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Private Equity Regulation in The Aftermath of The 2008 Financial Crisis: Is Title IV of The Dodd-Frank Act The Right Answer? The Political Economy of Dodd-Frank and The Case Against the Regulation of Private Equity Funds Under Title IV

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ABSTRACT

Title IV of the Dodd-Frank Act and its implementing rules set out a major reform of the private investment fund industry and establish a new framework for regulatory and supervisory oversight of private investment funds. Title IV eliminated the private adviser exemption previously available under the Investment Advisers Act of 1940 and required the SEC to establish rules and regulations requiring advisers to "private investment funds", including private equity funds, to register with the SEC under the Investment Advisers Act of 1940. Through the elimination of the private adviser exemption, Title IV and its implementing rules now require that investment advisers to private equity funds, hedge funds and certain other funds with assets under management of $150 million or more register with the SEC, comply with certain SEC books, records, disclosure and reporting requirements, and be subject to extensive periodic SEC examination, unless they qualify for specific exemptions. This new regulatory regime is designed to bring transparency and oversight to the activities of private investment funds, control the build-up of systemic risk in the financial system and address the market and regulatory failures that led to the 2008 financial crisis.

In this paper, I will i) analyze the political economy of the Dodd-Frank Act and its impact on the regulation of the private equity sector; ii) critically assess and challenge the Dodd-Frank and its implementing rules approach to the regulation of private equity funds; iii) evaluate the underlying economic theory of regulation and its relevance to the private equity sector; iv) challenge Title IV's reliance on disclosure as the primary method of reducing systemic risk and protecting fund investors; v) examine the relationship between private equity funds and systemic risk; vi) analyze the use of leverage by private equity funds and the risk of excessive leverage; and vii) offer an alternative approach to the regulation of the private equity industry and the risks associated with leveraged lending to private equity funds. Additionally, this paper will specifically explore the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable v. SEC and the importance, role and application of cost benefit analysis in financial regulation and particularly private equity regulation under Title IV and its implementing rules. Choosing whether and how to regulate is generally a question of regulators and the implementing agency evaluating tradeoffs and whether society, the financial system and the economy gain enough from the regulation to justify its costs. The goal is for regulators to ensure they adequately consider the effectiveness and consequences of their regulatory actions. In other words, the benefits must justify and exceed the costs of the proposed legislative action. This paper will further examine the costs and benefits of Title IV and its implementing rules, in light of the decision in Business Roundtable, and demonstrate how cost benefit analysis, when used properly, provides a fundamental decision making tool that helps regulators to ensure that regulatory efforts produce a net positive effect on society and the economy as a whole.

I will argue in this paper that the decision of regulators to regulate private equity funds and subject them to extensive SEC registration and reporting requirements (as reflected in Title IV of the Dodd-Frank Act) is inadequate, unnecessarily costly, inconsistent with the intended purpose of the Dodd-Frank Act and its underlying theory of regulation, too disclosure-focused, based on fundamental misconceptions as to the nature of private equity and does not properly address the risk of too much leverage. Furthermore, this paper will take the position that Title IV's implementing rules do not meet the economic analysis and cost benefit justification standards set by the D.C. Circuit Court in the Business Roundtable decision. The SEC, in implementing Title IV, failed to perform an adequate cost benefit analysis and to consider the impact of this legislation on efficiency, competition and capital formation in the context of private equity funds. It failed to articulate a satisfactory and reasoned explanation for its regulatory actions, including a rational connection between the pre-crisis conduct and failures it was trying to address and the regulatory choices made. This paper will argue that Title IV and its implementing rules are not supported by i) the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable, and ii) any other compelling argument demonstrating that the benefits of Title IV are greater than its costs.

Like any other post-crisis reform legislation, Title IV may have satisfied a political need, but it will not benefit the financial market or the economy as a whole, will not improve investor welfare and will not reduce the risks that private equity funds may pose to the financial system. I argue, instead, that since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', these funds and their advisers should be subject to a reduced regulatory regime and exempt from the SEC registration, reporting and disclosure requirements under the Dodd-Frank Act and its implementing rules. The concerns associated with the use of leverage by private equity funds and the risk of excessive leverage should be addressed through more substantive rules like leveraged lending regulation and tighter underwriting practices, standards and policies. By setting new standards for underwriting of leveraged loans by banks and other lenders, regulators and policymakers can ensure that private equity funds will have to meet higher standards when seeking buyout loans, therefore, reducing the risk of high leverage and the remote probability of a systemic financial crisis. Also, this paper will conclude that overall financial regulators, and particularly the SEC should ground their rulemaking in rigorous cost benefit analysis and standards, consistent with the Business Roundtable decision, to arrive at more rational decision-making and efficient regulatory actions that advance the public interest. This legislative approach, unlike Title IV of the Dodd-Frank Act and its implementing rules, will avoid hasty regulation that fails to achieve its goals and imposes costs that exceed its benefits. It will ensure that society and the economy actually gain enough from the regulation to justify its costs.

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I. INTRODUCTION

As the U.S. economy experienced the worst financial crisis since the Great Depression, regulators and policy-makers started to recognize the need for a comprehensive regulatory reform of the financial sector. The near-collapse of Bear Stearns in March 2008, followed by the bankruptcy of Lehman Brothers on September 15, 2008, and the bailout of American International Group on September 16, 2008, clearly demonstrated that the regulatory framework in place prior to the financial crisis was inadequate. Thus, in the aftermath of the financial crisis, U.S. regulators have sought to bring enhanced transparency to the financial sector, protect investors, improve the stability and integrity of the market and reduce systemic risk in the financial system through the introduction of a comprehensive regulatory reform.[1]

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, representing the most comprehensive and far-reaching overhaul of the nation's financial regulatory system since the 1930s.[2] The Dodd-Frank Act dramatically changes the regulatory landscape for all financial services companies in the U.S. and seeks to fill the gaps in the pre-crisis regulatory framework. Title IV of the Dodd-Frank Act and its implementing rules set out a major reform of the private investment fund industry and establish a new framework for regulatory and supervisory oversight of private investment funds.[3] Title IV eliminated the private adviser exemption previously available under the Investment Advisers Act of 1940 and required the SEC to establish rules and regulations requiring advisers to "private investment funds", including private equity funds, to register with the SEC under the Investment Advisers Act of 1940.[4] Through the elimination of the private adviser exemption, Title IV and its implementing rules now require that investment advisers to private equity funds, hedge funds and certain other funds with assets under management of $150 million or more register with the U.S. Securities and Exchange Commission (the "SEC"), comply with certain SEC books, records and reporting requirements, and be subject to extensive periodic SEC

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[1] *See* Viral V. Acharya et al, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, (NYU Stern School of Business 1st ed 2011).

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter the "Dodd-Frank Act" or simply "Dodd-Frank"].

[3] *See* Acharya et al, *supra* note 1.

[4] *See* Mary L. Schapiro, SEC Chairman, *SEC Adopts Dodd-Frank Act Amendments To Investment Advisers Act*, Washington DC, June 22, 2011, available at http://www.sec.gov/news/press/2011/2011-133.htm. These rules and rule amendments are designed to give effect to the provisions of Title IV of the Dodd-Frank Act that, among other things, increase the statutory threshold for registration by investment advisers with the SEC, require advisers to hedge funds, private equity funds and other private funds to register with the SEC, and require reporting by certain investment advisers that are exempt from registration. The new SEC rules are of particular importance to private fund managers and others evaluating whether they must register as investment advisers with the SEC or whether they can rely on an exclusion from the definition of "investment adviser" in the Investment Advisers Act or on certain exemptions from registration created by the Dodd-Frank Act. The SEC rules are described in two adopting releases. The "Registration Release" sets forth final rules implementing certain amendments to the Investment Advisers Act required by the Dodd-Frank Act and the SEC registration requirements. The second release, the "Exemption Release" sets forth final rules implementing new exemptions, created by the Dodd-Frank Act, from the registration requirements of the Investment Advisers Act, including: i) defining "venture capital funds" for purposes of the new Investment Advisers Act exemption for advisers to venture capital funds; ii) exempting from registration certain private fund advisers with less than $150 million in private fund assets under management in the United States; and iii) clarifying the meaning of certain terms used in the new exemption for foreign private advisers. (available at http://www.sec.gov/rules/final/2011/ia-3221.pdf).

