveys suggest that the hedge fund industry seems to be adjusting well to the registration and disclosure requirements of Dodd-Frank. The impact of the registration and disclosure rules appears to be much less significant than feared by the private fund industry.

Since 2012, when survey data for the previous study were collected, the SEC has made only minor changes to Form PF. The SEC regulation passed between 2012 and the current study affects money market funds, revises section 3 of Form PF as well as general instruction 15, and makes minor changes to the glossary of terms, adding and revising certain items.[97] The SEC periodically releases "Investment Management Regulatory Updates," and posts responses to frequently asked questions regarding Form PF.[98] Neither the new regulation nor updated guidance change or alter survey data in any meaningful way.

II. Private Fund Industry Five Years After Dodd-Frank

The private fund industry has evolved since the Dodd-Frank Act rules for private funds became operative in 2012; the industry has grown substantially since the enactment of Title IV. In lockstep with investor-driven changes, the regulatory environment for private funds continues to evolve. The SEC is providing more guidance on Form PF, and it may continue to amend the regulatory environment for the private fund industry. Moreover, with the passing of the JOBS

94. Wulf A. Kaal, *Private Fund Disclosures Under the Dodd-Frank Act*, 9 Brook. J. Corp. Fin. & Com. L. 428, 428 (2015) ("[T]he data analysis in this study suggests that the overall effect of private fund disclosure requirements on the private fund industry is moderate . . . .").

95. *Id.* at 428 ("The key findings of this study indicate that the majority of private fund advisers responding to the survey incurred less than $10,000 to prepare their initial data reporting to the SEC, with the cost of subsequent annual Form PF filings at about half the initial cost.").

96. *Id.* ("[I]t also indicates that the data reporting requirements for private funds and the corresponding SEC forms can be further improved. The majority of SEC-registered private fund advisers identified the ambiguity of Form PF data reporting requirements in Form PF as the most pressing issue.").

97. *See* Money Market Fund Reform, Amendments to Form PF, Investment Company Act Release No. 31166, 79 Fed. Reg. 47736, 47863 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274 & 279).

98. *Form PF Frequently Asked Questions*, U.S. Sec. & Exchange Commission, https://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml (last visited Feb. 15, 2016).

Act in 2012,[99] the SEC finally obtained a mandate to amend Rule 506,[100] ending more than six decades of private offerings that were subject to a ban on general solicitation and general advertising. Fortunately, academics and practitioners increasingly recognize that the private fund industry and the mutual fund industry are converging at an accelerating pace.[101]

1. Private Fund Industry Trends

Between 2013 and 2015, the private fund industry grew by 26%, increasing from just over $2 trillion AUM in 2013 to $2.7 trillion AUM at the end of 2015.[102] Traditional alternative investments, such as hedge funds and private equity,[103] have grown twice as fast as traditional investments, such as mutual funds and closed-end funds.[104] The larger private fund advisers have generated most of the private fund industry's growth. Assets managed by private fund advisers with more than $5 billion AUM have grown 141%, compared to 53% for firms with less than $5 billion.[105] However, in comparison to the overall asset management industry, hedge funds nonetheless represent a small portion of the business.[106]

99. *See supra* note 10.

100. Section 201 of the JOBS Act directed the SEC to lift the prohibition against general solicitation and general advertising, allowing a broadening of marketing efforts provided that all purchasers of the securities are accredited investors. JOBS Act, *supra* note 10, § 201(a)(1), 126 Stat. at 313. Under section 201(a)(1) of the JOBS Act, the SEC was required to revise Rule 506 no later than ninety days of the enactment of the JOBS Act, i.e., July 4, 2012. However, the SEC proposing release was not issued until September 2012 and was finally adopted in July 2013. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464 (proposed Sept. 5, 2012); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

101. Kaal, *supra* note 16

102. *Hedge Fund Industry—Assets Under Management*, Barclay Hedge, http://goo.gl/PB3P86 (last visited Feb. 15, 2016) (hedge fund industry had $2.721 trillion AUM in 2015).

103. Pooneh Baghai et al., *The $64 Trillion Question: Convergence in Asset Management*, McKinsey on Investing, Winter 2014/2015, at 11 ("We include assets held by hedge funds, private-equity firms, and real assets (in agriculture, commodities, energy, infrastructure, and real estate) held by financial investors.").

104. *Id.* at 6 ("exchange-traded funds, mutual funds, registered closed-end funds").

105. Deutsche Bank Global Prime Fin., Thirteenth Annual Alternative Investment Survey 2 (2015), http://www.kiscapital.com/LiteratureRetrieve.aspx?ID=193076.

106. Hedge funds make up around $3 trillion AUM compared to $15 trillion AUM for bank holding companies and $33.4 trillion AUM (and $18.2 trillion AUM in the United States) for mutual funds. While hedge funds have exhibited strong growth, they still represent a minority of total investment assets. *Compare* Inv. Co. Inst., 2015 Investment Company Fact Book i (2015) (U.S. investment company total assets were $18.2 trillion for the year ending in 2014), *with Hedge Fund Industry—Assets Under Management*, Barclay Hedge, http://goo.gl/PB3P86 (last visited Feb. 15, 2016) (hedge fund industry had $2.508 trillion AUM for the year ending in 2014); *see also* Managed Funds Ass'n, Dodd-Frank at 5: The Role of Alternative Investments in Today's Capital Markets 3 (2015) ("With approximately 3 trillion dollars in global assets under management, the hedge fund industry is relatively small in size when compared to the size and scale of the overall financial system. The industry is also significantly less concentrated than other parts of the financial services industry and its transparency is at an all-time high.").

Since the enactment of Title IV, the private fund industry has underperformed compared to indexes and benchmarks.[107] The underperformance may result from the institutionalization of private funds, because pension funds increase private fund holdings, and, furthermore, institutions represent over two-thirds of the private fund base—up from 20% a decade ago.[108] Despite the underperformance, evidence suggests that institutional investor satisfaction with hedge funds is high.[109]

The enactment of the Dodd-Frank Act also marked a turning point in the performance of investment strategies, specifically HFRI relative value, global aggregate, and event-driven strategies were the best performers since 2009. In contrast, equity, macro, and systemic diversified strategies performed the worst.[110]

As the investor profile for private funds shifts toward institutional investors, fees fall. Institutional investors constituted 65% of hedge fund AUM in 2015, compared to just 20% a decade ago.[111] As public and private pension funds increasingly invest in private funds, fund managers become trusted partners of pension funds, charitable foundations, and university endowments, which helps these organizations meet financial goals and fulfill their fiduciary obligations.[112] The institutionalization of the private fund industry creates pressure on its traditional fee structure. The 2/20 fee model (2% management fee/

107. Philippe Ferreira et al., A New Era for Hedge Funds? 5–7 (2015), http://goo.gl/XjTeik ("Hedge funds have underperformed traditional asset classes over recent years . . . . The Relative Value and Event Driven strategies have shown the highest Sharpe ratios since 2009, respectively outperforming the fixed income benchmark and a diversified portfolio."); *see also* James B. Steward, *As Hedge Fund Returns Falter, Money Continue to Flow In*, N.Y. Times (Feb. 26, 2015), http://www.nytimes.com/2015/02/27/business/hedge-fund-returns-falter-yet-money-continues-to-flow-in.html?_r=0. According to the NYT/Vanguard, within the five years that ended on January 2015, hedge funds returned 5.4%, compared to a passive 60% Stocks/40% Bonds Index, which would have returned 10%. This trend appears to have accelerated in recent years (the ten-year performance gap is only a 19% difference, while the five-year performance gap is an 85% difference). Note that the Dodd-Frank Act was passed in July 2010, while the five-year data start in January 2010.

108. Managed Funds Ass'n, *supra* note 106, at 4 ("Hedge funds are no longer just tools for high-net worth individuals. Today, institutional investors now represent nearly two-thirds of the industry's assets under management. Fund managers are trusted partners of pension funds, charitable foundations and university endowments that help these organizations fulfill their fiduciary obligations and meet financial goals."); Ferreira et al., *supra* note 107, at 14 ("Institutional investors now represent two-thirds of the hedge fund investor base, up from 20% a decade earlier. While this has contributed to increasing financial stability and reduced leverage ratios, operating costs have ballooned to meet demands for greater compliance and transparency and to implement tighter internal controls.").

109. Chris Flood, *Hedge Funds Remain a Popular Choice for Institutional Investors*, FT.Com (June 7, 2015, 6:21 AM), http://www.ft.com/intl/cms/s/0/3d990070-0946-11e5-b643-00144feabdc0.html#axzz3np0qUWI8 ("The popularity of hedge funds among large institutional investors shows no sign of abating despite widespread dissatisfaction with high fees and poor performance. According to Preqin, the data provider, assets run on behalf of the 10 largest institutional investors in hedge funds worldwide stood at $183bn at the end of June, an increase of almost 10 per cent over the previous 12 months."); Managed Funds Ass'n, *supra* note 106, at 5 ("Preqin, a leading research firm, found that institutional investor satisfaction with hedge funds is high. Those surveyed even indicated that they plan to maintain or increase existing allocations.").

110. Ferreira et al., *supra* note 107, at 10 (see chart: "Hedge funds have outperformed risk assets on a risk adjusted basis.").

111. Ferreira et al., *supra* note 107, at 14.

112. Managed Funds Ass'n, *supra* note 106, at 4.

20% incentive fee) is no longer representative of the private fund industry.[113] While smaller private funds still charge between 1.53% and 18% in fees,[114] larger funds charged between 1.37% and 16% in fees in 2015.[115] A combination of underperformance in the private fund industry, combined with the rush of new investors into alternative investments—pension funds, endowments, and other institutions now outnumber rich individuals as private fund investors—means that those investors have more bargaining power regarding fees.[116]

Post-Title IV compliance and operating costs are increasing. A 2014 survey attributed a 10% increase in annual operating costs to the Dodd-Frank Act.[117] The private fund industry has invested heavily in compliance measures; on average, the industry spends more than 7% of its total operating costs on compliance technology.[118] Smaller private funds spend more on compliance costs than their larger counterparts—both as a percentage of AUM and in relation to operating costs; this suggests that increasing regulatory scrutiny disproportionately impacts smaller funds.[119] Despite increased compliance costs, private funds

113. At the onset, I should state that there is variance in this data. While there is consensus among data providers that the figure is declining, variability does exist in the reported estimates. This is likely because of the opaqueness of how private funds disclose fees (at least over time) and different methodologies/samples. For the HFR/Lyxor estimate, see FERREIRA ET AL., *supra* note 107, at 7 ("The chart below highlights the fact that the 'two and twenty' hedge fund fee structure no longer prevails. The current average fee structure for the industry is a 1.5% management fee and 17% performance fee. On average, the smallest hedge funds have the highest fees [1.53% / 18%] while the largest have the lowest fees [1.37% / 16%]."). For the Eurekahedge estimate, see Madison Marriage, *Hedge Fund Performance Fees Decline Sharply*, FT.COM (Oct. 18, 2015, 7:04 AM), http://goo.gl/qdZFGQ ("According to Eurekahedge, the data provider, new hedge funds charge average performance fees of 14.7 per cent, a sharp drop on the 17.1 per cent typically charged in 2014."). For Preqin: Oliver Crabb*, A New Era for Hedge Fund Fees?—February 2014*, PREQIN BLOG (Feb. 12, 2014), https://www.preqin.com/blog/0/8340/hedge-funds-fees ("Data from Preqin's Hedge Fund Analyst online service shows that 2013 was a year of historically low fees among new fund launches. At 1.43% and 17.14% respectively, the average management and performance fees for new launches in 2013 were a long way off the once standard '2/20' fee structure.").

114. FERREIRA ET AL., *supra* note 107, at 7.

115. *Id.*; *see also Down to 1.4 and 17*, THE ECONOMIST (Feb. 8, 2014), http://www.economist.com/news/finance-and-economics/21595942-cost-investing-alternative-assets-fallingslowly-down-14-and-17 ("Just four in ten hedge funds now charge a management fee of 2%, according to Preqin, a data provider.").

116. FERREIRA ET AL., *supra* note 107, at 7; Michael P. Regan, *The Incredible Shrinking Hedge-Fund Fee*, BLOOMBERGVIEW (Oct. 27, 2015, 11:37 AM EDT), http://goo.gl/OGspWr ("The other trend has been a preference among big institutional investors to place money in larger hedge funds, causing smaller startups to lower their fees in order to attract investors.").

117. *See* FERREIRA ET AL., *supra* note 107, at 14 ("[I]t was estimated that hedge funds had seen a 10% increase in annual operating costs since 2008 attributable to compliance costs resulting from Dodd Frank reforms in the US."); THE COST OF COMPLIANCE, *supra* note 2.

118. THE COST OF COMPLIANCE, *supra* note 2, at 4–5 ("Based on extrapolations from our data, we believe that compliance is costing the industry more than USD3 billion with smaller fund managers spending USD700,000 on compliance on average, medium fund managers spending approximately USD6 million, and large fund managers spending more than USD14 million.").

119. Wulf A. Kaal, *What Drives Dodd-Frank Act Compliance Cost for Private Funds?*, 19 J. ALTERNATIVE INVS. 8 (2016) ("These findings are consistent with the hypothesis that the cost of financial regulation under the Dodd-Frank Act brings increasing returns to scale."). Earlier studies also suggested that increased compliance costs would impact smaller hedge funds more than larger ones. CITI PRIME FIN., *supra* note 2, at 4 ("Because these costs are higher on a relative basis for smaller hedge funds and lower for larger hedge funds . . . .").

typically still show higher profitability than the rest of the asset management industry.[120] Although it manages only 4% of the global asset management industry's total AUM ($2.8 trillion out of $68.7 trillion),[121] the private fund industry represented 34% of profits generated by that industry in 2013 ($31.2 billion out of $93.0 billion).[122]

Private funds' role in shadow banking (private funds operating as banks and engaging in lending) has proliferated since Title IV was enacted. The Dodd-Frank Act made it more difficult for some banks to operate successfully in the lending market, which created an opening for private funds' involvement in lending. In essence, because the Dodd-Frank Act discouraged banks from getting too big, private funds and other alternative lenders filled the void, providing financing to the small- and medium-size businesses that traditional banks were no longer equipped to serve.[123] Because of the Dodd-Frank Act's effect on private fund lending, the Act may have created opportunities for the growth of the private investment fund industry.[124] As a result of these new business opportuni-

120. Citi Investor Sales, 2014–2015 Annual Hedge Fund Operating Metrics Survey 4 (2015), https://perma.cc/F266-XG2T ("Extrapolating the work we did on industry-wide operating margins in last year's report, we were able to calculate in this year's third Annual Hedge Fund Operating Metrics Survey that the hedge fund industry represented 34% of the profits generated by the entire asset management industry globally in 2013 [$31.2 billion out of $93.0 billion], despite controlling only 4% of the industry's total AUM [$2.8 trillion out of $68.7 trillion].").

121. *Id.*

122. *Id.*

123. Tough new capital rules for banks have led to a proliferation in non-bank institutions (e.g., hedge funds/private equity) becoming more deeply involved in risky lending. The Financial Stability Oversight Council identifies this as a potential risk going forward. Fin. Stability Oversight Council, 2015 Annual Report 114 (2015), https://goo.gl/6jBJgH ("A pullback by banks could provide an opportunity for institutions not subject to the guidance such as private equity firms, unregulated arms of broker-dealers, and business development companies to expand their participation in the riskiest deals. In this scenario, banks would continue to originate less risky leveraged loans while firms not subject to the guidance would originate more risky loans targeted by the guidance. The migration in credit origination outside of the banking system could result in a further decline in underwriting standards for those particular loans, which could result in larger losses in stressed conditions."); *see also* Christine Idzelis & Craig Torres, *Risky Loans Shunned by Banks Are Booming in Wall Street's Shadow*, Bloomberg Bus. (May 21, 2015, 11:00 PM CDT), http://www.bloomberg.com/news/articles/2015-05-22/wall-street-flouts-fed-standards-to-fund-high-risk-loans ("Asset managers are reshaping the market for lending to midsize companies, some top U.S. bankers told the Federal Reserve Board earlier this month. Regulators have scrutinized large banks for risk, publishing strict guidance on leveraged lending in 2013. That's allowing non-bank funds, many with ties to private-equity firms, to fill the void by helping finance buyouts and indebted companies. The credit sustains jobs and businesses, but it's also operating beyond the oversight of bank supervisors."); Lauren Tara Lacapra & David Henry, *Analysis: Five Years After Lehman, Risk Moves into the Shadows*, Reuters (Sept. 12, 2013, 5:27 AM EDT), http://www.reuters.com/article/us-lehman-fiveyear-analysis-idUSBRE98B05620130912 ("Regulators, bank executives and others say that the idea of unregulated entities stepping further into banks' traditional businesses is troubling.").

124. *See* Fin. Stability Oversight Council, *supra* note 123, at 114; *Alternative Investment Five Years After Dodd-Frank*, DailyAlts (Aug. 15, 2015), http://dailyalts.com/alternative-investments-five-years-dodd-frank/ ("Since banks have been discouraged from getting 'too big,' hedge funds and other alternative lenders have stepped up to the plate, providing financing to small- and medium-size businesses that traditional banks are no longer equipped to lend to. Rather than cramping alternatives, Dodd-Frank has actually created new opportunities for the industry's growth.").

ties, private funds have developed new techniques for managing risk, such as using secured or collateralized loans rather than unsecured loans.

Since the enactment of Title IV, the growth of activist private funds (private funds that actively seek to influence management outcomes) has increased significantly. Not only have activist campaigns delivered outsize returns, but they have also attracted newcomers.[125] More than ten activist funds now manage over $10 billion each—more money than the entire asset class managed ten years ago. The higher performance of this investment strategy allows activist private fund managers to use the higher 2/20 fee structures, which other fund managers can no longer demand.[126] The surge in activist private funds has influenced (target) firms' strategic and financial decision making more profoundly than any other trend.[127]

2. Regulatory Developments

Several notable regulatory trends and developments have affected the private fund industry in the aftermath of unprecedented registration obligations for private fund advisers under the Dodd-Frank Act.

Importantly, since 2015, the SEC has greatly increased its focus on the role of the chief compliance officer ("CCO").[128] While SEC Commissioners have noted that CCOs who perform diligently and in good faith are less likely to be subjected to enforcement actions,[129] chief operating officers ("COOs") are increas-

125. J.P. Morgan, The Activist Revolution: Understanding and Navigating a New World of Heightened Investor Scrutiny 1 (2015) ("No recent development has influenced firms' strategic and financial decisionmaking as profoundly as the surge in shareholder activism following the global financial crisis. From a few activist funds managing less than a total of $12 billion in 2003, the activist asset class has ballooned to more than $112 billion in assets under management for activist hedge funds with most of that growth occurring since 2009 . . . . These figures are in addition to the significant capital focused on activist strategies by multi-strategy funds. Today, more than 10 activist funds (activist or multi-strategy funds) manage over $10 billion each, or about as much as the entire asset class 10 years ago for each fund."); Rob Copeland, *Returns from Activist Hedge Funds Are Causing a Stir*, Wall Street J. (July 7, 2014, 6:45 PM ET), http://www.wsj.com/articles/returns-from-activist-hedge-funds-are-causing-a-stir-1404773120.

126. *See supra* note 125.

127. New evidence points to large effects on target firm governance/decision making as a result of activism. *See, e.g.*, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 Colum. L. Rev. 1085 (2015); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* (Colum. Law & Econ. Working Paper No. 521, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2656325.

128. Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, The Role of Chief Compliance Officers Must Be Supported (June 29, 2015), https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html ("Chief Compliance Officers of Investment Advisers (CCOs) play an important and crucial role in fostering integrity in the securities industry. They are responsible for making sure that their firms comply with the rules that apply to their operations.").

129. *Id.* ("In the seven years that I have served as a Commissioner, it has been my experience that the Commission does not bring enforcement actions against CCOs who take their jobs seriously and do their jobs competently, diligently, and in good faith to protect investors. I do not believe that these CCOs should fear the SEC."); Andrew Ceresney, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, 2015 National Society of Compliance Professionals National Conference: Keynote Address (Nov. 4, 2015), https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseney.html ("I am hopeful that, after you hear my remarks, you will understand that these actions

ingly subjected to monetary penalties and named in settlement orders.[130] Firms that outsource their chief compliance roles to third parties face increased scrutiny and threat of examination.[131] The SEC warns that CCO liability could become an issue if CCOs mislead regulators, engage in affirmative misconduct, or fail to carry out compliance responsibilities.[132]

The SEC has also announced an initiative focused on cybersecurity.[133] While the SEC is generally concerned about the protection of the confidential information of its advisers and individual customer information, as well as other electronic data,[134] initial statements indicate that the SEC is focusing on data removal, unauthorized access, vendor security, written information security policies, networks, physical devices, controls with access systems and data, and the overall identifica-

punish misconduct that falls outside the bounds of the work that nearly all of you do on a daily basis; do not involve the exercise of good faith judgments; and are consistent with the partnership we have developed to foster compliance with the laws.").

130. Blackrock Advisors, LLC, Investment Company Act Release No. 31558, 2015 WL 1776222 (Apr. 20, 2015) (SEC settling with Blackrock and CCO and imposing remedial sanctions); SFX Fin. Advisory Mgmt. Enters., Inc., Investment Advisers Act Release No. 4116, 2015 WL 3653814 (June 15, 2015) (SEC settling with SFX Financial Advisory and CCO and imposing remedial sanctions); Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html ("Both settlements [In the Matter of Blackrock Advisors and In the Matter of SFX Financial Advisory Management Enterprises] illustrate a Commission trend toward strict liability for CCOs under Rule 206(4)-7.").

131. Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, National Exam Program Risk Alert: Examinations of Advisers and Funds that Outsource Their Chief Compliance Officers 1 (Nov. 9, 2015), https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf ("Advisers and funds with outsourced CCOs should review their business practices in light of the risks noted in this Risk Alert to determine whether these practices comport with their responsibilities as set forth in the Compliance Rules. Advisers with outsourced CCOs retain the responsibility for adopting and implementing an effective compliance program.").

132. *See* Ceresney, *supra* note 129 ("I want to emphasize that we and the Commission carefully weigh recommending and bringing actions against CCOs. We look hard at the facts and fairness concerns in each case. The overwhelming majority of the cases we bring involve CCOs who crossed a clear line by engaging in affirmative misconduct or obstructing regulators, or who wore multiple hats. I haven't heard any concern about those cases. The concern I have heard relates to the small number of cases where we have charged CCOs with causing violations, i.e., where the CCOs exhibited wholesale failures in carrying out responsibilities that were clearly assigned to them. In my view, a complete understanding of these cases should provide comfort that we are exercising our judgment appropriately to recommend actions only when the conduct crossed a clear line."); *see, e.g.*, Alphabridge Capital Mgmt., LLC, Investment Company Act Release No. 31700, 2015 WL 3982040 (July 1, 2015) (Enforcement Division's charges against a brokerage firm's director of compliance, who was accused of fleecing investors and stealing money from the firm).

133. Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, National Exam Program Risk Alert: OCIE's 2015 Cybersecurity Examination Initiative 1 (Sept. 15, 2015), https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

134. *See id.*; *see also* Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, No. 2015-02, IM Guidance Update: Cybersecurity Guidance (2015), https://www.sec.gov/investment/im-guidance-2015-02.pdf ("The Division has identified the cybersecurity of registered investment companies ('funds') and registered investment advisers ('advisers') as an important issue. Both funds and advisers increasingly use technology to conduct their business activities and need to protect confidential and sensitive information related to these activities from third parties, including information concerning fund investors and advisory clients. This guidance update highlights the importance of the issue and discusses a number of measures that funds and advisers may wish to consider when addressing cybersecurity risks. Because of the rapidly changing nature of cyber threats, the Division will continue to focus on cybersecurity and monitor events in this area.").

tion and periodic assessment of cybersecurity risks. Specific examples of SEC action in the context of cybersecurity include the settlement of charges brought against an investment adviser that failed to adopt cybersecurity controls.[135]

a) Rule Changes

The Dodd-Frank Act and the JOBS Act reframe core regulatory assumptions about the private fund industry, increasing the visibility of private funds and their critical role in capital formation. Fulfilling its mandate under both acts, the SEC continues to refine and expand the regulatory landscape for the private fund industry by amending rules and SEC reporting forms that apply to the private fund industry.[136]

The passing of the JOBS Act in 2012 dissolved a key legal distinction between mutual funds and private funds pertaining to advertising. After more than six decades of private offerings with a ban on general solicitation and general advertising ("GSGA") that applied when institutions made private securities offerings under Rule 506 of Regulation D,[137] the SEC finally had a mandate to amend Rule 506.[138] Under Rule 506(c), for the first time in the history of the private fund industry, the SEC allowed GSGA in a Regulation D offering.[139] The rule was finalized and published in the *Federal Register* on June 24, 2013, and became effective on September 23, 2013.[140]

While lifting the ban on GSGA for private fund advisers represented a significant change for the private fund industry, the new advertising opportunities are only reluctantly being accepted;[141] the uncertainty associated with investor

135. R.T. Jones Capital Equities Mgmt., Inc., Investment Advisers Act Release No. 4204, 2015 WL 5560846 (Sept. 22, 2015) (settlement acceptance); Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Investment Adviser with Failing to Adopt Proper Cybersecurity Policies and Procedures Prior to Breach (Sept. 22, 2015), https://www.sec.gov/news/pressrelease/2015-202.html. The adviser had posted personally identifiable information, including client information, to a third-party-hosted web server that was hacked, though it was not determined that the personally identifiable information had been compromised, and there was no evidence of financial loss by any client.

136. See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166, 79 Fed. Reg. 47736, 47863 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274 & 279); *Form PF Frequently Asked Questions*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml (last visited Feb. 15, 2016).

137. Advertising was banned under the previous Rule 506. *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251, 11253 (Mar. 16, 1982) (to be codified at 17 C.F.R. pts. 230 & 239) ("Like rule 146, rule 506 prohibits any general solicitation or general advertising."). For discussion about why the solicitation ban was likely overinclusive and impeded full regulatory transparency, see Cary Martin, *One Step Forward for Hedge Fund Investors: The Removal of the Solicitation Ban and the Challenges that Lie Ahead*, 16 U. PA. J. BUS. L. 1143, 1153–60 (2014).

138. *See supra* note 100.

139. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 5464 (proposed Sept. 5, 2012).

140. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A, 78 Fed. Reg. 44771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

141. William Alden, *Hedge Fund Advertising Off to a Slow Start, Survey Finds*, N.Y. TIMES DEALBOOK (Apr. 4, 2014, 6:07 PM), http://goo.gl/H5vB8z ("What is more, 55 percent of hedge fund managers and 63 percent of private equity fund managers said that they did not plan to advertise at the present

verification rules, coupled with several specific restrictions, make advertising by private fund advisers unlikely for the foreseeable future. Either an accredited investor must fit into one of the categories of persons who would typically qualify as an accredited investor, or the issuer has to reasonably believe that it does. The steps to verify individual investors under new Rule 506 may be found in Rule 506(c)(2)(ii), which provides four nonmandatory, nonexclusive investor verification methods.[142]

b) SEC Examinations, Enforcement Actions, and Settlements

The SEC has intensified examinations and enforcement actions since the enactment of Title IV of the Dodd-Frank Act in 2012. Since 2012, the SEC has voiced particular concern over the equitable allocation of expenses among investment advisers' portfolio funds, the allocation of investment opportunities among private investment fund advisers' clients, and the fund advisers' personal investing and outside business activities.[143]

Between 2012 and 2015 the SEC initiated several enforcement actions under the Investment Advisers Act[144] as well as other legal provisions that affected the private fund industry. These enforcement actions included the enforcement of Rule 206(4)-7, which requires funds to adopt, implement, and annually review

time, while 8 percent of hedge fund managers and 14 percent of private equity managers said that they would never engage in advertising, the survey found."); PREQIN SPECIAL REPORT: JOBS ACT 2 (2014), https://goo.gl/HGik89 ("Alternative investment managers have been slow to take advantage of the marketing opportunities presented by the JOBS Act, with just 4% of hedge fund managers and 5% of private equity managers stating that they have already registered under 506(c) which allows general solicitation [Fig. 2].").

142. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A, 78 Fed. Reg. at 44776 (final rule). The income test relies on the income stipulations reported on IRS forms for the most recent two years as well as written representations from purchasers pertaining to their reasonable expectation of reaching the income level required to qualify as an accredited investor. The net worth test, in contrast, is based on a review of three months of documentation pertaining to assets, a report from a national credit reporting agency, and a written declaration from the investor that all liabilities required to make a determination of net worth have been disclosed. Third-party verification is possible via a written stipulation from a qualified third party that confirms the third party has taken reasonable steps in the three months before the investment to confirm that the purchaser is an accredited investor. For purposes of the third-party verification test, permissible third parties include registered investment advisers, broker-dealers, licensed attorneys, and certified accountants. Lastly, Rule 506(c)(2)(ii) now allows issuers to show accredited investor status of previous purchasers of an issuer's securities in a Rule 506(b) offering prior to the effective date of Rule 506(c) by obtaining a certification from such purchaser that he or she qualifies as an accredited investor.