examination, unless they qualify for specific exemptions.[5] This new registration and reporting regime is designed to bring transparency and oversight to the activities of private investment funds and their advisers.[6] The primary objectives of this legislation are to control the build-up of systemic risk in the financial system, enhance financial stability, address the market and regulatory failures that led to the 2008 financial crisis and reduce the likelihood of a major financial crisis in the future.[7]

In this paper, I will: i) analyze the political economy of the Dodd-Frank Act, its impact on the regulation of the private equity sector and the argument that financial reforms introduced after a financial crisis are usually flawed, overbroad and excessive;[8] ii) critically assess and challenge the Dodd-Frank and its implementing rules approach to the regulation of private equity funds; iii) evaluate the underlying economic theory of regulation and its relevance to the private equity sector; iv) challenge Title IV's reliance on disclosure as the primary method of reducing systemic risk and protecting fund investors; v) examine the relationship between private equity funds and systemic risk; vi) analyze the use of leverage by private equity funds and the risk of excessive leverage; and vii) offer an alternative approach to the regulation of the private equity industry and the risks associated with leverage lending to private equity funds. Additionally, this paper will specifically explore the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable v. SEC[9] and the importance, role and application of cost benefit analysis in financial regulation and particularly private equity regulation under Title IV and its implementing rules. Choosing whether and how to regulate is generally a question of regulators and the implementing agency evaluating alternative regulatory approaches, tradeoffs and whether society, the financial system and the economy gain enough from the regulation to justify its costs. The goal is for regulators to ensure they adequately consider the effectiveness and consequences of their regulatory actions and determine the best course of action. In other words, the benefits must justify and exceed the costs of the proposed legislative action.

In Business Roundtable v. SEC the U.S. Court of Appeals for the D.C. Circuit struck down the SEC's proxy access rule[10] which had been promulgated under the Securities Exchange

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5 *See* §§ 401-419 of the Dodd-Frank Act. Section 403 of the Dodd-Frank Act eliminated the "private adviser exemption" contained in Section 203(b)(3) of the Investment Advisers Act of 1940 and introduced the requirement for advisers to "private funds", including private equity funds to register with the SEC. The amended Section 203(b)(3) reads as follows: (b) The provisions of subsection (a) shall not apply to— (1) any investment adviser, *other than an investment adviser who acts as an investment adviser to any private fund*, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.

6 *Id.*

7 *See* Acharya et al, *supra* note 1.

8 *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* (September 25, 2004). NYU, Law and Econ Research Paper 04-032; Yale Law & Econ Research Paper 297; Yale ICF Working Paper 04-37; ECGI - Finance Working Paper 52/2004. Available at SSRN: http://ssrn.com/abstract=596101 or http://dx.doi.org/10.2139/ssrn.596101

9 Business Roundtable v. SEC, 647 F.3d 1144, 1150, 1156 (D.C. Cir. 2011).

10 Compulsory proxy access has been debated for more than seventy years in what a former SEC Commissioner has called "a knockdown, drag-out political brawl." *See* Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 Bus. Law. 361, 378 (2009).

Act of 1934, as amended by the Dodd-Frank Act.[11] The court held that the rulemaking process was "arbitrary and capricious and not in accordance with law" and that the SEC had failed to perform an adequate cost benefit analysis of the rule.[12] The court vacated the rule on the basis that it violated the Administrative Procedure Act[13] and that the SEC "failed adequately to consider the rule's effect upon efficiency, competition and capital formation".[14] In concluding that the SEC had failed to meet its cost benefit analysis obligations, the court made clear that the rule required "a far more rigorous economic analysis and cost benefit justification than the SEC had assumed was necessary."[15] In the words of Judge Ginsburg, "the SEC fell far short of its statutory obligation to determine as best it could the economic implications of the rule".[16] Business Roundtable has become one of the most important financial regulation decisions since cost benefit analysis was developed in the early 1970s by holding financial regulators strictly accountable for the quality of their cost benefit analysis.[17] The decision is significant as it was the first challenge of a rule adopted under the Dodd-Frank Act, based on the implementing agency's failure to perform an adequate cost benefit analysis.[18] It also represents a turning point indicative of an unprecedented level of judicial scrutiny of financial regulation, forcing the SEC and other regulators poised to issue rules and regulations under the Dodd-Frank Act, to take a whole new look at their rulemaking process.[19] Despite extensive criticism, the decision appears to have mandated more demanding and strict standards of judicial review of the cost benefit analysis of financial regulation. Depending on one's view, such a powerful approach or filter of financial regulation could either "further ossify the financial rulemaking process[20] or make the rules that emerge from the process more rational, efficient, and transparent."[21]

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[11] Rule 14a-11 or the Proxy Access Rule (adopted by the SEC in 2010) required that prior to board elections, public companies must include in the proxy statement a limited number of candidates for director positions nominated by certain large shareholders. The purpose of the rule was to loosen management's control over the company's directors.

[12] *See* Business Roundtable v. SEC, *supra* note 9.

[13] Pub.L. 79–404, 60 Stat. 237, enacted on June 11, 1946.

[14] *See* Business Roundtable v. SEC, *supra* note 9.

[15] *Id.*

[16] *Id.*

[17] *See* Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking* (2013). Seattle University Law Review, Vol. 36, P. 695 (2013); U of Penn, Inst for Law & Econ Research Paper No. 12-34. Available at SSRN: http://ssrn.com/abstract=2164423.

[18] *See* Eric Posner and Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation* (April 22, 2014). University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 660. Available at SSRN: http://ssrn.com/abstract=2346466 or http://dx.doi.org/10.2139/ssrn.2346466

[19] *See* Jessica Holzer, Corporate News: Court Deals Blow to SEC, Activists, Wall St. J., July 23, 2011, at B3 (arguing that "the court's holding could have far-reaching implications for all Dodd-Frank rulemaking"); S*ee* also Ben Protess, *Court Ruling Offers Path to Challenge Dodd-Frank*, N.Y. Times (Aug. 17, 2011) http://dealbook.ny times.com/2011/08/17/court-ruling-offers-path-to-challenge-dodd-frank (explaining that "*Business Roundtable* exposes many Dodd-Frank rules to challenge since the economic analysis in the SEC's proxy access rule is better than most other final rules").

[20] *See Recent Case, Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), 125 Harv. L. Rev. 1088, 1092, 1095 (2012) (arguing that "the *Business Roundtable* approach creates a judicial blockade that will result in ossification of SEC regulations")

[21] *See* Matthew D. Adler & Eric A. Posner, *New Foundations of Cost-Benefit Analysis*, 122, 185–90 (2006); *See* Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 Yale L.J. 165, 225–26 (1999); *See* Lisa Schultz Bressman, *Beyond Accountability: Arbitrariness and Legitimacy in the Administrative State*, 78 N.Y.U. L. Rev. 461, 476 (2003) (arguing that "requirements obliging agencies to explain their decision making process and

This paper will further examine the costs and benefits of Title IV and its implementing rules, in light of the decision in Business Roundtable, and demonstrate how cost benefit analysis, when used properly, provides a fundamental decision making tool that helps regulators to ensure that regulatory efforts produce a net positive effect on society and the economy as a whole. It will evaluate whether Title IV and its implementing rules i) are supported by the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable; ii) represent the best regulatory choice and are tailored to impose the least burden on society, the financial system and the economy; and iii) reflect a regulatory approach that maximizes net benefits.

I will argue in this paper that the decision of regulators to regulate private equity funds and subject them to extensive SEC registration and reporting requirements is inadequate, unnecessarily costly, inconsistent with the intended purpose of the Dodd-Frank Act and its underlying theory of regulation, too disclosure-focused, based on fundamental misconceptions as to the nature of private equity and does not properly address the risk of too much leverage. It will not accomplish the legislation's purpose of helping identify and reduce systemic risk in the U.S. financial system and will not make the financial system more stable or less risky. It follows the traditional post-crisis legislative pattern which is usually excessive, burdensome, flawed and populist in nature. It tries to prevent the rise of systemic risk in investment vehicles that are not a major source of systemic risk problems.

Furthermore, this paper will take the position that Title IV's implementing rules do not meet the economic analysis and cost benefit justification standards set by the D.C. Circuit court in the Business Roundtable decision. The SEC in implementing Title IV, failed to perform an adequate cost benefit analysis and to consider the impact of this legislation on efficiency, competition and capital formation in the context of private equity funds. It failed to articulate a satisfactory and reasoned explanation for its regulatory actions, including a rational connection between the pre-crisis conduct and failures it was trying to address and the regulatory choices made. This paper will argue that Title IV's implementing rules are not supported by i) the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable, and ii) any other compelling argument demonstrating that the benefits of Title IV's implementing rules are greater than their costs.

Like any other post-crisis financial reform legislation, Title IV of the Dodd-Frank Act may have satisfied a political need, but will not benefit the financial market or the economy as a whole, will not improve investor welfare and will not reduce the risks that private equity funds may pose to the financial system. It goes beyond the concerns that led to the 2008 financial crisis and does not represent the proper legislative response that is geared toward correcting and mitigating the problems and failures that actually led to the 2008 financial crisis. This government intervention in the private equity sector was driven by the political pressure on Congress to quickly launch a comprehensive reform of the financial system, following the 2008 financial crisis. It reflects a questionable public policy decision that does not adequately address the propensity of the financial sector to put the entire system at risk, and fails to protect the

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justify their decisions ensure rational decision making"); *See*, Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis*, 68 U. Chi L. Rev. 1137, 1185–93 (2001).

benefits that private equity funds bring to the national economy. Its targeting of the private equity industry is simply misguided.

This paper also offers a conceptual framework for examining whether private equity funds create a systemic risk problem, what risks are truly "systemic", in the context of private equity funds and the use of leveraged buyout techniques, how (if at all) those risks should be regulated and whether Title IV of the Dodd-Frank Act and its implementing rules through their disclosure-based regulatory solution are the right answer.

I further argue in this paper, that since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', these funds and their advisers should be subject to a reduced regulatory regime and exempt from the SEC registration and reporting requirements under Title IV of the Dodd-Frank Act and its implementing rules. The concerns associated with the use of leverage by private equity funds and the risk of excessive leverage should be addressed through more substantive rules like leveraged lending regulation and tighter underwriting practices, standards and policies. By setting new standards for underwriting of leveraged loans by banks and other lenders, regulators and policymakers can ensure that private equity firms will have to meet higher standards when seeking buyout loans, therefore, reducing the risk of high leverage and the remote probability of a systemic financial crisis. This approach will: i) eliminate the unnecessary, costly and burdensome compliance requirements of Title IV and its implementing rules; ii) reduce and mitigate the potential risk posed by private equity funds and their use of leverage; and iii) protect the benefits that private equity funds bring to the economy.

This paper will also conclude that overall financial regulators and particularly the SEC should ground their rulemaking in rigorous cost benefit analysis and standards, consistent with the Business Roundtable decision, to arrive at more rational decision-making and efficient regulatory actions that advance the public interest. This legislative approach, unlike Title IV of the Dodd-Frank Act and its implementing rules, will avoid hasty regulation that fails to achieve its goals and imposes costs that exceed its benefits. It will ensure that society and the economy gain enough from the regulation to justify its costs. In the words of Professor Cass Sunstein, a leading academic commentator on cost benefit analysis, "rigorous cost benefit analysis creates confidence in the ability of regulators to craft effective and appropriate solutions to market problems. It also deters regulators from proceeding with rules that promise to impose big economic burdens without corresponding gains."[22] This approach is important especially now that the Dodd-Frank Act has significantly increased the amount of financial rulemaking. The scale and scope of Dodd-Frank regulations have made it critical for regulators to apply rigorous cost benefit analysis to the rulemaking process and ensure they adequately consider the effectiveness and consequences of their regulatory actions.

From this Introduction, this paper proceeds as follows. Part II describes the private investment funds industry and compares private equity to hedge funds and venture capital funds. It also examines the regulation of private investment funds, before and after the Dodd-Frank

[22] *See* Cass R. Sunstein, *The Stunning Triumph of Cost-Benefit Analysis*, BLOOMBERG (Sept. 12, 2012), available at http://www.bloomberg.com/news/2012-09-12/the-stunning-triumph-of-cost-benefit-analysis.html.

Act. Part III examines the case against the regulation of private equity funds under the Dodd-Frank Act and challenges the Dodd-Frank and its implementing rules approach to the regulation of private equity funds. It analyzes the political economy of the Dodd-Frank Act, the nature of post-crisis financial reforms and their tendency to be excessive, overbroad, populist in nature and heavily influenced by the post-crisis political and economic environment. It also explores the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable v. SEC and the importance, role and application of cost benefit analysis in financial regulation and particularly private equity regulation under Title IV and its implementing rules. It examines whether Title IV's implementing rules are supported by the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable. Part III also evaluates the underlying economic theory of regulation and Title IV's reliance on disclosure as the primary method of reducing systemic risk and protecting fund investors. Part IV examines the relationship between private equity and systemic risk and looks more closely at the question of whether private equity funds create a systemic risk problem through their use of leverage. Part V then outlines a set of recommendations for establishing more substantive rules like leveraged lending regulation and tighter underwriting practices, standards and policies. It looks at recent legislative initiatives and offers an alternative approach to the regulation of private equity funds and the risk of excessive leverage. It also evaluates the challenges of leveraged lending regulation. The paper closes, in Part VI, with a brief summary of the research and conclusion.

II. BACKGROUND

A. PRIVATE EQUITY FUNDS

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market.[23] Private equity funds are closed-end pooled investment vehicles, most frequently organized as limited partnerships that invest in privately held operating businesses.[24] In essence, these are investment funds which: i) buy, own and sell controlling positions in mature companies; ii) finance a substantial part of their investments through the use of debt; iii) employ fund managers paid by performance; and iv) have a finite life span of usually 10-12 years.[25]

A private equity fund typically is controlled by its general partner, which makes investment decisions for the fund and is affiliated with the private equity firm that advises the fund.[26] The private equity fund obtains capital commitments, at the beginning of its term though private placement transactions, from sophisticated institutional investors who agree to become

[23] *See* Steven M. Davidoff, Black Market Capital, 2008 Colum. Bus. L. Rev. 172, 191 (2008).
[24] *See* Testimony of Douglas Lowenstein, former President & CEO, Private Equity Growth Capital Council (PEGCC), before the House Financial Services Committee, Washington DC, October 6, 2009 available at www.house.gov/apps/list /hearing/...dem/lowenstein_testimony.pdf; and PEGCC Comment Letter by Douglas Lowenstein to the SEC (April 12, 2011) available at www.sec.gov/comments/s7-05-11/s70511-26.pdf.
[25] *See* Jeffrey A. Blomberg, *Private Equity Transactions – Understanding Some Fundamental Principles*, 17 Bus. L. Today 51 2007-2008.
[26] *See* Lowenstein, *supra* note 24.

limited partners of the fund.[27] The limited partners contribute capital to the fund over its term (usually between ten to twelve years) and are not involved in the management and control of the fund. After committing their capital, the limited partners, have little say as to how the general partner uses the investment funds, as long as the basic covenants of the fund partnership agreement are followed. It is also customary for the general partner to provide at least one percent of the total capital committed.

Limited partners of private equity funds usually include corporate pension funds, public retirement plans, foundations, endowments, sovereign wealth funds, insurance companies and to a lesser extent high net worth individuals.[28] This general partner-limited partner structure gives investors in the fund the opportunity to benefit from the experience and expertise of the fund manager and therefore achieve greater returns on investment than if they otherwise invested on their own. The investment strategies of private equity funds are mostly long-term "buy and hold" strategies, as opposed to trading strategies which are more associated with hedge funds. They purchase highly illiquid securities and are typically prohibited, by the terms of their partnership agreements or other governing documents, from: i) hedging for speculative purposes; ii) purchasing commodities or derivatives; and iii) investing in hedge funds or publicly traded securities.[29]

Private equity funds pursue a variety of investment strategies (e.g., venture capital, growth capital, real estate, buyout, distressed and mezzanine investing) and invest in a broad range of industries and geographic regions.[30] They seek to acquire a controlling interest in undervalued or under-managed companies that they can grow or improve with a view toward eventual sale or public offering.[31] The goal is to transform these under-performing and undervalued companies into capital efficient and profit generating companies.

Private equity funds typically have a fixed life, usually ten to twelve years, but can be extended for up to three additional years. The private equity firm normally has up to five years to invest the fund's committed capital into companies, and then has an additional five to seven years to return the capital to its investors.[32] Once in control, private equity funds tend to alter the structure of their target companies by disposing of assets that the target companies do not use efficiently, streamlining the operations of the target companies and replacing or restructuring management and the targets business plan to enhance value. They typically hold companies for

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[27] *See* Eileen Appelbaum and Rosemary Batt, *A Primer on Private Equity At Work,* Center for Economic and Policy Research, Washington DC, February 2012, available at www.cepr.net/documents/publications/private-equity-2012-02.pdf

[28] *Id.*

[29] *See* Houman B. Shadab, *Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds*, 29 Nw. J. Int'l L. & Bus. 603 2009. Available at http://ssrn.com/abstract=1340731.