143. Issues regarding fund expenses arose in the context of a private equity fund attempting to integrate two portfolio companies owned by separate private equity funds, resulting in a misallocation of expenses. *See* Lincolnshire Mgmt., Inc., Investment Advisers Act Release No. 3927, 2014 WL 4678600 (Sept. 22, 2014). The 2015 Fenway case illustrates the conflicts that arise among affiliates at the expense of fund clients. *See* Fenway Partners, LLC, Investment Advisers Act Release No. 4253, 2015 WL 6689228 (Nov. 3, 2015).

144. Between 2012 and 2015, the SEC brought 108 actions against advisers for violations under the Investment Advisers Act of 1940. Count based on a Westlaw search of SEC releases. The most common sections used in SEC enforcement actions under the Investment Advisers Act are sections 204(a), 206(1), 206(2), 206(4), and 207.

compliance policies.[145] Failure on the part of advisers to specifically tailor a compliance program for their businesses has led to significant penalties.[146] Other notable enforcement actions against private funds during this period include actions for undisclosed conflicts of interest,[147] misallocation of expenses,[148] and inflating the values of certain illiquid assets held by private funds.[149]

In 2015, the SEC announced that it would focus its attention on undisclosed conflicts of interest, prioritizing the investigation and penalization of such conflicts.[150] The SEC settled charges with private investment managers who received accelerated portfolio company monitoring fees from sales and IPOs of portfolio companies[151] and who failed to disclose conflicts arising from the manager's conversion of portfolio company monitoring fees that could have partially been offset.[152] As a result of several other private fund adviser examinations, the SEC has also voiced concern over disclosure and conflict mitigation practices relating to the use of affiliated services providers, including operating partners,[153] focusing on whether expenses are properly chargeable to the private fund rather than to its manager.

A serious concern voiced by the SEC pertains to the allocation of investment opportunities among private investment fund advisers' clients.[154] In particular,

145. Norm Champ, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Remarks to the Practising Law Institute, Hedge Fund Management Seminar 2014 (Sept. 11, 2014), https://www.sec.gov/News/Speech/Detail/Speech/1370542916156#_ftnref15.

146. Navigator Money Mgmt., Inc., Investment Company Act Release No. 30897, 2014 WL 346399 (Jan. 30, 2014) (compliance policies only parroted Commission's rule, failing to actually tailor the program to the specific advertising the firm was engaging in).

147. Matthew Crisp, Exchange Act Release No. 67761, 2012 WL 3756973 (Aug. 30, 2012) ("Crisp exploited undisclosed conflicts of interest for his personal gain while working as a partner and fiduciary of Adams Street Partners, LLC when he secretly formed a private investment vehicle and misappropriated Adams Streets funds into it.").

148. Robert Pinkas, Investment Advisers Act Release No. 3371, 2012 WL 1029035, at *1 (Feb. 15, 2012) ("Pinkas misappropriated $173,000 from a fund client to pay the costs of defending himself in an unrelated Commission investigation. Pinkas subsequently made material misrepresentations to the fund's investors about the misappropriation, telling them that multiple law firms had reviewed the fund's indemnification provisions and concluded that his use of fund assets to cover his attorney's fees in the other matter was appropriate.").

149. SEC v. Yorkville Advisors, LLC, No. 12 CIV. 7728 GBD, 2013 WL 3989054, at *1 (S.D.N.Y. Aug. 2, 2013).

150. Other enforcement actions against private funds were taken pursuant to section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (2012), and section 10(b) of the Exchange Act, 15 U.S.C. § 77q(b) (2012), which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

151. Blackstone Mgmt. Partners, LLC, Investment Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015) (violations of the Advisers Act arising from the undisclosed receipt of fees and conflicts of interest); Press Release, U.S. Sec. & Exch. Comm'n, Blackstone Charged with Disclosure Failures (Oct. 7, 2015), https://www.sec.gov/news/pressrelease/2015-235.html ("Full transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses.").

152. Fenway Partners, LLC, Investment Advisers Act Release No. 4253, 2015 WL 6689228, at *5 (Nov. 3, 2015) ("[I]nherent conflict of interest associated with these payments to Fenway Consulting was not disclosed in or otherwise authorized by the Organizational Documents.").

153. *See id.*

154. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Five Years On: Regulation of Private Fund Advisers After Dodd-Frank (Oct. 16, 2015) ("Disclosure of conflicts was another area. Examiners ob-

different fee structures among private fund advisers' portfolio funds can influence advisers' allocation incentives.[155] The SEC is also concerned with practices that may result in advisers improperly favoring some limited partners over others, which could include giving potential co-investors a co-investment opportunity in exchange for a future commitment or an increased commitment. If such private fund advisers' practices are not adequately disclosed, co-investments can often be problematic. They can be especially problematic if a fund's governing documents prohibit such an allocation or allocation policy.

The SEC has also voiced concern over the equitable allocation of expenses among funds.[156] In particular, it has voiced concern over whether regular co-investors, employee/executive funds, and other preferred clients are contributing their respective pro rata portion of fund expenses.[157] In one case, the SEC settled charges with a private fund adviser that had not appropriately allocated broken deal expenses to co-investors; the adviser did not disclose such misallocations in the funds' marketing materials or limited partnership agreements.[158]

The SEC has pursued several enforcement actions. For example, it has settled charges with a private fund manager over the use of fund assets that had not

served that some hedge fund advisers may not be adequately disclosing conflicts related to advisers' proprietary funds and the personal accounts of their portfolio managers. Examiners saw, for example, advisers allocating profitable trades and investment opportunities to proprietary funds rather than client accounts in contravention of existing policies and procedures.").

155. Julie M. Riewe, Co-Chief, Asset Mgmt. Unit, Div. of Enf't, U.S. Sec. & Exch. Comm'n, Conflicts, Conflicts Everywhere (Feb. 26, 2015), https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html ("For private funds—meaning hedge funds and private equity funds—the AMU's 2015 priorities include conflicts of interest, valuation, and compliance and controls. On the horizon, on the hedge fund side, we anticipate cases involving undisclosed fees; all types of undisclosed conflicts, including related-party transactions; and valuation issues, including use of friendly broker marks."). Examples of such cases include the following: Clean Energy Capital, Investment Company Act Release No. 3785, 2014 WL 709469 (Feb. 25, 2014); Lincolnshire Mgmt., Inc., Investment Advisers Act Release No. 3927, 2014 WL 4678600 (Sept. 22, 2014).

156. White, *supra* note 154 ("In addition to these exam findings, I urge you to focus on a number of recent, important enforcement actions by the Commission against private fund advisers. Many of these actions also center on disclosure and conflicts of interest, including advisers misallocating expenses to funds; failing to disclose loans from clients; using funds to pay their operating expenses without authorization and disclosure; and failing to disclose fees and discounts from service providers.").

157. Amy Ward Pershkow, *Another Lesson for Private Funds on Expense Allocation*, LAW360 (May 22, 2015, 10:07 AM ET) ("Reports also speculate that some larger private equity firms may also be impacted by other themes raised in these speeches, such as the allocation of expenses between funds and co-investors."); Jon Eisenberg, *SEC Enforcement Actions Against Investment Advisers*, K&L GATES LEGAL INSIGHT (Oct. 21, 2015), http://goo.gl/cX4U4l; Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges KKR with Misallocating Broken Deal Expenses (June 29, 2015), https://www.sec.gov/news/pressrelease/2015-131.html ("'This is the first SEC case to charge a private equity adviser with misallocating broken deal expenses,' said Andrew J. Ceresney, Director of the SEC Enforcement Division. 'Although KKR raised billions of dollars of deal capital from co-investors, it unfairly required the funds to shoulder the cost for nearly all of the expenses incurred to explore potential investment opportunities that were pursued but ultimately not completed.'").

158. Kohlberg Kravis Roberts & Co., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at *1 (June 29, 2015) ("However, KKR did not allocate broken deal expenses to KKR co-investors from 2006 to 2011 except for a partial allocation to certain co-investors in 2011. Nor did KKR expressly disclose in the LPA or related offering materials that it did not allocate broken deal expenses to KKR co-investors, as described below, even though these co-investors participated in and benefited from KKR's sourcing of private equity transactions.").

been authorized under the fund's operating documents,[159] entered into a consent order against private fund managers based on the misallocation of compliance costs to their private funds rather than to the managers,[160] and settled charges with a private fund manager over the manager's receipt of a higher discount rate for manager-related legal services than the discount rate received by its funds for deal work.[161]

Notable SEC settlements include the settlement of charges with a private fund adviser to a registered fund for the adviser's failure to manage and disclose a senior trader's conflict of interest pertaining to that trader's external business interests;[162] in another case, charges were settled against a private fund adviser that did not disclose a loan by a client to one of the adviser's senior executives before investing other clients' funds with different and inconsistent terms.[163]

Registered investment advisers should expect a challenging regulatory environment in the coming years. Given the trends discussed above and the SEC guidance provided in public statements, it is likely that the private fund industry will encounter new or proposed regulations; increased SEC enforcement actions against private fund managers; lengthier, more intrusive SEC examinations; and increasing challenges in obtaining waivers from bad actor restrictions on fundraising. Among other non-final rules in 2015, the Department of Treasury's proposed rules that target investment advisors' filing and reporting requirements regarding money laundering,[164] Form ADV disclosures,[165] and the definition of "accredited investor"[166] provide a taste of the future regulatory environment in the private fund industry.

159. *See, e.g.*, Alpha Titans, LLC, Exchange Act Release No. 74828, 2015 WL 1927183, at *2 (Apr. 29, 2015) ("used fund assets to pay for adviser-related operating expenses in a manner (1) not clearly authorized under the funds' operating documents, and (2) not accurately reflected in the funds' financial statements as related party transactions").

160. Cherokee Inv. Partners, LLC, Investment Advisers Act Release No. 4258, 2015 WL 6749947, at *3 (Nov. 5, 2015) ("[T]he limited partnership agreements did not disclose that the Funds would be charged for a portion of the advisers' own legal and compliance expenses.").

161. Blackstone Mgmt. Partners, LLC, Investment Advisers Act Release No. 4219, 2015 WL 5834037, at *1 (Oct. 7, 2015) ("Because of its conflict of interest as the recipient of the accelerated monitoring fees and the beneficiary of the disparate legal fee discounts, Blackstone could not effectively consent to either of these practices on behalf of the funds it advised. As a result, Blackstone breached its fiduciary duty to the funds in violation of Section 206(2) of the Advisers Act and also violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.").

162. Blackrock Advisors, LLC, Investment Company Act Release No. 31558, 2015 WL 1776222, at *1 (Apr. 20, 2015) ("This matter concerns investment adviser BlackRock's failure to disclose a conflict of interest involving the outside business activity of one of its portfolio managers.").

163. Guggenheim Partners Inv. Mgmt. LLC, Investment Advisers Act Release No. 4163, 2015 WL 4720298, at *1 (Aug. 10, 2015) ("GPIM breached its fiduciary duty by failing to disclose that one of its senior executives approached an advisory client and received a $50 million loan in order for him to participate personally in an acquisition led by Guggenheim Partners, LLC [GPIM's corporate parent].").

164. Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680 (proposed Sept. 1, 2015).

165. Amendments to Form ADV and Investment Advisers Act Rules, 80 Fed. Reg. 33718 (proposed June 12, 2015).

166. For the SEC discussion on changing the accredited investor standard, see U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" (2015), https://www.sec.gov/

3. Confluence of Private and Mutual Funds

Investor-driven trends in financial markets suggest that the traditional distinction between mutual and private funds is dissipating.[167] Several factors suggest that mutual funds are becoming more like hedge funds as a matter of investment strategy, while hedge funds are becoming more like mutual funds as a matter of regulatory framework.[168] The factors that perhaps best illustrate the confluence of private and mutual funds include the growth of the private fund industry, the proliferation of retail alternative funds, and the fundamental reshaping of the regulatory landscape for the private fund industry.[169]

Prior to the 2008–2009 credit crisis, the asset management industry consisted of two distinct product segments—regulated (mutual) funds and private funds. Today, both private and regulated fund managers offer "liquid" alternative products to the same investor segments. Liquid alternatives offer adequate management fees and strong growth potential for mutual fund managers. For private managers, liquid alternative products provide access to large asset pools, including defined contribution plans that were otherwise unavailable to private fund advisers. The increased offerings of liquid alternatives represent managers' response to investor demands for a combination of risk mitigation, liquidity, lower fees associated with mutual funds, and the absolute returns of private funds. Investments in liquid alternatives have more than doubled since 2008, now representing over $550 billion in assets.[170]

Retail investors' preferences also represent a major factor affecting the confluence of private and mutual funds. Retail investors gained access to private fund strategies and higher returns through liquid alternative funds. In fact, overall demand in the alternative investment sector is largely driven by retail investors who seek not only the prospect of significant performance, but also risk-adjusted and consistent returns that are not correlated to the market.[171] Through liquid alter-

corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf. For the accredited investor rule changes that occurred in the context of the crowdfunding rules, see Crowdfunding, 80 Fed. Reg. 71388 (Nov. 16, 2015) (to be codified as amended at 17 C.F.R. pts. 200, 227, 239, 240, 249, 269 & 274).

167. Kaal, *supra* note 16, at 5.

168. *Id.* at 18–28.

169. *Id.* at 18.

170. SEI, *supra* note 9, at 2.

171. McKinsey & Co., The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments 3–15 (2014) ("Retail investors, meanwhile, are moving rapidly into the market, as new product vehicles provide unprecedented access to a broad range of alternatives managers and strategies. Structural, rather than cyclical, forces are accelerating the adoption of alternatives, chief among them the linking of alternatives to critical investment outcomes—a phenomenon that takes the value of alternatives strategies 'beyond alpha.' Gone are the days when the sole attraction of alternatives was the prospect of high-octane performance. The market meltdown caused by the global financial crisis, coupled with the extended period of volatility and macroeconomic uncertainty that followed, have left their marks, and investors are now turning to alternatives for consistent, risk-adjusted returns that are uncorrelated to the market. They are also increasingly looking to alternatives to deliver on other crucial outcomes like inflation protection and income generation. . . . [R]etail flows are expected to be three to four times those of institutional flows. Demand has been strongest in the U.S. market.").

natives, retail investors were able to merely pay mutual fund fees, which in turn increased demand for liquid alternatives by retail investors.[172]

The confluence of mutual and private funds has implications for both industries. First, the confluence of mutual and private funds provides the private fund industry wider recognition as an integral part of mainstream finance; in turn, this affects the evolution of the private fund industry.[173] Second, this confluence makes governance alternatives and possible governance improvements available to the mutual fund industry. Furthermore, the confluence of mutual and private funds creates a positive effect for the growth of the retail alternative fund market.