[30] *See* Brian Cheffins and John Armour, *The Eclipse of Private Equity*, 33 Del. J. Corp. L. 1 200, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982114.

[31] *See* Felix Barber and Michael Goold, *The Strategic Secret of Private Equity*, Harvard Business Review, September 2007, available at http://hbr.org/2007/09/the-strategic-secret-of-private-equity/ar/1; *See* Robert Shapiro & Nam Pham, *The Role of Private Equity in US Capital Markets*, (2008) available at http://www.sonecon.com/docs/studies/Role-ofPEinUSCapitalMarkets-FINAL.pdf ("the strategic objective of all private equity transactions and subsequent operations is to raise the value of the acquired company, which normally involves steps to raise its earnings.").

[32] *See* Appelbaum and Batt, *supra* note 27.

3-5 years and then sell them or take them public hoping to realize a gain as a result of the increased value they have created through their restructuring and reorganization efforts during their period of ownership. As a "closed-end" vehicle, investors in the fund cannot withdraw their funds until the fund is terminated (as opposed to mutual funds where investors can withdraw their funds whenever they like).[33] Therefore, private equity investments are very illiquid with investors committing their capital for the full investment window.

The private equity firm or general partner is usually compensated in three ways. First, the general partner earns an annual management fee, typically a percentage of capital committed, and then, as investments are realized, a percentage of capital employed.[34] This management fee is usually two percent. Second, the general partner earns a share of the profits of the fund, referred to as "carried interest," that almost always equals twenty percent (once a hurdle rate of return has been achieved).[35] Finally, some general partners charge deal and monitoring fees to the companies in which they invest. The extent to which these fees are shared with the limited partners is a somewhat contentious issue in fundraising negotiations. These fees are commonly split 50–50 between general and limited partners.

The role of leverage is central in the private equity investment strategy and the use of debt has always been a substantial part of private equity transactions as it increases the return on equity. Private equity funds usually acquire companies through the use of leveraged buyout financing, taking advantage of the cheaper cost of debt and the deductibility of interest expenses.[36] They use the assets of the target company as collateral to borrow the funds necessary to acquire the company and the debt remains on the target company's balance sheet as part of its capital structure. Therefore, private equity funds seek companies that can generate sufficient cash flow to service the debt that is incurred to acquire them.[37] A typical private equity investment will utilize a relatively small portion of equity and a large pool of debt financing, with the objective being to deliver superior risk-adjusted returns by improving the financial performance, operations and growth profile of the acquired companies.[38] Because such a large portion of the fund's investment is paid for with debt, the fund realizes a greater return on its own equity investment when it liquidates that interest in the future.[39] Assuming the return on the total value invested by the fund is higher than the interest the fund pays on the borrowed debt, leverage increases return on equity. In a traditional private equity transaction the deal is usually financed

[33] *See* Jeremy Stein, *"Why Are Most Funds Open-End? Competition and the Limits of Arbitrage,"* (2005), Quarterly Journal of Economics, 120, February, 247-272.
[34] *See* Eileen Appelbaum and Batt, *supra* note 27.
[35] *Id.*
[36] *See* Lowenstein, *supra* note 24. [The cost of servicing the debt is reduced by virtue of the fact that interest payments are tax deductible, whereas dividend payments are not. Thus, every dollar paid to the company's senior lenders and bondholders in fact only costs the company a fraction of that amount. The benefits of this tax treatment ultimately accrue to the fund that owns the company and its investors].
[37] *See* Josh Lerner and Ann Leamon, *A Note on European Private Equity*, (May 6, 2011). Harvard Business School Finance Case No. 811-103. Available at SSRN: http://ssrn.com/abstract=2012738
[38] *See* Arthur B. Laffer et al, The Private Equity Edge: How Private Equity Players and The World's Top Companies Build Value and Wealth, (1st Ed. 2009).
[39] *See* Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 23 J. Econ. Perspectives 121, 124 (2009).

with anywhere between seventy and ninety percent debt and the remaining portion is financed with equity commitments of the private equity fund.[40]

Private equity funds buy businesses the way that individuals purchase houses, namely with a down payment or deposit supported by a mortgage.[41] A major difference, however, is that homeowners pay their own mortgages, whereas private equity funds require the companies they buy for their portfolios to take out these loans, thus making them, not the private equity fund or its investors, responsible for the loans.[42] The only money that the private equity fund and its investors have at risk is the initial equity they put up as a down payment.[43] In essence, leveraged buyout financing is very similar to a nonrecourse mortgage in which an acquirer buys an asset borrowing funds against this asset.

Consider the individual who purchases a house for $100,000 with a $10,000 down payment and a mortgage for $90,000. If the house appreciates in value by $30,000 to $130,000, the buyer will have a net gain of $20,000 (the $30,000 appreciation less the down payment of $10,000) reflecting a 200% return on the initial investment of $10,000. If the house declines in value by $30,000 and the homeowner defaults on the loan, the bank will foreclose on the house. In this scenario, the individual will lose only his or her initial investment of $10,000. The bank will lose $20,000. A very similar logic applies when private equity funds acquire companies putting up very little equity and financing the rest of the purchase through the use of debt. The use of leverage by private equity funds simply magnifies the return to the fund investors from its successful investments while minimizing the losses from its unsuccessful efforts.

Because such a large percentage of a typical private equity investment is financed with debt, the more debt that a private equity fund can secure (typically loans from banks or other financial lenders) and the cheaper it is to secure the debt, the less of its own capital it will have to use to purchase the initial interest in the portfolio company. Therefore, when the fund eventually sells the interest, the investment will be more profitable because the fund will internalize more of the gains from the sale, resulting in greater return on equity. The debt used by private equity funds almost always includes a loan portion that is senior and secured and is arranged by a bank or an institutional investor. The debt component in leveraged buyout transaction also often includes a junior, unsecured portion that is financed by either high yield bonds or "mezzanine debt (debt which is subordinated to the senior debt).[44]

By way of illustration, suppose a new private equity fund begins with $1,000,000 of its own capital obtained through capital commitments from limited partners. Then suppose that the private equity fund can borrow $15,000,000 from banks or other lenders at an interest rate of 6%. Then the private equity fund invests the entire $16,000,000 in a single investment, which the general partner is confident will generate an annual return of 15%. The private equity fund plans to return the borrowed capital plus interest at the end of the year. Therefore, the value of the

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[40] *Id.*
[41] *See* Appelbaum and Batt, *supra* note 27.
[42] *Id.*
[43] *Id.*
[44] *See* Michael C. Jensen, *Eclipse of the Public Corporation*, Harvard Business Review (Sept.-Oct. 1989), revised 1997. Available at SSRN: http://ssrn.com/abstract=146149 or [http://dx.doi.org/10.2139/ssrn.146149.](http://dx.doi.org/10.2139/ssrn.146149)

investment at the end of the year will be $18,400,000 and the fund will pay back the banks and other lenders $15,900,000 ($15,000,000 in principal and $900,000 in interest). The fund would be then left with a total of $2,500,000 and a net positive gain of $1,500,000 once it subtracts the initial investment of $1,000,000. This example reflects a 150% return on an investment that had an unleveraged return of 15%. This financing technique is reinforced by the fact that after the private equity fund liquidates its position in a portfolio company the debt that was used to purchase the fund's initial controlling interest ultimately remains on that company's balance sheet as a part of its capital structure. This is the primary reason for the use of leverage and leveraged buyout financing techniques by private equity funds.

It is important to note that the use of leverage by private equity funds may have a significant impact on investment results because, while it may enhance investment gains as described above, it may also magnify investment losses.[45] It magnifies the potential positive or negative impact that any change in a company's earnings may have on the return on equity.[46]

As the use of leveraged buyout financing has accelerated since the 1980s, mainly as a result of low interest rates and innovative financial engineering, concerns about financial stability and the risk associated with excessive leverage have been raised. Much of the criticism of the private equity industry has been focused on this concept and the use of leverage, namely that the use of leverage increases the risk of insolvency and that in many cases "companies will need to devote at least half their yearly cash flow to meet interest payments on their debt."[47] Regulators, policymakers and commentators argue that there is a cost to using massive debt in a company's capital structure. That cost is the fact that financial risk increases when a company uses extensive leverage because debt and interest must be paid regardless of whether a company is profitable and generates sufficient operating cash flows.

Additionally, if a portfolio company of a private equity fund experiences distress or enters bankruptcy, the equity partners in the fund will lose their stake in this company and creditors can seize the property or business, but the private equity firm that sponsored the private equity investment is not liable for the fund's losses. Therefore, the occasional bankruptcy of a portfolio company will have very little effect on the fund returns and even less on the private equity firm that sponsored the investment, although it may be devastating for the failed company, its employees, creditors, supplies, vendors and sometimes the economy as a whole.

B. HEDGE FUNDS

Despite the prevalence of hedge funds and the massive attention that hedge funds have received over the last several years, neither U.S. nor European regulators have been able to formulate a legal or statutory definition of what constitutes a "hedge fund".[48] There is also no

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[45] *See* Andreas Heed, *"Regulation of Private Equity."* Journal of Banking Regulation 12 (2010): 24-47.
[46] *Id.*
[47] *See* Julie Creswell, *Profits for Buyout Firms as Company Debt Soared*, N.Y. TIMES, Oct. 5, 2009, at A1 (explaining that the Simmons Bedding Company had been driven into bankruptcy by private equity firms that "were able to buy companies like Simmons with borrowed money and put down relatively little of their own cash"); See also Serena Ng, *Buyout Bonanza Compels Firms To Pile on Debt*, WALL ST J., Dec. 27, 2006, at C1 ("Private-equity investors . . . are pushing companies further out on a limb.").
[48] *See* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. Davis Bus. L. J. 323, 366 (2007).

definition of the term "hedge fund" under U.S. securities laws. Rather, "hedge funds are typically described as lightly regulated private investment vehicles that try to maximize risk-adjusted returns for investors as compared to simply beating some index or the market as a whole."[49]

A hedge fund is a private pool of capital through which investments are made using a strategy designed to "hedge" against risks in equity investments.[50] The term "hedge fund" comes from the funds' traditional role as a hedging vehicle against downturns in more conventional investments.[51] These funds tend to trade actively and usually try to exploit market inefficiencies by taking positions based on market moves. In recent years the term has been expanded to cover funds that employ very complex investment strategies and financial instruments. Hedge funds have regularly been structured as limited partnerships or limited liability companies, to benefit from the flow-through tax treatment with fund investors being limited partners or LLC members, respectively, who acquire their interests in the fund in private placements that are exempt from the registration requirements of the federal securities laws.[52] Hedge fund managers usually charge a management fee equal to 2% of the total asset value of the fund and a performance incentive fee equal to 20% of any profits earned by the fund.

Although private equity and hedge funds are often lumped together, it is important to distinguish between the two categories, particularly for the purpose of understanding and evaluating Title IV of the Dodd-Frank Act. Hedge funds are short-term investors which seek to profit from short-term speculative investments, much of which is not even directed at company stock.[53] They usually have holding periods of weeks or months, not years. Hedge funds differ from private equity in that hedge funds implement investment strategies while private equity is an asset class in itself. A hedge fund typically engages in short-term trading of financial instruments and compensates its managers on an annual or quarterly basis.[54] Hedge funds generally implement a wide array of investment strategies including long or short positions in equity securities, arbitrage, emerging markets and event driven investments. They usually invest in stocks, bonds, currencies, options or commodities (or any combination of these categories) and aim to capitalize on short-term gains, using a variety of trading strategies and derivative financial instruments. The goal is to produce risk-adjusted positive returns from various market opportunities.[55] They also seek to maintain relative liquidity so that their investors may invest and disinvest at regular intervals ranging from monthly to annually. Unlike mutual funds that own very diversified portfolios, hedge funds sometimes invest a large amount of money in one single position.

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[49] *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, (March 24, 2006). Washington U. School of Law Working Paper No. 06-03-02. Available at SSRN: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.

[50] *See* Franklin R. Edwards, *Hedge Funds and The Collapse of Long Term Capital Management*, 13 J. Econ. Persp. 189, 190 (1999); Ralph S, Janvey, *Hedge Funds*, 21 REV. Of SEC & COMMODITIES REG. 91, 91 (1998).

[51] *Id.*

[52] *See* Paredes, *supra* note 49; *See* also Alexander Ineichen and Kurt Silberstein, *AIMA'S Roadmap to Hedge Funds,* 53, 132 (Nov 2008).

[53] *See* Davidoff *supra* note 23.

[54] *Id.*

[55] *See* Paredes, supra note 49.

By contrast, a private equity fund typically takes long-term management positions in mature companies and compensates the fund managers once every several years upon the sale of the fund's assets. Hedge funds may be activist investors that try to influence corporate governance, but they typically do not acquire controlling interests. They use extensive leverage and trade complex financial instruments such as derivatives and credit default swaps. In contrast, private equity funds nearly always acquire a controlling interest in an operating business and implement restructuring and reorganization measures with the objective of a future public offering or sale of the business.

Hedge funds traditionally combine long and short positions. They concentrate rather than diversify and they borrow and leverage their portfolio.[56] These strategies allow them to hedge their bets on stock or commodity prices. By combing these two strategies ("long" bets that some positions will rise with "short" bets that some positions will fall), "hedge funds essentially try to minimize the risk of loss in any one position."[57] This strategy "allows for capital appreciation while hedging against the risk of loss due to different events in the market."[58] In other words, by shorting stocks, a hedge fund can limit its exposure if the market, or a particular industry or geographic region dropped, while at the same time reaping gains in other positions if the market rose.[59] Under this hedge fund model, the primary objective is to generate absolute returns regardless of market conditions.[60]

C. <u>VENTURE CAPITAL FUNDS</u>

Venture capital is a subset of private equity and the key difference between the two types of funds lies in their investment focus.[61] Whereas venture capital funds usually invest in early-stage pre-revenue startup companies, private equity funds invest in companies along all stages of a company's life-cycle (usually more mature operating companies with an established business model and track record of performance). Venture capital funds usually finance new companies and then take on an active role as the advisor or director to help the new company grow and mature, unlike private equity funds which usually acquire controlling positions in their portfolio companies and restructure/reorganize existing businesses.[62]

In all other respects, however, private equity funds and venture capital funds are not so different and share the same characteristics. Both are pools of capital assembled by professional investment teams from institutional investors and wealthy individuals in private offerings, exempt from the registration requirements of U.S. securities laws. The primary objective of both venture capital and private equity funds is to build and develop companies for an initial public offering or an acquisition.

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[56] *See* Ordower, *supra* note 48.

[57] *See* Lydie Pierre-Louis, *Hedge Fund Fraud and the Public Good*, (December 21, 2009). Fordham Journal of Corporate and Financial Law, Vol. 15, No. 21, 2009. Available at SSRN: http://ssrn.com/abstract=1531364 or http://dx.doi.org/10.2139/ssrn.1531364.

[58] *See* Alan Murray, *Hedge Funds Need to Open Up*, Wall St. J., April 5, 2006.

[59] *See* Pierre-Louis, *supra* note 57.

[60] *Id.*

[61] *See* Valentina Elzon, *What's Private Equity Got To Do With It?,* 30 Rev. Banking & Fin. L. 691 2010-2011.

[62] *See* Stephen M. Tuuk, *Formation and Operation of Venture Capital Companies,* 69 Mich. B. J. 40 1990.

Venture capital funds typically do not assume operating control of the businesses they invest in. They are active investors but not managers. Private equity funds, on the other hand, typically see themselves not as supporting but rather as taking over management of the businesses they invest in.[63] Additionally, venture capital funds typically do not use leverage or borrowed capital. Private equity funds, on the other hand, use debt and usually leverage their equity investments by having the target company take on debt that substantially exceeds the amount of equity the private equity firm invested. Thus, most private equity investments are in the form of leveraged buyouts, as discussed above.

Venture capital investments in high growth and technology companies have had many successes over the last three decades. In fact, "some of the best known and most successful technology or growth companies and brands in the world are venture backed, including Apple, Google, FedEx, Intel, Cisco, Starbucks, eBay, Yahoo, Facebook, Home Depot and many others."[64] Throughout its history, venture capital investments have established and built entire industry sectors by funding breakthrough technologies and innovations. From "biotechnology to information technology to clean technology, thousands of start-up ventures have been brought to life, improving the way we live and work each day."[65]

The venture capital industry, similar to the private equity sector, is a major driver of economic growth and job creation by helping entrepreneurs turn innovative ideas and breakthrough technologies into products and services that change the way we live and work.[66] Venture capital funds simply provide the funding and guidance and assume the risks necessary for building high-growth companies capable of bringing these technologies and innovations to market.[67] Making investments at the earliest stages of a company's development, often before the company has any product or revenues, involves significant risk, which severely limits the funding sources for such companies.[68] Yet, venture capital funds assume this risk together with the company founders and other investors by providing capital in exchange for an equity stake in the company.[69] These features and particularly the willingness to take these risks at an early stage of the business make venture capital a very unique asset class. Among the key features that venture capital fund managers look for when investing in a portfolio company are a growing market for the company's products or technologies, an effective management team, proprietary

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[63] *See* Lowenstein, *supra* note 24.