III. Methodology

To compare the short- and long-term effects of Title IV of the Dodd-Frank Act and make statistical inferences, this study analyzes the sampling of individual investment advisers registered in the United States. The author collected relevant data for identical populations via a 2012 study[174] and his 2015–2016 follow-up study using an identical survey instrument.[175] Respondents (2012: N = 94; 2015: N = 69) answered questions in several categories[176] that were designed to identify the effects of Title IV.

The population for both surveys consisted of 1,267 registered private fund advisers. To identify the population for the 2012 survey, the author obtained a dataset for the relevant population from the SEC's Investment Adviser Registration Depository ("IARD") website,[177] comprising 12,598 registered investment adviser firms.[178] To ensure a random sample, the author applied several filters that were not biased toward certain subgroups of hedge fund advisers.[179] The

172. *Id.*

173. Kaal, *supra* note 16, at 29.

174. Kaal, *supra* note 2.

175. Wulf A. Kaal, *The Private Fund Industry Five Years After Dodd-Frank: A Survey Study*, 35 Rev. Banking & Fin. L. (forthcoming 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2732915.

176. The categories included, among others, long-term effect of reporting and disclosure rules on private funds, cost of compliance, compliance measures, strategic responses, long-term effect of reporting and disclosure rules on the private fund industry, effect of the regulatory regime on AUM, and effect of the regulatory regime on profitability.

177. The SEC collects data pertaining to registered private fund advisers on its IARD website: *Historical Archive of Investment Adviser Reports*, U.S. Sec. & Exchange Commission, http://www.sec.gov/foia/iareports/inva-archive.htm (last modified Feb. 1, 2016); *see also Division of Investment Management: Electronic Filing for Investment Advisers on IARD*, U.S. Sec. & Exchange Commission, https://www.sec.gov/iard (last modified Aug. 12, 2015) (providing information on the IARD and how to register or obtain information on investment advisers).

178. *See Historical Archive of Investment Adviser Reports*, *supra* note 177 (using dataset dated May 1, 2012).

179. To obtain the population for the 2012 survey, the author first filtered for affirmative responses to Item 7.B on Form ADV, "Are you an adviser to any *private fund*?" Form ADV, *supra* note 33, pt. 1A, at 11–12 (Item 7.B). This initial filter decreased the dataset significantly, as 4,054 firms responded in the affirmative and 327 firms did not answer the question, for a total of 4,381 firms. To ensure only U.S. hedge fund advisers were included in the population, the author removed investment adviser firms that had not reported a U.S. phone and fax number, including any firms that reported phone or fax numbers with more than ten numbers. Thereafter, the author filtered for firms that had completed the revised version of Form ADV, dated November 2011. These filters resulted in

resulting dataset of 1,267 firms included investment adviser firms that (1) advise private funds, (2) have contact information in the United States, (3) completed the November 2011 version of Form ADV, and (4) have a status effective date as of November 1, 2011. The author had no control over the selection of the sample. All respondents were approached using the same methodology, and they volunteered their participation.

Modes of data collection for the 2012 and 2015 surveys were consistent. For the 2012 survey, the author conducted some phone interviews, but predominantly relied on e-mails with electronic surveys and faxes with questionnaires to collect responses. In contrast, the sole mode of data collection for the 2015 survey consisted of e-mails with electronic surveys. Mode effects are insignificant because each data collection method was based on the same questionnaire, and respondents were asked the same sequence of questions. Furthermore, only a small portion of the responses were obtained via phone interviews. The only incentive offered to survey participants was the author's promise to share the results of the survey study with respondents upon completion.

The coding procedure and format for the 2012 and 2015 surveys were identical.[180] The survey instrument contained a large proportion of open-ended questions that the author coded into response clusters. The author only used closed-ended questions to quantify items. Any closed-ended questions in the survey instrument were dichotomous and continuous, and all response options for closed-ended questions were exhaustive and mutually exclusive. The author tested the survey questions for the 2012 study through more than twenty rounds of test runs with registered industry representatives and academics working in the field, and he regularly checked the coding for accuracy and internal consistency.

The coding of respondents' estimations was binary where possible. Affirmative responses in "Yes" and "No" categories were coded as "1." Open-ended questions were coded into clusters. For each open-ended question—survey questions two, three, four, five, nine, ten, eleven, and twelve—the author created a separate worksheet.[181] The author summarized the basic idea(s) in each response to an

a subset of 3,824 investment advisers. Finally, the author filtered the dataset for investment adviser firms with the status effective dates as of November 1, 2011, resulting in 1,264 firms. The author added three investment advisers that volunteered responses without direct solicitation by the author after confirming that these three investment advisers were listed in the SEC database, bringing the total number of firms to 1,267.

180. The survey instrument in the appendix asked private fund manager respondents in 2012 and 2015 to describe the possible effects of hedge fund manager registration requirements under the Dodd-Frank Act relating to several categories, including compliance measures, strategic responses, long-term effect of reporting and disclosure rules on private funds, long-term effect of reporting and disclosure rules on the private fund industry, cost of compliance, effect of the regulatory regime on AUM, and effect of the regulatory regime on profitability.

181. Question 2 asked, "Which of the following actions have you taken to assure compliance with Dodd-Frank Act registration and reporting requirements?" Option "n." was "Other" and provided a blank for details. Twenty-four firms checked the "Other" option, and one of those firms did not provide details. The other twenty-three firms provided thirty-six discrete responses. There were thirteen different potential clusters, but only five met the criteria for being a cluster—at least three responses. Question 3 asked, "Do you plan to implement strategic responses to the new registration and disclo-

open-ended question in the top row of each worksheet and placed a check mark in the column that corresponded to the adviser firm that provided the response. The author used a check mark for each subsequent response that fit into the existing clusters. If a response did not fit into an existing cluster, the author created a new cluster. Upon coding all of the responses for one question, the author counted the responses for each cluster. The author determined that at least three firms providing similar responses to a question, either by using identical words or meaning, justified the creation of a cluster category. The author adjusted cluster categories when coding had been too narrow or too broad.[182] The author used responses by fewer than three firms in an established cluster to analyze existing clusters but did not create a separate cluster for those responses.

1. Sample Constraints

The 2012 and 2015 surveys were subject to sampling constraints. Private fund advisers traditionally oppose publicity and have a strong preference for confidentiality and privacy.[183] Most private fund advisers do not respond to survey

sure requirements?" Question 3.b further probed, "If yes, what strategic responses do you plan to implement?" Eighty-six firms answered Question 3, and twenty-four of them responded "yes." Three of those twenty-four firms did not provide an open-ended response. From the twenty-one firms that said "yes" and provided a response, there were thirty-five discrete answers that fell into twelve potential clusters. Six of the potential clusters met the cluster criteria. Question 4 asked, "In what ways will the new registration and disclosure rules affect your fund(s) in the next 5 years?" Eighty-two firms answered the question. There were thirty-seven potential clusters based on 162 discrete responses. Sixteen of those potential clusters met the cluster criteria. Question 5 asked, "In what ways will the new registration and disclosure rules affect your industry in the next 5 years?" Seventy-eight firms answered the question. There were 140 discrete responses and forty-three potential clusters. Only ten of the potential clusters met the criteria for a cluster. Question 9 asked, "What affected your response to Item 8 [After the enactment of Dodd-Frank Act reporting and disclosure requirements, what asset size (AUM) would you desire to operate your fund(s)?]?" Sixty-two firms answered Question 9. There were 109 responses that broke into thirty-five potential clusters. Eleven potential clusters met the criteria. Question 10 asked, "Would you take the Form PF threshold for quarterly reporting of $1.5 billion assets (AUM) into account in determining the appropriate size of assets (AUM) for your fund(s)? If yes, how would you take it into account?" Eighty-seven firms answered the question, and seventeen of those firms said "yes." Eight of those seventeen firms did not provide any answer to the open-ended question. The remaining nine provided twelve answers that did not fit into a cluster. Question 11 asked, "Have the new registration and disclosure requirements affected your fund's earnings/net rate of return to your investors? If yes, how?" Ninety-two firms answered the question, and only twenty-two said "yes." Those twenty-two firms provided forty discrete responses that fit into fourteen potential clusters. Six of those potential clusters met the criteria for a cluster. Question 12 asked, "Have the new registration and disclosure requirements affected the profits of your investment management company? If yes, how?" Ninety-two firms answered the question, and seventy-two said "yes." Those seventy-two firms provided 112 discrete answers, which fit into fourteen potential clusters. Seven of those potential clusters met the criteria of a cluster.

182. For example, in Question 4, the initial cluster was "increased procedures, reporting, and monitoring." However, after reviewing all responses, the author determined that "increased procedures," "increased reporting," and "increased monitoring" could be separate cluster categories because some firms did not mention all three. The author reviewed the terminology used in non-cluster responses to determine if they could be included in an existing cluster.

183. Reasons cited by respondents for non-responses include, but are not limited to, a general policy not to partake in any surveys for privacy concerns and the advice of counsel.

questions. Therefore, obtaining a substantial effective sample size for survey studies with private fund advisers is difficult. The response rate for the 2012 survey was 7.42% of a population of 1267, and the response rate for the 2015 survey was 5.44% of a population of 1267.

Obtaining the correct contact information for possible survey participants is another major obstacle for survey research involving private fund advisers. The identity and contact information for relevant survey respondents is generally not publicly available. The author obtained the contact information for the population of this study via individual website searches. Such searches generated the contact information for the CCO and/or the chief legal officer of the firms in the population for both studies.[184]

2. Selection Bias

Sample selection bias may present a serious problem in survey studies. It may exist when researchers select observations with the shared traits the researcher hopes to explain,[185] and when researchers use nonstatistical selection procedures.[186] In the survey study context, obtaining information through voluntary responses can create an inherent selection bias because people with a special interest may be more likely to respond to the survey questions.[187]

184. While SEC Form ADV requires advisers to disclose the contact information of registrants' CCO, the SEC's IARD dataset does not list that contact information and does not include e-mail addresses.

185. *See* Richard A. Berk, *An Introduction to Sample Selection Bias in Sociological Data*, 48 Am. Soc. Rev. 386, 391 (1983); David Collier, *Translating Quantitative Methods for Qualitative Researchers: The Case of Selection Bias*, 89 Am. Pol. Sci. Rev. 461, 462 (1995); Barbara Geddes, *How the Cases You Choose Affect the Answers You Get: Selection Bias in Comparative Politics*, 2 Pol. Analysis 131, 140 (1990); Thomas W. Hall et al., *The Effectiveness of Increasing Sample Size to Mitigate the Influence of Population Characteristics in Haphazard Sampling*, 20 Auditing: J. Prac. & Theory 169, 169 (2001).

186. *See* Peter Jones, Statistical Sampling and Risk Analysis in Auditing 11–12 (1999); Donald A. Leslie et al., Dollar-Unit Sampling: A Practical Guide for Auditors 36–37 (1980); Arthur J. Wilburn, Practical Statistical Sampling for Auditors 4–6 (1984); Herbert Arkin, *Statistical Sampling in Auditing*, 27 N.Y. Certified Pub. Acct. 454, 457 (1957); W. Edwards Deming, *On the Contributions of Standards of Sampling to Legal Evidence and Accounting*, 19 Current Bus. Stud. 14, 18–21 (1954); Hall et al., *supra* note 185, at 170; Thomas W. Hall et al., *The Use of and Selection Biases Associated with Nonstatistical Sampling in Auditing*, 12 Behav. Res. Acct. 231, 232–33 (2000); Tom Hall et al., Haphazard Selection: Is It Time to Change Audit Standards? 1, 3–4 (Aug. 1, 2010) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1687443; Neal B. Hitzig, *Statistical Sampling Revisited*, CPA J., May 2004, at 30, http://www.nysscpa.org/cpajournal/2004/504/essentials/p30.htm; Clive S. Lennox et al., *Selection Models in Accounting Research*, 87 Acct. Rev. 589, 611 (2012); Jennifer Wu Tucker, *Selection Bias and Econometric Remedies in Accounting and Finance Research*, 29 J. Acct. Literature 31, 32 (2010).

187. Several research traditions are based on research designs that can be subject to sample selection biases. Sample selection bias is mostly "a generic problem in social research . . . when [researchers] do[] not observe a random sample of a population of interest." *See* Christopher Winship & Robert D. Mare, *Models for Sample Selection Bias*, 18 Ann. Rev. Soc. 327, 328 (1992). Increasing the sample size may not necessarily increase representativeness or compensate for the potential selection bias of nonstatistical techniques. *See* Dan M. Guy et al., Practitioner's Guide to Audit Sampling 160 (1998); Jones, *supra* note 186; Richard L. Ratliff et al., Internal Auditing: Principles and Techniques 628 (2d ed. 1996); Arkin, *supra* note 186, at 460; Deming, *supra* note 186, at 23. Exclusive reliance on observational schemes that are free from selection bias may mean ignoring significant findings with substantial policy implications. Others argue that selection bias naturally results from human behavior. *See generally* Reuben Gronau, *Wage Comparisons—A Selectivity Bias*, 82 J. Pol. Econ.

Neither the population sample for the 2012 survey[188] nor the 2015 follow-up study[189] sample are biased. The comparison of the two populations is consistent and unbiased because respondents in both surveys are equally required to comply with Title IV. The author also had no control over the selection of either sample. Each member of the respective population of hedge fund advisers had a known nonzero chance of being selected as part of the sample. The author approached all respondents using the same methodology, and all respondents volunteered their responses. Respondents in both samples answered identical survey instruments.

The samples for both surveys (2012: N = 94; 2015: N = 69), 7.42% and 5.44% of the identified populations of 1,267 private fund advisers, are representative of the two populations of registered private fund managers. The descriptive statistics for both surveys demonstrate that the samples are not biased and do not favor a particular subgroup of private fund advisers. The comparative descriptive statistics demonstrate that both samples are representative of the population, at least under the examined parameters. There is no indication for either sample that respondents who did respond to the survey were different from non-respondents.

IV. Results

This study supports policymakers in their assessment of the long-term implications of Title IV for the private fund industry. The author quantifies and compares compliance costs; he also assesses and compares compliance measures, the private fund industry's strategic responses to the implementation of the Dodd-Frank Act, the possible long-term effects of private fund registration, the implications of the disclosure requirements in the Dodd-Frank Act pertaining to private funds, the long-term effects of reporting and disclosure rules on private funds and the private fund industry, the effect of the regulatory regime on AUM, and the effect of the regulatory regime on profitability.

1119 (1974); James J. Heckman & Guilherme Sedlacek, *Heterogeneity, Aggregation, and Market Wage Functions: An Empirical Model of Self-Selection in the Labor Market*, 93 J. Pol. Econ. 1077 (1985); James J. Heckman & Guilherme L. Sedlacek, *Self-Selection and the Distribution of Hourly Wages*, 8 J. Lab. Econ. S329 (1990); James J. Heckman & Bo Honoré, *The Empirical Content of the Roy Model*, 58 Econometrica 1121 (1990); H. Gregg Lewis, *Comments on Selectivity Biases in Wage Comparisons*, 82 J. Pol. Econ. 1145 (1974); A.D. Roy, *Some Thoughts on the Distribution of Earnings*, 3 Oxford Econ. Papers 135 (1951); Robert J. Willis & Sherwin Rosen, *Education and Self-Selection*, 87 J. Pol. Econ. S7 (1979). The assumptions about how selection occurs are important for selection bias models. *See generally* Drawing Inferences from Self-Selected Samples (Howard Wainer ed., 1986); Nonparametric and Semiparametric Methods in Econometrics and Statistics: Proceedings of the Fifth International Symposium in Economic Theory and Econometrics (William A. Barnett et al. eds., 1991); Arthur S. Goldberger, *Abnormal Selection Bias*, *in* Studies in Econometrics, Time Series, and Multivariate Statistics 67 (Samuel Karlin et al. eds., 1983); Lung-Fei Lee, *Some Approaches to the Correction of Selectivity Bias*, 49 Rev. Econ. Stud. 355 (1982); Abbas Arabmazar & Peter Schmidt, Note, *An Investigation of the Robustness of the Tobit Estimators to Non-Normality*, 50 Econometrica 1055, 1055 (1982). The techniques used to prevent selection bias have mixed success rates, may skew results, and can worsen estimates. *See* Ross M. Stolzenberg & Daniel A. Relles, *Tools for Intuition About Sample Selection Bias and Its Correction*, 62 Am. Soc. Rev. 494, 494 (1997).

188. Kaal, *supra* note 2.

189. Kaal, *supra* note 94.

Figure 1 shows the percentage of responses to each coded question in the survey instrument. The 2012 survey had 94 respondents, and the 2015 survey had 69 respondents. The majority of survey participants in 2012 and in 2015 completed the entire survey. For consistency, the author rescaled the surveys; furthermore, the numbered questions in the Appendix follow hardcopy numbering, not the SurveyMonkey numbering. In both surveys, the open-ended questions (3a and 14, for each survey) had the lowest response rate. Both of these questions required explanations of responses to prior questions in the same context application. For instance, Question 3a was an open-ended question asking, "If yes, what strategic responses do you plan to implement?" A comparison of the question response means for 2012 and 2015 shows that survey respondents' overall responsiveness declined more in 2015 than in 2012, especially after the first two survey questions. The lower 2015 response rate can at least be partially explained by an overall lower interest of respondents in the survey's subject matter. In 2012, the survey was administered right after the new rules under Title IV of the Dodd-Frank Act became effective. In 2015, the industry had largely adjusted to the revised regulatory regime. In fact, as noted earlier, the decline in response rate may itself be suggestive of the industry's relative rapid adaptation to the new statutory and regulatory regime.

1. Adviser Response to Dodd-Frank

Figure 2 indicates that in both 2012 and 2015 a majority (72% and 75%) of private fund adviser respondents did not plan a strategic response to Title IV of the Dodd-Frank Act. "Strategic responses" in both surveys describe actions taken to avoid or limit the impact of Title IV. The slightly higher rate of denial of strategic responses in 2015 could be a function of the private fund industry's increasing acceptance and tolerance of the revised regulatory regime following the Dodd-Frank Act.

Figure 3 shows that a majority of respondents in 2012 and 2015 instituted measures in response to the requirements imposed by Title IV, with the mean response rate slightly higher in 2015. The most common actions taken include: (1) outsourcing compliance work, (2) hiring additional counsel, (3) instituting new recordkeeping policies, (4) hiring additional staff, (5) changing marketing materials, and (6) changing communications with investors. In the 2012 survey, note the higher response rate pertaining to instituting new recordkeeping policies—a direct requirement associated with the new reporting obligations under Form PF, which was implemented after the passage of Title IV. It is also noteworthy that in 2015 a substantially higher rate of responses (47% in 2015 versus 25% in 2012) suggests that respondents changed their communications with investors. Since 2012, many private fund advisers have changed and increased their communications with investors, often based on advice from counsel.

Figure 4 shows the least common actions taken in response to Title IV. Private fund advisers in the 2012 and 2015 samples rarely terminated existing employment relationships. Among less common actions, however, the rate at which

Figure 1
Response Summary of Responses to Survey Questions by Percentage

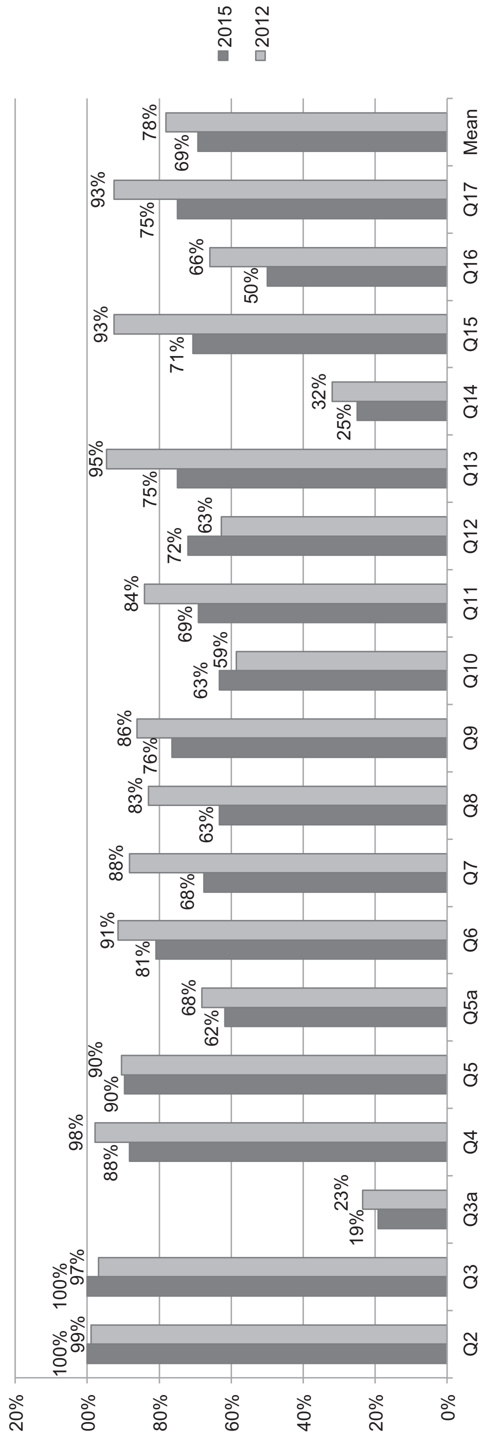


Figure 2
Advisers that Plan a Response to the Dodd-Frank Act

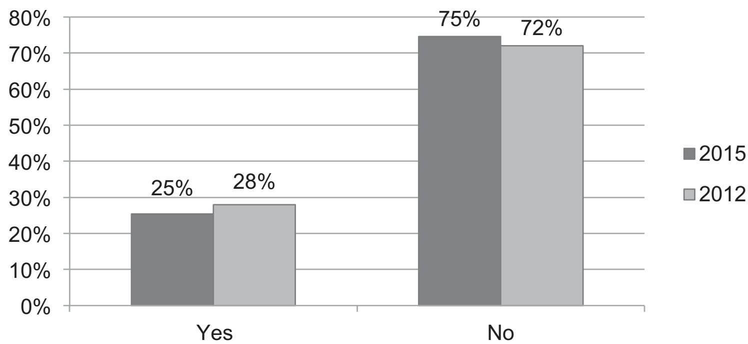
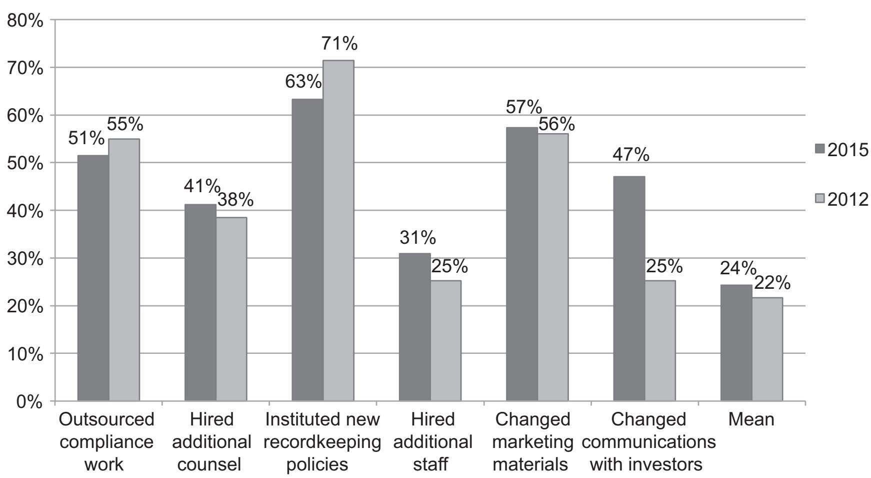


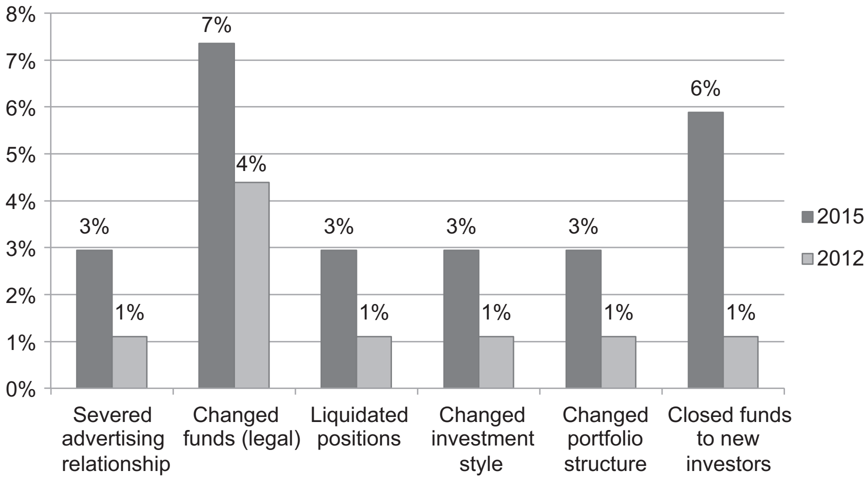
Figure 3
Most Common Actions Taken in Response to the Dodd-Frank Act



respondents severed an advising relationship, changed the funds' legal structure, liquidated positions, changed investment style, changed portfolio structure, or closed funds to new investors doubled or tripled in the 2015 as compared to the 2012 survey. Most notably, the comparative data in Figure 4 suggest that at least a part of the industry is increasingly changing the legal structure of their fund(s) and closing funds to new investors in response to the regulatory changes

Figure 4

Least Common Actions Taken in Response to the Dodd-Frank Act



imposed in 2012. These changing trends may influence the evolving industry adaptation to subsequent regulatory changes in the aftermath of the Dodd-Frank Act.

Figure 5 shows respondents' reactions to 2012 and 2015 survey questions regarding other actions taken in response to the Dodd-Frank Act. Of those that responded in 2015, 31% hired a compliance firm. In contrast, only 23% of respondents in 2012 hired a compliance firm. This suggests that firms subject to increased regulatory requirements after 2012 internalized higher compliance costs by doing in-house compliance work. However, this trend must be contrasted with disparate comparative results pertaining to the implementation of new policies and programs. Compared with the 2012 survey, which indicates 41% of respondents implemented new policies and programs, the 2015 survey shows that only 15% of respondents implemented new policies and programs. While the data seem to offset increasing responses that reference additional compliance costs from 2012 to 2015, the references to implementation of new policies and procedures would naturally have been higher in the 2012 survey, as the period during which the survey was administered marked the introduction of compliance requirements under the Dodd-Frank Act.