[64] *See* Money Tree Report. 2008. Historical trend data. https://www.pwcmoneytree.com/MTPublic/ns/nav.jsp?page=definitions. *See* also Bygrave, W. and Hunt, S. 2005. Global Entrepreneurship Monitor: 2004 Financing Report. Babson Park, MA; London, UK: Babson College-London Business School.

[65] *See* Venture Impact: *The Economic Importance of Venture Backed Companies to the U.S. Economy*, 2011 Pages 6-7, also available at http://www.nvca.org/index.php?Itemid=95&id=67&option=com_content &view=article.

[66] *Id.*

[67] *See* Paul Gompers and Josh Lerner, *Venture Capital Investment Cycles: The impact of public markets.* Journal of Financial Economics 87, no. 1 (January 2008): 1-23.

[68] *Id.*

[69] *See* Andrew Zacharakis and Jeffery McMullen, *Venture capitalists' decision making across three countries: An institutional theory perspective*, (2007) Journal of International Business Studies 38(5): 691-708.

product or technology, a compelling technical or business advantage over competitors, a solid business model and an exit strategy.[70]

During this investment stage, venture capital funds provide more than just funding to the growing companies they invest in.[71] Typically, they sit on the board of directors and provide strategic counsel regarding development and production, making connections to commercialize the company's product and bring technologies to market, aid sales and marketing efforts, develop an exit strategy and assisting in hiring key management.[72] Additionally, venture capital funds also guide the company through multiple rounds of financing to fund its growth and operations until the company reaches profitability. The venture capital fund goal is to develop and grow the company to a point where it can go public or be acquired by a larger corporation at a price that far exceeds the amount of capital invested.[73] Once all the investments of a particular fund have been liquidated and the proceeds have been distributed to the fund investors, the fund ends. In most cases, however, the investors reinvest these earnings in a new fund and the same process begins again.[74] Once the structure, nature and activities of private equity funds, hedge funds and venture capital funds are understood, one can begin to examine how private equity funds are regulated.

D. THE REGULATION OF PRIVATE INVESTMENT FUNDS

In reaction to the 2008 financial crisis Congress and the SEC introduced a major regulatory reform of the private investment funds industry through the enactment of Title IV of the Dodd-Frank Act and its implementing rules[75]. Title IV has significantly changed the regulatory landscape for private investment funds and their managers (fund advisers).[76] It imposes significant new registration and compliance burdens on managers of private equity funds, hedge funds and other private investment funds with assets under management of $150 million or more.[77] Title IV and its implementing rules also establish onerous recordkeeping and reporting requirements for registered investment funds and their advisers. Under Dodd-Frank and its implementing rules, these funds and their managers must register with the SEC, screen potential investors and track information pertaining to such things as their use of leverage, including off-balance sheet leverage, their counterparty risk exposure, the amount of assets under management, their trading and investment practices and positions, their asset valuation policies and practices, the type of assets they hold and side arrangements with different investors in the fund.[78] The information is to be made available for SEC inspection and for potential filing with the SEC.[79] Additionally, Title IV and its implementing rules require advisers to private equity and hedge funds to maintain records of such other information as the SEC, in consultation with

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[70] *See* Bob Zider, *How Venture Capital Works*, 76 Harv. Bus. Rev 131, 133-134 (1998).
[71] *Id.*
[72] *See* Gompers and Lerner, *supra* note 67.
[73] *Id.*
[74] *See supra* note 65.
[75] *See* Schapiro, *supra* note 4.
[76] *See* Seth Chertok, *A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 6 VA Law & Bus. Rev. No. 1 Spring 2011.
[77] *See supra* note 5.
[78] *Id.*
[79] *Id.*

the Financial Stability Oversight Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.[80] Since private investment funds like private equity and hedge funds often carry substantial risk and manage large assets, this enhanced supervision, SEC registration and record keeping are expected to allow regulators to analyze and evaluate the systemic risk associated with these funds, and hold fund managers to more stringent reporting and registration requirements.[81] The overall objective is to monitor systemic risk through increased transparency. This paper will demonstrate that in the context of private equity funds, this legislative approach is inadequate, unnecessary and inefficient. It falls short of achieving the intended purpose of Title IV and its costs exceed its benefits. The discussion that follows examines the pre and post Dodd-Frank regulatory environment for private equity funds.

i) PRE-DODD-FRANK REGULATORY ENVIRONMENT

Prior to the Dodd-Frank Act, there was very little supervision of private equity funds as private investment funds along with their investment advisers were historically exempt from registering with the SEC. The Investment Advisers Act of 1940 (the "Advisers Act")[82] requires any person falling within the definition of an "investment adviser" to register with the SEC and comply with certain reporting and recordkeeping requirements, unless they qualify for an exemption.[83] Managers of private investment funds typically are considered to be "investment advisers" for purposes of the Advisers Act. Hence, absent an express exemption from registration, advisers to private equity funds would need to register with the SEC. However, prior to the Dodd-Frank Act, many private equity fund managers avoided registration with the SEC under the Advisers Act by relying on the "private investment adviser" exemption which exempted firms that: i) had fewer than 15 clients over the course of the preceding 12 months and ii) neither had held themselves out generally to the public as an investment adviser nor acted as an investment adviser to any registered investment company.[84] Private equity fund managers relied on this exemption to avoid having to comply with the numerous requirements associated with registration, including increased fiduciary burdens, the adoption of compliance policies, required record maintenance, various reporting requirements, periodic examination by the SEC and restrictions relating to fees and custody of assets.

Under this exemption, private investment advisers (the actual fund managers) could manage up to fourteen funds (regardless of the number of investors in the fund), without

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[80] *See* Section 404 of the Dodd-Frank Act. The financial stability oversight council was created under the Dodd-Frank Act to, among other things, "identify risks to the financial stability of the US". Under Title IV the SEC is required to make available to the financial stability oversight council "copies of all reports, documents, records and information filed with or provided to the SEC by private equity and hedge fund advisers as the council may consider necessary for the purpose of assessing the systemic risk posed by private funds."

[81] *See* Chertok, *supra* note 76.

[82] Investment Advisers Act of 1940, 15 U.S.C § 80b-1 to -21 (2006).

[83] The term "Investment Adviser" is broadly defined to include "any person, who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." § 202(a)(11) of the Investment Advisers Act. The registration requirement for investment advisers is contained in § 203(a).

[84] *See* § 203(b)(3) of the Investment Advisers Act of 1940.

registering with the SEC, since each fund counted as one "client" for purposes of the exemption under the Advisers Act.[85] The SEC tried to eliminate this provision in 2004 through the enactment of the Hedge Fund Rule, which required fund managers to look through to private fund investors when counting the number of clients they advise. As a result most private equity and hedge fund advisers were no longer able to rely on the "private investment adviser" exemption, thereby forcing them to register with the SEC. This effort by the SEC to regulate private investment funds was driven primarily by the failure of Long-Term Capital Management in 1998. Long-Term Capital Management was a hedge fund specializing in high-risk arbitrage trading strategies. The fund used extensive leverage and at its height in 1998, it had $5 billion in assets, controlled over $100 billion and had positions whose total worth was over a $1 trillion.[86] Due to its highly leveraged nature and a financial crisis in Russia, the fund sustained massive losses and was in danger of defaulting on its loans.[87] Had LTCM gone into default, it would have triggered a global systemic failure of the financial system and a major financial crisis, caused by the massive write-offs the fund's creditors would have had to make.[88] In September 1998, the Federal Reserve Bank of New York stepped in and arranged a $3.6 billion private bailout in order to avoid the potential widespread impact of the fund's collapse and a major financial crisis that could have had disastrous consequences to the financial system and the economy as a whole. A systematic meltdown of the financial market was thus prevented.