2. Compliance Costs

Figure 6 illustrates respondents' total cost of compliance with Title IV. A majority of respondents in both the 2012 and 2015 surveys realized compliance costs ranging from $50,000 to $200,000. The comparative data suggest that

Figure 5

Other Actions Taken in Response to the Dodd-Frank Act

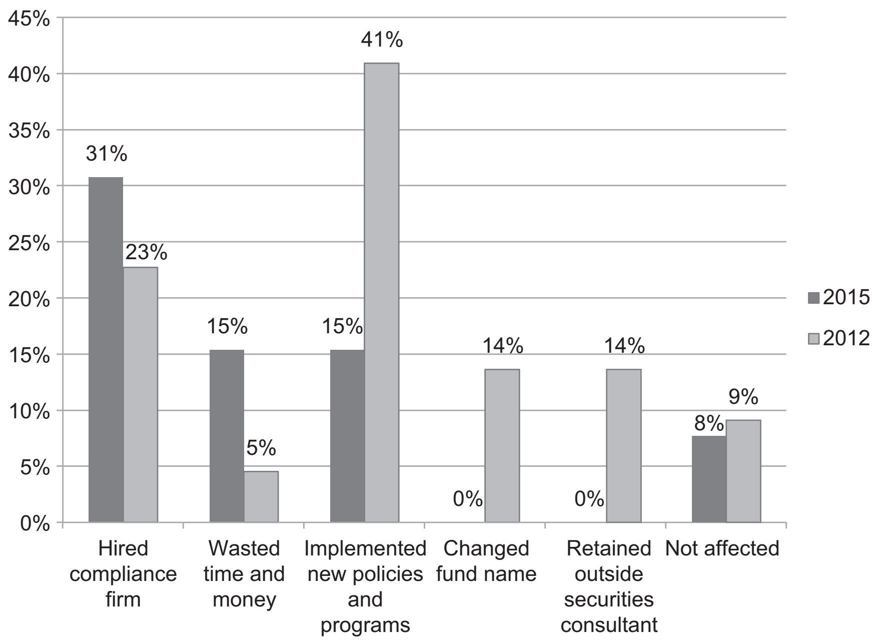


Figure 6

Dodd-Frank Act Compliance Costs

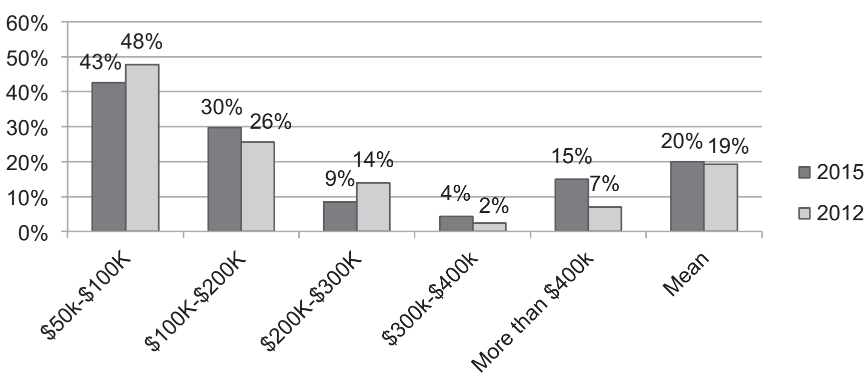
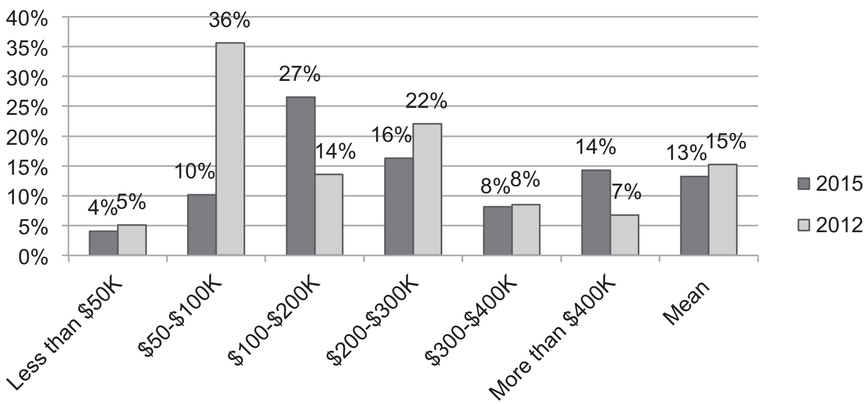


Figure 7
Annual Compliance Costs for all Federal Regulations

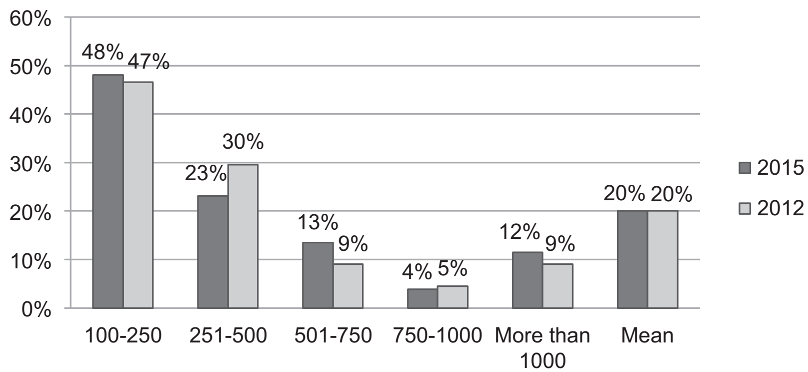


survey respondents identified higher costs between 2012 and 2015. In 2012, 48% of respondents identified the compliance costs associated with the Dodd-Frank Act as between $50,000 and $100,000, and 26% of respondents saw compliance costs between $100,000 and $200,000. In contrast, with the 2015 survey, responses suggest that 43% of respondents identified the compliance costs associated with the Dodd-Frank Act as between $50,000 and $100,000, and 30% percent of respondents identified compliance costs between $100,000 and $200,000. The reported increased compliance costs structure is supported by survey responses pertaining to Dodd-Frank compliance costs exceeding $400,000. While 7% of respondents in 2012 estimated total compliance costs of over $400,000, 15% of respondents in 2015 suggested that Dodd-Frank compliance costs exceeded $400,000.

Figure 7 shows respondents' estimations of the total annual cost to comply with all federal regulations pertaining to the private fund industry. Comparing the 2012 and 2015 figures for the $50,000 to $100,000 range and the $100,000 to $200,000 range suggests that the cost structure for the industry has increased significantly. In the 2015 survey, only 10% of respondents—as compared with 36% in 2012—identified the cost ranging from $50,000 to $100,000. However, when compared to their 2012 counterparts, many more 2015 respondents identified compliance costs in the $100,000 to $200,000 range (14% in 2012 as compared with 27% in 2015). Furthermore, responses citing more than $400,000 in compliance costs for all federal regulation have doubled since the 2012 survey (7% in 2012 versus 14% in 2015).

Figure 8 shows the total annual hours required to comply with the Dodd-Frank Act. A clear majority of respondents spent fewer than 500 hours to com-

Figure 8
Hours Required to Comply with the Dodd-Frank Act



ply with Title IV. The overall compliance hour trends shown in Figure 8 are consistent with the compliance cost trends in Figure 6. However, Figure 8 suggests that in 2015, the industry spent fewer hours on compliance work in the 251–500 hour range than in 2012 and more hours in the 100–250 hour range. One possible explanation is that the industry became more effective in satisfying the reporting obligations of Dodd-Frank in the interim between 2012 and 2015.

Figure 9 shows respondent estimates for the hours needed to comply with all federal rules and regulations pertaining to private fund advisers in 2012 and 2015. For both surveys, the compliance hour trends shown in Figure 9 are consistent with the compliance cost trends shown in Figure 7. Comparing the 2012 and 2015 figures for the 100–250 hour and the 251–500 hour categories suggests that the hours required to comply with all federal regulation have increased significantly. In the 2015 survey, fewer respondents reported the hours ranging from 100–250 hours (33% in 2012 compared with 26% in 2015); instead, a much higher number had compliance hour requirements in the 251–500 hour range (22% in 2012 compared with 30% in 2015). Assuming that compliance hour requirements are proxies for compliance costs, the comparative data in Figure 9, like that in Figure 7, suggest that the cost structure for all federal regulation increased between 2012 and 2015.

3. Assets Under Management

Figure 10 illustrates the responses to Question 7 for both the 2012 and 2015 surveys: "Would you take the current regulatory regime into account in determining the appropriate size of asset[s] (AUM)] for your fund(s)?" The comparative data in Figure 10 suggest that investment advisers of private funds are increasingly taking the regulatory structure into account when determining their

Figure 9

Annual Hours Required to Comply with All Federal Rules

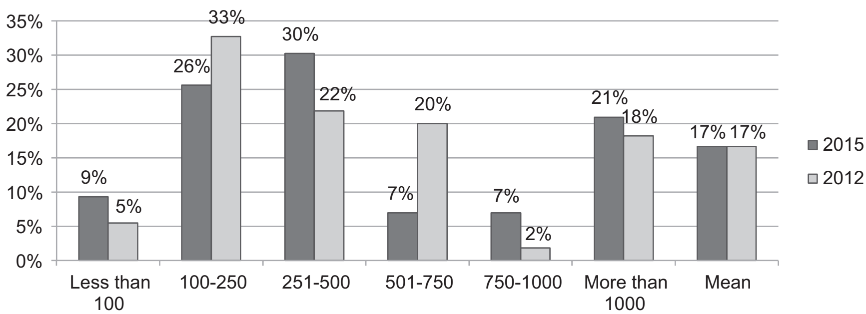
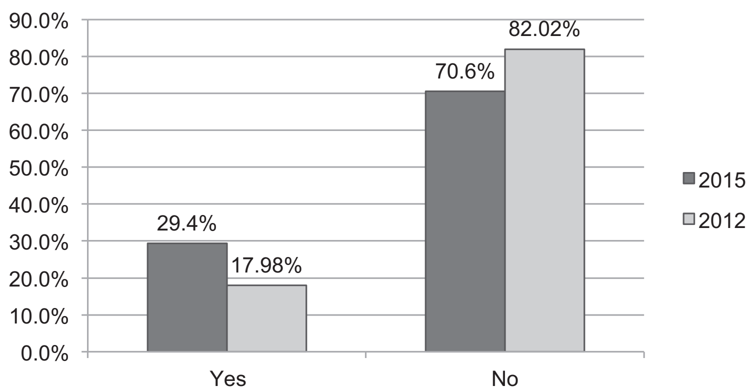


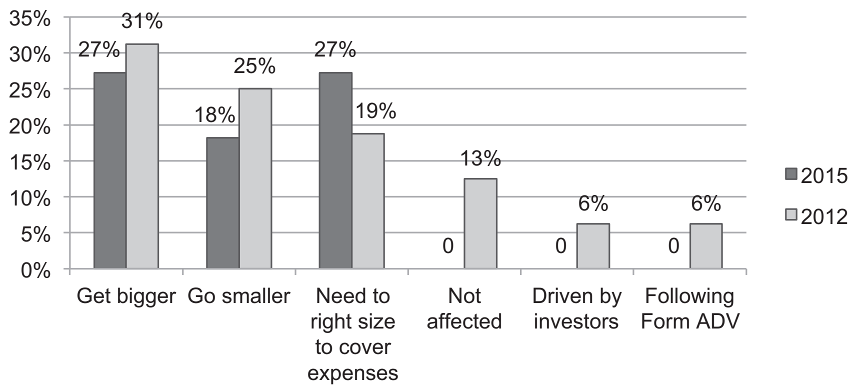
Figure 10

Percentage of Advisers Considering the Regulatory Regime in the AUM Decision



AUM. This can partially be explained by the higher overall post-Dodd-Frank-Act cost structure for the industry as identified in Figures 6, 8, and 9. A higher cost structure can partially be offset with higher AUM and correspondingly higher incoming fees. However, this finding is inconsistent with anecdotal evidence suggesting that only in a minority of private investment funds would expenses be paid using either all or a portion of the management fee. In contrast, the most common operating principle for the majority of private fund advisers is that rather than taking AUM into consideration as the evidence in Figure 10 suggests, the investment adviser tries to shift as much of his or her operating expenses as

Figure 11
How Advisers Account for the Regulatory Regime in the AUM Decision



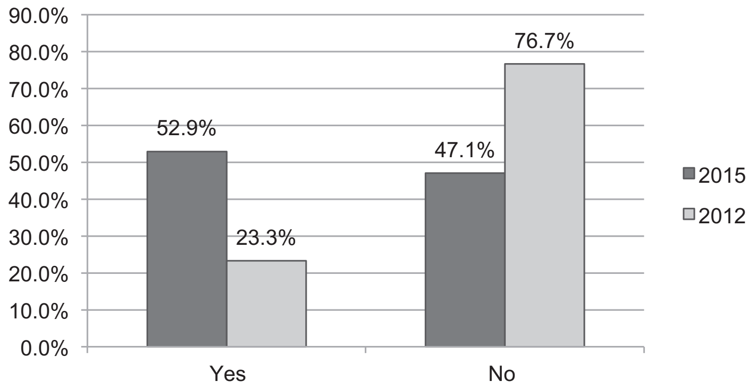
possible to the fund, so that a maximum of the net management fee becomes compensation to the managers/owners—a practice much critiqued by private fund investors.

Figure 11 shows the majority of clustered responses pertaining to Question 7: "Would you take the current regulatory regime into account in determining the appropriate size of asset[s] (AUM) for your fund(s)? If yes—how would you take it into account?" A majority of respondents stated that, as a result of the current regulatory regime, their AUM would need to change. While 18.2% would lower their AUM to avoid the regulatory hassle, 27.3% would still want to increase their AUM. Another 27.3% indicated a desire to attain the right size to cover expenses.

Figure 12 shows the responses to a survey question: "Did you take it [the regulatory regime] into account [in determining the appropriate size of asset (AUM) for your fund(s)] before the Dodd-Frank Act was enacted?" A majority of respondents in 2012 (76.7%) did not take the regulatory regime into account in determining their AUM prior to the Dodd-Frank Act. In contrast, the majority of 2015 respondents (52.9%) did take the regulatory regime into account. The comparative data in Figure 12 could suggest that the regulatory framework after the enactment of the Dodd-Frank Act plays a role in the investment fund advisers' AUM decision-making process. Private fund advisers are increasingly taking the regulatory structure into account in determining their AUM. This can partially be explained with the higher overall post-Dodd-Frank-Act cost structure for the industry, which is shown in Figures 6, 8, and 9. Investment advisers can offset higher compliance costs with an increased AUM and a corresponding increase in fee revenue. These findings are consistent with anecdotal evidence that suggests investment advisers' costs have substantially increased because of

Figure 12

Advisers Taking Regulatory Regime into Account in Their AUM Decision Prior to the Enactment of the Dodd-Frank Act



the SEC's enforcements, settlements, and rulemaking in the aftermath of the Dodd-Frank Act.

Figure 13 quantifies the AUM preferences of survey respondents. The comparative data in Figure 13 suggest that the respondents in the 2015 survey preferred a higher AUM—in the range from $500 million to $1 billion—than those in 2012. In 2012, 29% of respondents had an AUM preference in the range from $150 million to $500 million and only 16% of respondents preferred a $500 million to $1 billion AUM. In 2015 these figures reversed; only 15% of respondents had an AUM preference in the range from $150 million to $500 million, and 33% of respondents preferred $500 million to $1 billion AUM. The data in Figure 13 are consistent with the data presented in Figure 12, suggesting that (perhaps because of the increased compliance costs for the industry as identified in Figures 6, 8, and 9) the regulatory framework after the enactment of the Dodd-Frank Act plays an increasing role in investment fund advisers' AUM decision-making process.

Figure 14 illustrates the array of responses in the 2012 and 2015 surveys regarding a question about factors that influenced respondents' AUM preferences. The 2012 and 2015 response clusters are only partially consistent. In 2012, 24% of respondents noted their existing size as a core factor influencing their AUM preference, and 26% did not see regulation as a factor; in 2015, 26% of respondents quoted additional expenses and target investment opportunities as factors. Another 26.5% of the 2015 respondents opined that there was no impact on their AUM preference. The comparative data in Figure 14 suggest that additional regulatory obligations imposed on the private investment fund industry in the regulatory shift that resulted from the Dodd-Frank Act do influence AUM preferences.

Figure 13
Desired AUM After the Dodd-Frank Act

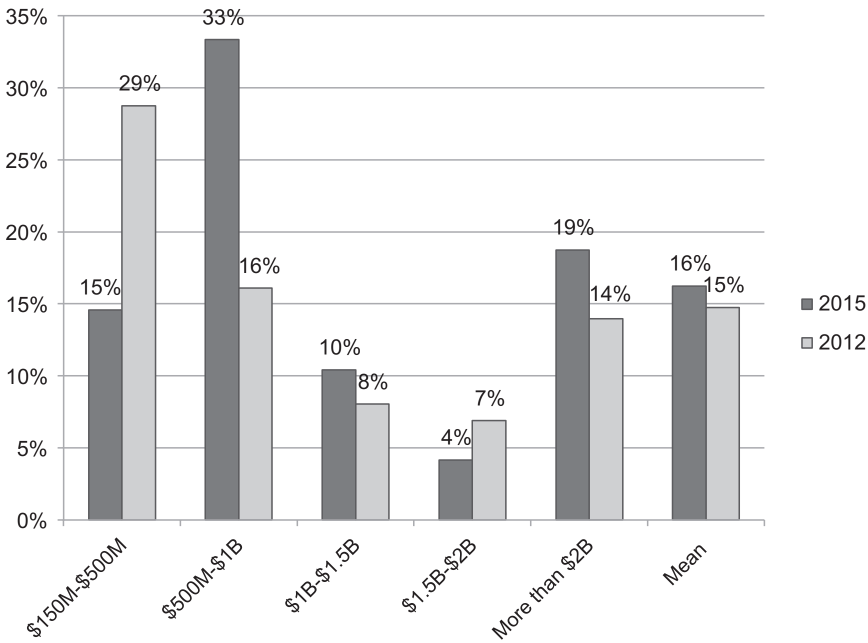


Figure 15 compares data from the 2012 and 2015 surveys, showing survey participants' assessment of the importance of the Form PF quarterly reporting threshold of $1.5 billion AUM in the AUM decision. Figure 15 illustrates a shift in survey respondents' attitudes towards the Form PF reporting threshold from 2012 to 2015. In 2012, only 19% of respondents took the Form PF quarterly threshold into account, whereas 33% of respondents in 2015 found the threshold relevant. Again, the increased costs associated with an evolving regulatory framework after the Dodd-Frank Act (Figures 6, 7, and 9) may help explain the increasing relevance of reporting thresholds. Private investment fund advisers have to file Form PF for each of their reporting funds annually unless their AUM exceeds $1.5 billion, which triggers a quarterly Form PF reporting obligation for each reporting fund. At an average quarterly cost of around $10,000 for each reporting fund, the Form PF[190] costs may make participants more likely to consider the Form PF reporting threshold in the AUM decision.

190. *Id.*

Figure 14
Factors Influencing AUM Preference

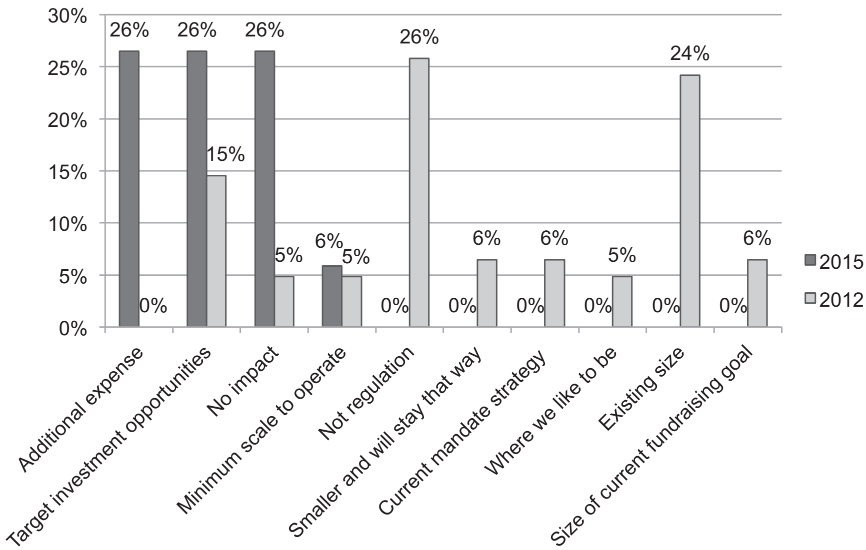


Figure 15
Advisers that Consider the $1.5 Billion Form PF Threshold in the AUM Decision

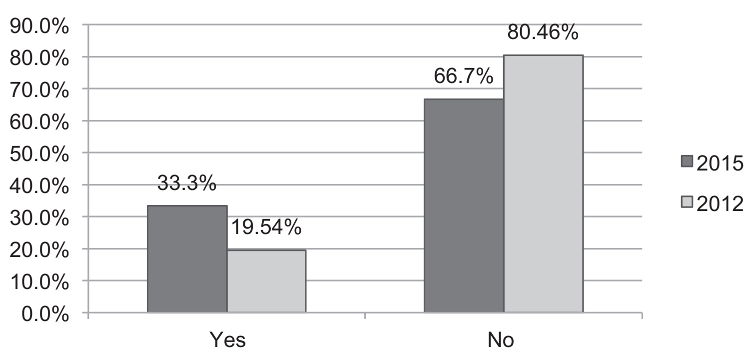
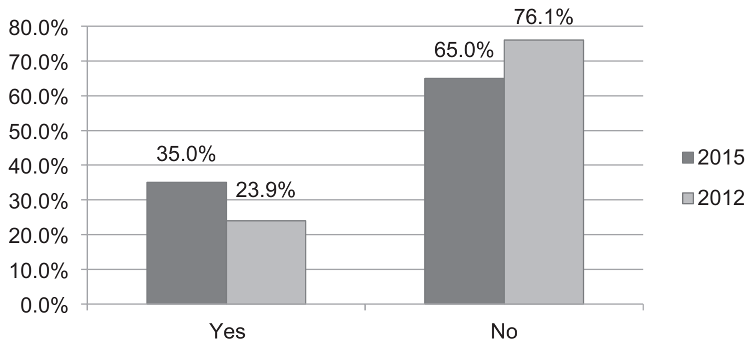


Figure 16
The Dodd-Frank Act's Effect on Fund Earnings



4. Fund Earnings

Figure 16 illustrates that the majority of survey respondents in both the 2012 survey (76.1%) and 2015 survey (65%) believed that the Dodd-Frank Act did not affect reporting funds' earnings. Although Dodd-Frank Act compliance costs predominantly affect the investment advisers of private funds rather than the funds themselves, investment advisers have increasingly created fund structures that allow them to pass most of their compliance expenses through to their reporting funds. These pass-through costs are applied to the funds' trading revenues, which results in an overall adverse impact on the funds' earnings.

Figure 17 illustrates that the majority of those respondents who believed that the Dodd-Frank Act affected their funds' earnings blamed additional compliance costs associated with the Dodd-Frank Act. They cited cost to management, cost to fund, opportunity cost, increased expenses, and additional time. However, the comparative data from the 2012 and 2015 surveys suggest that between 2012 and 2015, investment advisers saw the costs on fund earnings increasingly associated with opportunity costs (rates rose from 9% in 2012 to 32% in 2015) and not with increased expenses (rates fell from 53% in 2012 to 36% in 2015). This is consistent with anecdotal evidence that suggests the industry largely absorbed increased expenses associated with the Dodd-Frank Act through the increased use of pass-through expense terms in structuring investment adviser and private fund relationships between 2012 and 2015.

5. Effect on Profits

Figure 18 highlights respondents' assessment of the Dodd-Frank Act's effect on investment management company profits. The 2012 and 2015 responses

Figure 17

How the Dodd-Frank Act Affected Fund Earnings

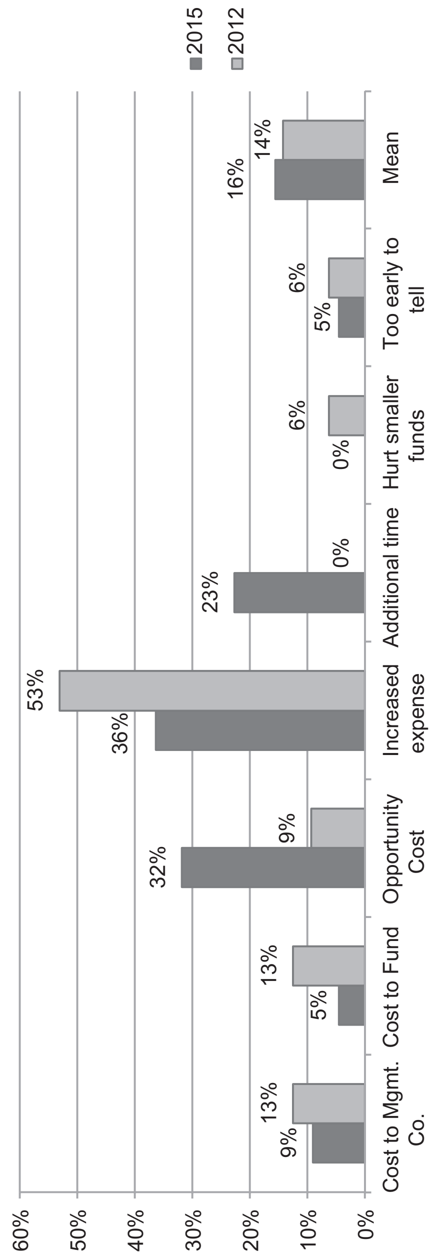
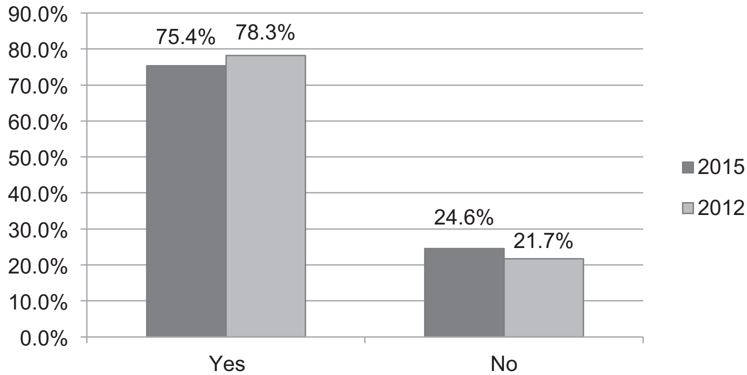


Figure 18
Dodd-Frank Act's Effect on Management Company Profits



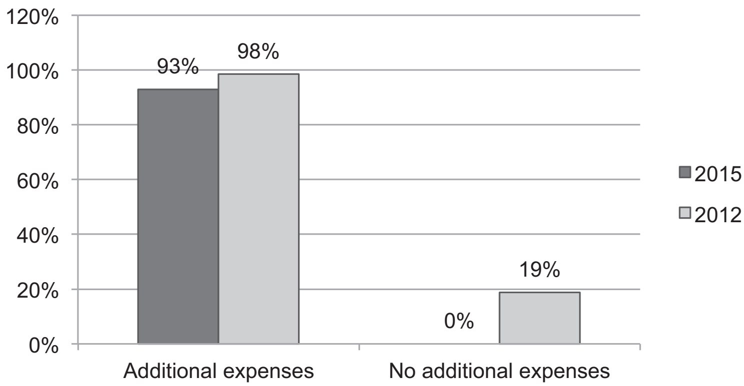
were largely consistent. In 2012, a higher proportion of respondents suggested that the Dodd-Frank Act affected profits than in 2015; this may suggest that in 2015 Dodd-Frank-Act-related costs had a lower impact than in 2012. This is consistent with the cost savings associated with higher compliance effectiveness and efficiency over time. It may also reflect a greater industry-wide use of pass-through expense terms in structuring investment adviser and private fund relationships during that time period. However, this is not consistent with anecdotal evidence suggesting that, since the early 2000s, private fund advisers have instituted expense pass-through regimes—a common structure that allows investment advisers to pass through either all or a significant part of their regulatory compliance costs to their reporting funds.

Figure 19 illustrates that a clear majority of respondents in 2015 (93%) believed that the profits of their investment management company were affected by additional expenses associated with the Dodd Frank Act. Whereas in 2012 when 19% of respondents said that the act had no effect on management company profits, no such responses were made in the 2015 survey. The overall response trend between the 2012 and 2015 surveys appears to attribute the possible detrimental impact of the Dodd-Frank Act on management company profits to additional expenses.

Figure 20 shows the respondents' perspectives in the 2012 and 2015 surveys on the ways in which Title IV may affect advisers' funds in the next five years. The clustered response categories in the 2012 and 2015 surveys are only partially consistent. In contrast with the 2012 response clusters that mostly made reference to staffing and administrative or recordkeeping burdens, the 2015 survey includes rather drastic clustered response categories, such as "lower returns" and "consolidate or close funds"; these activities would reflect a substantial effect on the reporting funds. However, the 2015 cluster categories also include a cat-

Figure 19

Dodd-Frank's Effect on Management Company Profits



egory that references respondents' uncertainty as to the effect of the Act on funds. In the 2015 survey, only 50% of respondents cited additional costs, whereas in 2012, over 60% of respondents considered additional costs to be a factor that would affect the funds over the next five years.

Figure 21 illustrates the 2012 and 2015 respondents' estimations as to how Title IV will affect the private fund industry in the next five years. In both surveys, a majority of respondents referenced additional expenses and barriers to entry for private fund market entrants. However, the 2015 responses also suggested that barriers to entry do represent an increasing problem for small firms in the private fund industry, given the currently changing post-Dodd-Frank legal environment. In 2012, only 24% of respondents made references to barriers to entry for small firms, whereas 33% made such references in 2015.

V. Summary of Key Findings and Policy Implications

The findings of this comparative survey study support evidence from earlier studies,[191] which suggest that the industry adapted well to the evolving regulatory environment following the enactment of the Dodd-Frank Act. Despite the low regulatory impact of the Dodd-Frank Act overall, this article indicates that compliance costs associated with the evolving regulatory environment for private fund advisers have many unexpected consequences that could have the potential to further shape industry practices.