Despite the efforts of the SEC to regulate private investment funds through the Hedge Fund Rule, the Court of Appeals for the D.C. Circuit, in the 2006 case of *Goldstein v. SEC* rejected the SEC initiative to eliminate this exemption, thus letting fund managers count their private funds as single clients and continue to rely on the private investment adviser exemption.[89] The court held that the rule adopted by the SEC exceeded the SEC's rule-making authority and was thus invalid. This was the first of many attempts by regulators to increase private fund regulation, supervision and transparency. Although the Hedge Fund Rule was eventually invalidated and rejected by the decision of the Court of Appeals in Goldstein v. SEC, it provides an important insight as to the SEC's view regarding the risks associated with private investment funds and private equity funds in particular.[90] In enacting the Hedge Fund Rule the SEC was more concerned with defining private investment funds so as to exclude private equity and venture capital funds from SEC regulation and the registration requirements.[91] From the Hedge Fund Rule release it is clear that the SEC was simply not concerned with fraud associated with private equity funds the way that it was concerned with hedge fund fraud.[92] In addition, the SEC

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[85] *Id.*

[86] *See* Barbara George, Lynn Dymally & Maria Boss, *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?,* 5 N.Y.U.J.L & Bus. 359, 369, 399 (2009); *See also* Lydie Pierre-Louis, *supra* note 57.

[87] *Id.*

[88] *Id.*

[89] *See Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

[90] *Id.*

[91] *Id.* ("We propose to define a "private fund" by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds").

[92] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed.Reg. 72054 (Dec. 10**,** 2004), (codified at 17 C.F.R. pts. 275, 279), ("[T]he Commission has not encountered significant enforcement problems with advisers with respect to their management of private equity or venture capital funds. In contrast, the Commission has developed a substantial record of frauds associated with hedge funds. A key element of hedge fund

was also concerned with diverting its limited and already-overburdened resources. It therefore decided to focus on hedge funds and allocate its resources to address the more serious problem that could potentially lead to a systemic failure and a global financial crisis, like the LTCM debacle.[93]

Additionally, prior to the Dodd-Frank Act, private equity funds were able to avoid extensive SEC regulation by relying on exemptions from SEC registration under the Investment Company Act of 1940 (the "ICA").[94] The ICA regulates both the organization of companies, such as "mutual funds that engage in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public," as well as what these companies may ultimately invest in. Investment companies are usually registered with the SEC pursuant to Section 3(a) of the ICA which mandates SEC registration for any "issuer which is or holds itself out as being engaged primarily…in the business of investing, reinvesting or trading in securities."[95] Prior to the Dodd-Frank Act, private equity funds were exempt from such registration either under: i) Section 3(c)(1) of the ICA, because they had no more than 100 beneficial owners and did not offer their securities to the public, or ii) Section 3(c)(7) of the ICA, because their investors were all "qualified purchasers", namely individuals or family entities with not less than $5 million in investments, or institutions with not less than $25 million in investments.[96] Prior to the Dodd-Frank Act, private equity funds, along with venture capital and hedge funds used to fall within the scope of one of these exemptions and avoid the SEC registration and reporting requirements.

ii) Post-Dodd-Frank Regulatory Environment

Title IV of the Dodd-Frank Act and its implementing rules introduced the most significant regulatory change in the history of the private investment fund industry in the United States, taking the regulatory oversight of this industry to an unprecedented level.[97] Title IV and its SEC implementation rules introduced a registration requirement for private investment fund managers with the SEC and increased the reporting and disclosure requirements pertaining to confidential and proprietary information. These legislative measures focus primarily on eliminating excessive risk through SEC supervision and oversight.

Title IV and its implementing rules have replaced the "private investment adviser" exemption with new, more narrow exemptions, thereby broadly expanding the Advisers Act's

advisers' fraud in most of our recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors, which in some cases was used to induce a false sense of security for investors when they might otherwise have exercised their redemption rights.").

93 *Id.* ("Because hedge funds are where we have seen a recent growth in fraud enforcement actions, we will focus our examination resources on their advisers, rather than on advisers to private equity or venture capital funds, at this time.").

94 *See* 15 U.S.C. §§ 80a-1 - 80a-64 (2006). The registration requirements for qualifying investment companies are contained in Section 8(a) of the Investment Company Act, codified as 15 USC §§ 80a-1 - 80a-64 (2006).

95 *Id.*

96 *Id.*

97 *See* Wulf Kaal, Barbara Luppi and Sandra Paterlini, *"Did the Dodd-Frank Act Impact Hedge Fund Performance?"* (February 1, 2014). University of St. Thomas (Minnesota) Legal Studies Research Paper No. 14-09. Available at SSRN: http://ssrn.com/abstract=2389416 or http://dx.doi.org/10.2139/ssrn.2389416.

registration requirements for private investment funds and their advisers.[98] Through the elimination of the private investment adviser exemption, Title IV and its implementing rules introduced a general requirement that an investment adviser to any private equity fund or other private pool of capital, with assets under management of $150 million or more, must register with the SEC, thus bringing the private equity fund managers within the purview of SEC regulation. Title IV removed the previous exemptions discussed above in furtherance of "providing transparency and preventing potential dangers for systemic risk and investor abuse."[99] In place of the "private investment adviser exemption", Title IV and its implementing rules added several much more limited exemptions from registration with the SEC. Most importantly, advisers to private funds with less than $150 million under management are exempt,[100] as well as "foreign private advisers"[101] and advisers to venture capital funds.[102] If a fund adviser is not exempt, registration with the SEC will be required and this fund and its advisers will become subject to extensive regulatory and supervisory oversight by the SEC.

The primary purpose of Congress in repealing the private investment adviser exemption was to require advisers to private investment funds who had previously been considered exempt from SEC registration, to register under the Advisers Act.[103] This SEC registration requirement is intended to limit and control systemic risk, prevent fraud, provide more transparency and information to investors and help the SEC to control the activities of "market participants operating in the shadows of our markets."[104] Title IV and its implementing rules also significantly increase the record-keeping and reporting obligations applicable to fund managers of private equity funds. Under Title IV and its implementing rules, these funds and their managers (fund advisers) must also screen potential investors and track information pertaining to such things as their use of leverage, including off-balance sheet leverage, their counterparty risk exposure, the amount of assets under management, risks metrics, products used by the fund managers, their trading and investment practices and positions, their asset valuation policies and practices, the type of assets they hold and side arrangements with different investors in the fund.[105] The information is to be made available for SEC inspection and for potential filing with the SEC.[106] Additionally, Title IV and its implementing rules require advisers to private equity and hedge funds to maintain records of such other information as the SEC, in consultation with the Financial Stability Oversight Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment and analysis of systemic risk.[107] They require the SEC to examine various factors including the investment strategy, size, and governance of investment advisers in order to assess and determine the systemic risk associated with private investment funds and their activities.

98 *See* § 403 of the Dodd-Frank Act.
99 *Id.*
100 *See* § 408 of the Dodd-Frank Act.
101 *See* § 403 of the Dodd-Frank Act.
102 *See* § 407 of the Dodd-Frank Act.
103 *See* Chertok, *supra* note 76.
104 *See* 155 Cong. Rec. H14419-20 (daily ed. Dec. 9, 2009) (statement of Rep. Paul Kanjorski); *See* also 156 CONG. REC.S5925 (daily ed. July 15, 2010) (statement of Sen. Richard Durbin).
105 *Id. See* also SEC Form PF 2012 and SEC Form ADV 2012.
106 *Id.*
107 *See* Section 404 of the Dodd-Frank Act, *supra* note 80.

The data collected by the SEC under Title IV will be shared with the systemic risk regulator and the SEC will report to Congress annually on how it uses this data to reduce systemic risk in the financial system and protect investors and market integrity.[108] In effect, these new standards seek to fill the regulatory gap that previously existed by extending the registration, disclosure and reporting requirements under the Advisers Act.[109] SEC former Chairman Mary L. Schapiro stated with regard to Title IV that: "these rules will fill a key gap in the regulatory landscape…in particular, our proposal will give the SEC, and the public, insight into hedge funds and other private fund managers who previously conducted their work under the radar and outside the vision of regulators."[110] By requiring private equity fund managers to register with the SEC as investment advisers, Title IV and its implementing rules effectively seek to end the "shadow" financial system.[111]

To register with the SEC, fund advisers must complete Form ADV, which requires substantial disclosures to the SEC and to the adviser's clients.[112] This form is the main data collection tool the SEC uses to oversee investment advisers. Form ADV must be updated at least annually and, with respect to certain key information, at the time of certain changes in the reported information. Form ADV is divided into Part 1 and Part 2 and is updated by the registered investment adviser at the end of each year.[113] Part 1 requires "information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees."[114] Part 2 requires registered advisers to provide new and prospective clients with a brochure and brochure supplements containing most of the information provided in form ADV's Part 1.[115] All of the information disclosed under form ADV is fully available to the public. The goal is to provide a level of transparency that will assist investors in making their due diligence, and will deter fraud and facilitate earlier discovery of potential misconduct.[116]

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[108] *See* Kaal, Luppi and Paterlini, *supra* note 97.