Investment advisers' strategic responses to the evolving regulatory environment for the private fund industry are an important element for discerning the impact of the Dodd-Frank Act. While in both the 2012 and 2015 surveys,

191. Kaal, *supra* note 2.

Figure 20

How the Dodd-Frank Act Will Affect Fund(s) in the Next Five Years

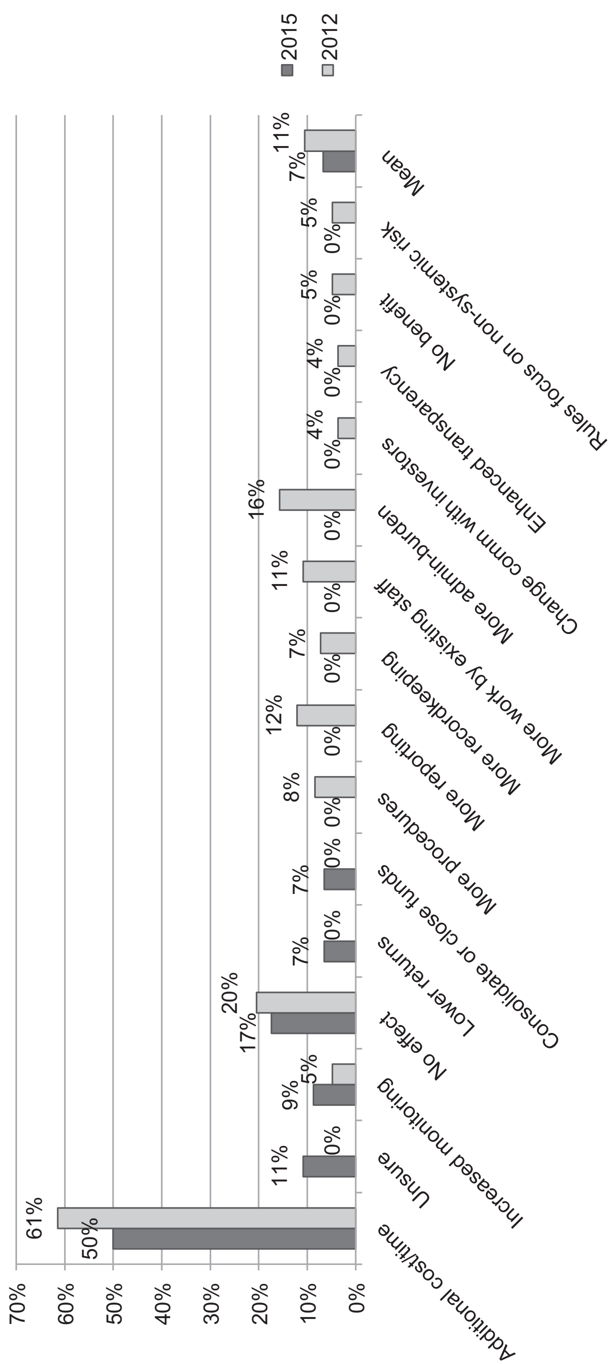
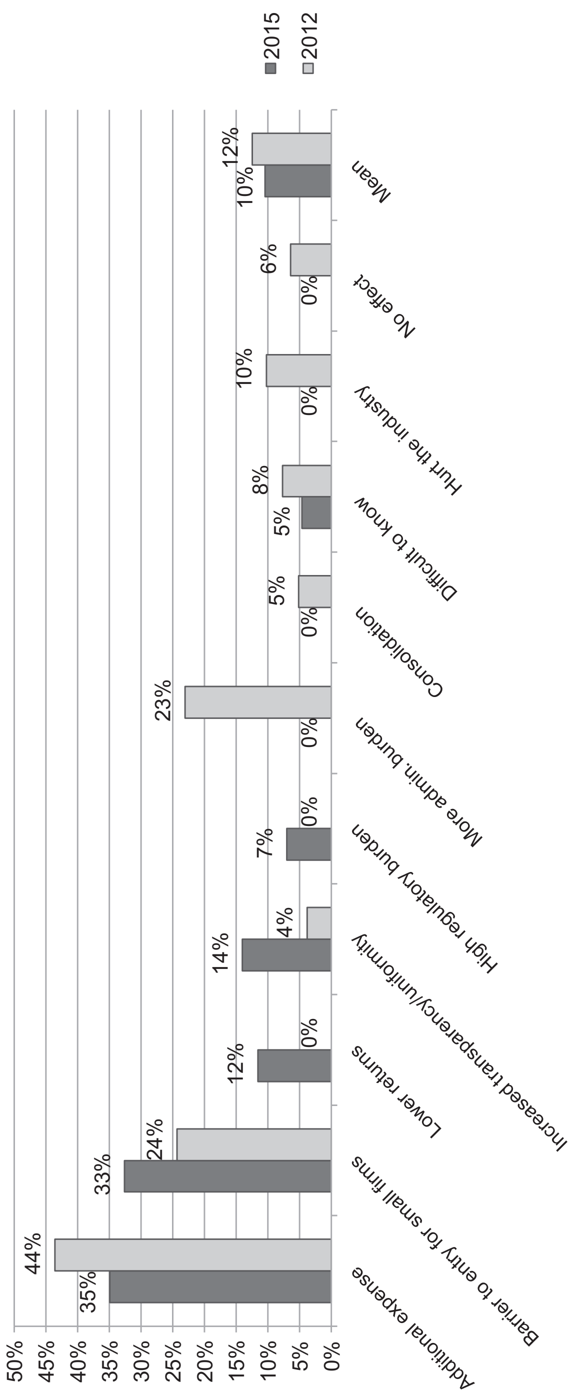


Figure 21

How the Dodd-Frank Act Will Affect the Industry in the Next Five Years



a majority (72% and 75%, respectively) of respondents did not plan a strategic response to Title IV of the Dodd-Frank Act, readers should note a few developments. In 2015, a substantially higher rate of respondents (47% in 2015 versus 25% in 2012) suggested that respondents changed their communications with investors; this is consistent with anecdotal evidence suggesting that, since the 2012 survey, private fund advisers have changed and increased their communications with investors, often based on advice from counsel. In a legal environment where SEC examinations, enforcement actions, and major settlements define the rules promulgated following the enactment of the Dodd-Frank Act,[192] it has become increasingly important for private fund advisers to communicate with investors, emphasizing the effect of these new conditions on fund operations. The comparative data also suggest that—at least under some metrics—rather than outsourcing required compliance work, the industry is increasingly doing such work in-house. This is consistent with the SEC's emphasis on COO liability[193] and subsequent enforcement actions since 2012 that have focused on compliance departments.[194] Moreover, the comparative data suggest that since 2012, at least a part of the industry is closing funds to new investors and even changing funds' legal structures in response to the evolving regulatory landscape.

Perhaps the most important findings of this comparative survey study pertain to the comparative and long-term implications of the compliance costs associated with the evolving post-Dodd-Frank-Act regulatory environment and its effect on private fund advisers. The comparative data suggest that between 2012 and 2015 the industry was subject to an overall higher cost structure.[195] In fact, the data suggest that the annual cost of compliance doubled for many survey respondents, moving from the $50,000 to $100,000 range to the $100,000 to $200,000 range. The survey provides evidence that the industry became more effective from 2012 to 2015 in its compliance with obligations related to the Dodd-Frank Act;[196] however, if one assumes that compliance hour requirements are a proxy for compliance cost, then the comparative data[197] suggest that the cost structure for all federal regulation increased between 2012 and 2015.

Comparative data on the possible impact of the evolving regulatory environment on the AUM of private investment fund advisers facilitate an analysis of the implications of rulemaking on the industry's evolution. The comparative data in this study suggest that investment advisers of private funds are increasingly taking the regulatory structure into account when determining their AUM.[198] The comparative data suggest that the 2015 survey respondents prefer a higher AUM than 2012 survey respondents.[199] Whereas in 2012, 29% of survey respondents

192. *See supra* notes 143–66 and accompanying text.
193. *See supra* notes 128–35 and accompanying text.
194. *See supra* notes 128–35 and accompanying text.
195. *See supra* figs. 6, 7 & 9 and accompanying text.
196. *See supra* fig. 8 and accompanying text.
197. *See supra* figs. 7 & 9 and accompanying text.
198. *See supra* figs. 10 & 12 and accompanying text.
199. *See supra* fig. 13 and accompanying text.

had an AUM preference in the range from $150 million to $500 million, and only 16% preferred a $500 million to $1 billion AUM, in 2015 these figures reversed; only 15% of respondents had an AUM preference in the range from $150 million to $500 million, and 33% of respondents preferred a $500 million to $1 billion AUM. While this finding can be partially explained with the higher overall post-Dodd-Frank-Act cost structure for the industry,[200] it is inconsistent with private fund advisers' general tendency to grow AUM to increase profitability. To ensure that as much as possible of the net management fee becomes compensation for the managers, investment advisers typically try to allocate as many operating expenses to the fund as possible. Nevertheless, the comparative data provided in this survey study suggest that the additional regulatory obligations imposed on the private investment fund industry in the aftermath of the tectonic regulatory shift stemming from the Dodd-Frank Act influence AUM preferences. It is unclear if changing AUM preferences will result in permanent AUM changes over time. However, from a policy perspective, changing AUM preferences associated with compliance costs could eventually result in consolidations that facilitate cost savings or precipitate a trend towards family offices that do not manage third-party assets.

The impact of the evolving post-Dodd-Frank-Act regulatory environment on investment advisers' profitability has raised industry-wide concerns.[201] The majority of survey respondents believed in both the 2012 survey (76.1%) and the 2015 survey (65%) that the Dodd-Frank Act did not affect reporting funds' earnings. Of those respondents who did believe that the Act affected their reporting fund's earnings, the comparative data suggest that between 2012 and 2015 investment advisers saw the costs on fund earnings increasingly associated with opportunity costs (2012: 9%; 2015: 32%) rather than with increased expenses (2012: 53%; 2015: 36%). This is consistent with anecdotal evidence suggesting that the industry largely absorbed the increased expenses associated with the Dodd-Frank Act through the increasing use of pass-through expense terms when structuring investment adviser and private fund relationships between 2012 and 2015. From a policy perspective, increased opportunity costs might merit continuous monitoring.

The private fund industry has long voiced concerns about the long-term implications of the evolving regulatory environment on investment advisers' reporting funds.[202] The comparative evidence in this study suggests that long-term effects of the evolving post-Dodd-Frank-Act regulatory environment might be more substantial than the industry and regulators initially anticipated. The greater percentage of 2015 responses, compared to 2012 responses, made references to "lower returns" and planned to "consolidate or close funds," which may

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200. *See supra* figs. 6, 8 & 9 and accompanying text.

201. *The Dodd Frank Act Five Years Later: Are We More Prosperous?: Hearing Before the H. Comm. on Fin. Servs.*, 114th Cong. 6 (2015) (statement of Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute) (discussing the Dodd-Frank Act's relatively high cost relative to benefits); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-16-169, DODD-FRANK REGULATIONS: IMPACTS ON COMMUNITY BANKS, CREDIT UNIONS AND SYSTEMATICALLY IMPORTANT INSTITUTIONS (2015), http://www.gao.gov/assets/680/674459.pdf.

202. *See supra* note 3.

suggest a more substantial effect on reporting funds. Confirming these trends, 2012 and 2015 estimates predicting the state of the private fund industry over the next five years also made references to additional expenses and barriers to entry to the private fund market. The 2015 survey responses suggest that barriers to entry for small firms are becoming increasingly a problem for the private fund industry in the continuously evolving post-Dodd-Frank-Act legal environment. Whereas in the 2012 survey only 24% of respondents referenced barriers to entry for small firms, in 2015, 33% made such references.

VI. APPENDIX: 2015 SURVEY INSTRUMENT

Survey Questions

1. Is your investment adviser/fund manager registered with the SEC?
   a. Yes ☐
   b. No ☐
2. Which of the following actions have you taken to assure compliance with Dodd-Frank Act registration and reporting requirements?

   Please check all that apply:

   Outsourced compliance work ☐
   a. Hired additional counsel ☐
   b. Instituted new record-keeping policies ☐
   c. Hired additional staff ☐
   d. Fired staff ☐
   e. Severed an advising relationship with client(s) (i.e., closed fund and went private to escape registration and disclosure requirements) ☐
   f. Changed marketing materials ☐
   g. Changed communications with investors ☐
   h. Changed fund (legal) structure ☐
   i. Liquidated positions ☐
   j. Changed investment style ☐
   k. Changed portfolio structure ☐
   l. Closed fund(s) to new investors ☐
   m. Other ☐

   ____

3. Do you plan to implement strategic responses to the new registration and disclosure requirements?

   a. No ☐

   b. If yes ☐, what strategic responses do you plan to implement?

   ____

   ____

   In what ways will the new registration and disclosure rules affect your fund(s) in the next five years?

   ____

   ____

4. In what ways will the new registration and disclosure rules affect your industry in the next five years?

   ____

   ____

5. Please respond to the questions pertaining to the new registration and reporting requirements in each category:

   a. Time:

      i. Compliance with the Dodd-Frank Act reporting requirements will take approximately:

         1. 100–250 hours per year ☐
         2. 250–500 hours per year ☐
         3. 500–750 hours per year ☐
         4. 750–1000 hours per year ☐
         5. More than 1000 hours per year ☐
         6. Other ________________________________ ☐

      ii. Compliance with all federal rules and procedures (Treasury, SEC, CFTC etc.) will take approximately:

         ______ hours per year

   b. Cost (defined as actual expenses incurred):

      i. Compliance with the new reporting requirements will annually cost approximately:

         1. $50,000–$100,000 ☐

2. $100,000–$200,000 ☐
3. $200,000–$300,000 ☐
4. $300,000–$400,000 ☐
5. More than $500,000 ☐
6. Other ______________________________

ii. Compliance with all federal rules and procedures (Treasury, SEC, CFTC etc.) will annually cost approximately:

$____________

6. Would you take the current regulatory regime into account in determining the appropriate asset size (AUM) for your fund(s)?

a. No ☐

b. If Yes ☐,

i. How would you take it into account?

____

ii. Did you take it into account before the Dodd-Frank Act was enacted?

a. No ☐

b. Yes ☐

7. After the enactment of the Dodd-Frank Act reporting and disclosure requirements, what asset size (AUM) would you desire to operate your fund(s):

a. $150 mil–$500 mil ☐

b. $500 mil–$1 bil ☐

c. $1 bil–$1.5 bil ☐

d. $1.5 bil–$2 bil ☐

e. More than $2 bil ☐

f. Other _____________________ ☐

g. N/A ☐

8. What affected your response to Item 8?

____

____

9. Would you take the Form PF threshold for quarterly reporting of $1.5 bil assets (AUM) into account in determining the appropriate size of assets (AUM) for your fund(s)?

   a. No ☐

   b. If yes ☐, how would you take it into account?

   ____

   ____

10. Have the new registration and disclosure requirements affected your fund's earnings/net rate of return to your investors?

   a. No ☐

   b. If yes ☐, how?

   ____

   ____

11. Have the new registration and disclosure requirements affected the profits of your investment management company?

   a. No ☐

   b. If yes ☐, how?

   ____

   ____