[109] *See* H.R. Rep. No 111-517, at 865 (2010) (*Joint Explanatory Statement of the Comm. of Conf*.), available at http://www.gpo.gov/fdsys/pkg/CRPT-111hrp517/pdf/CRPT-111hrpt517.pdf; ["By expanding the reporting requirements of private equity fund advisers to the SEC, Title IV is intended to provide greater protections for investors and the financial system"].

[110] *See* Press Release, U.S. Sec & Exchange Commission, *"SEC Adopts Dodd Frank Act Amendments to Investment Advisers Act"*, (June 22, 2011), available at: http://www.sec.gov/news/press/2011/2011-133.htm.

[111] *See* Davidoff, *supra* note 23, ["Shadow – in terms of the fact that hedge funds and private equity funds were always viewed as financial institutions operating behind the scenes, in the shadows, outside the purview of the SEC and with very little regulation or oversight"].

[112] *Id.*

[113] *See* PWC, "*A Close Look – The Dodd-Frank Wall Street Reform and Consumer Protection Act: Reporting by Private Fund Advisers on Form PF"*, (November 2011), available at www.pwc.com/.../closer-look-final-rule-private-fund-advisers-form-pf.pdf.

[114] *Id.*

[115] *Id.*

[116] *See* SEC Release No. IA-3308 (Oct. 31, 2011) (SEC-CFTC joint adopting release). The SEC implementing rules were presented in two adopting releases: Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221 (Jun. 22, 2011), available at http://www.sec.gov/rules/final/2011/ia-3221.pdf; and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222 (Jun. 22, 2011), available at http://www.sec.gov/rules/final/2011/ia-3222.pdf.

In addition to mandatory registration requirements, the amended Form ADV, under Title IV of the Dodd-Frank Act and its implementing rules, requires substantial disclosure of information regarding the fund structure, ownership, the gross asset value, the investment strategy, investment products used by the fund, the scope of services provided and the fund's use of consultants. In addition to the filing requirements under the amended Form ADV, Title IV and its implementing rules also require registered fund advisers to file periodic reports on Form PF. The reporting requirement in Form PF is intended to enable the Financial Stability Oversight Council to monitor and control systemic risk in the U.S. financial markets and to facilitate investigations and examinations by the SEC and the CFTC.

Another important change under Title IV and its implementing rules comes in the form of increased state supervision, as it raised the assets under management threshold for federal regulation of investment advisers.[117] Title IV and its implementing rules modify the allocation of responsibility for mid-sized fund advisers between state regulators and the SEC. They establish the requirements for investment advisers to register with the state authorities if they have assets under management above $100 million.[118] The sections that follow examine the case against the regulation of private equity funds under Title IV of the Dodd-Frank Act and its implementing rules and analyze whether Title IV represents the right approach to the regulation of private equity funds.

III. THE CASE AGAINST THE REGULATION OF PRIVATE EQUITY FUNDS UNDER TITLE IV OF THE DODD-FRANK ACT – IS TITLE IV THE RIGHT ANSWER?

The following section of this paper will: i) analyze the political economy of the Dodd-Frank Act and its impact on the regulation of the private equity sector; ii) examine the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable v. SEC and the importance, role and application of cost benefit analysis in financial regulation and particularly private equity regulation under Title IV and its implementing rules; iii) examine the economic theory of regulation underlying the Dodd-Frank Act and its relevance to the private equity sector; and iv) challenge Title IV's reliance on disclosure as the primary method of reducing systemic risk and protecting fund investors. This section of the paper will argue that the regulation of private equity funds under Title IV of the Dodd-Frank Act and its implementing rules is inadequate, unwarranted and flawed. It is unnecessarily costly, inconsistent with the intended purpose of the Dodd-Frank Act and its underlying theory of regulation, too disclosure-focused, based on fundamental misconceptions as to the nature of private equity and does not properly address the risks and problems that led to the 2008 financial crisis. It will not accomplish the legislation's purpose of helping identify and reduce systemic risk in the U.S. financial system and will not make the financial system more stable or less risky. It follows the traditional post-crisis legislative pattern which is usually excessive, burdensome, flawed and populist in nature.

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[117] *See* Kaal, Luppi and Paterlini, *supra* note 97.
[118] *See* 15 U.S.C. § 80b-3 (Dodd-Frank Act § 410).

Furthermore, this section of the paper will take the position that Title IV of the Dodd-Frank Act and its implementing rules do not meet the economic analysis and cost benefit justification standards set by the D.C. Circuit court in the Business Roundtable decision. The SEC in implementing Title IV, failed to perform an adequate cost benefit analysis and to consider the impact of this legislation on efficiency, competition and capital formation. It failed to articulate a satisfactory and reasoned explanation for its regulatory actions, including a rational connection between the pre-crisis conduct and failures it was trying to address and the regulatory choices made. This section of the paper will argue that Title IV and its implementing rules are not supported by i) the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable, and ii) any other compelling argument demonstrating that the benefits of Title IV are greater than its costs.

Like any other post-crisis financial reform legislation, Title IV of the Dodd-Frank Act and its implementing rules may have satisfied a political need, but will not benefit the financial market or the economy as a whole, will not improve investor welfare and will not reduce the risks that private equity funds may pose to the financial system. They go beyond the concerns that led to the 2008 financial crisis and do not represent the proper legislative response that is geared toward correcting and mitigating the failures that actually led to the 2008 financial crisis. Additionally, the economic theory of regulation underlying the Dodd-Frank Act does not support the regulation of private equity funds or any government intervention in the private equity sector.

This section of the paper will further argue that this government intervention in the private equity sector was driven by the political pressure on Congress to quickly launch a comprehensive reform of the financial system, following the 2008 financial crisis. It is a reflection of the political and economic environment following the 2008 financial crisis. It represents a questionable public policy decision that does not adequately address the propensity of the financial sector to put the entire system at risk, and fails to protect the benefits that private equity funds bring to the national economy. It is too broad, excessive, disclosure-focused and its targeting of the private equity industry is simply unwarranted and misguided.

A. THE POLITICAL ECONOMY OF THE DODD-FRANK ACT

The history of financial regulation in the U.S. suggests that financial reforms are usually adopted after a major financial crisis or market crash.[119] The Securities Act of 1933 and the Securities Exchange Act of 1934 were adopted following the 1929 stock market collapse and the Great Depression.[120] The Sarbanes-Oxley Act of 2002 was enacted following the collapse of Enron and WorldCom and the corporate accounting scandals of the early 2000s.[121] Finally, the Dodd-Frank Act was enacted following the 2008 financial crisis and the near-collapse of the

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[119] *See* John Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated* (January 9, 2012). Cornell Law Review, 2012; Columbia Law and Economics Working Paper No. 414. Available at SSRN: http://ssrn.com/abstract=1982128.

[120] *Id.*

[121] *Id.* For a description of the financial irregularity and accounting restatements in the era leading to the enactment of the Sarbanes-Oxley Act, see John Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269 (2004).

entire financial system.[122] In the words of Professor John Coffee, "In the world of financial regulation, experience has shown – since at least the time of the South Seas Bubble three hundred years ago – that only after a catastrophic market collapse, can legislators and regulators overcome the resistance of the financial community and adopt comprehensive "reform" legislation."[123] Professor Coffee further explains that regulatory intensity increases after a market crash and that "in each of these cases, the comprehensive reform legislation that followed in the wake of the market collapse showed hints of the public's desire for retribution."[124] These post-crisis reforms are usually a response to public outrage prompted by a financial crisis or market crash. Professor Stephen Bainbridge also describes the phenomenon that financial reforms tend to follow market turmoil as the "boom-bust-regulate pattern that characterizes U.S. financial regulation."[125]

Before we examine the political economy of the Dodd-Frank Act and its impact on the regulation of the private equity sector under Title IV and its implementing rules, it is worth pausing to consider why is it that financial reform legislation seems only to be introduced after a market crash or financial crisis. Professor Coffee further explains this legislative pattern by reference to a basic theory of political science.[126] U.S. Investors and shareholders, in Professor Coffee's view, are naturally "dispersed, poorly organized, have limited or diffused political power and so constitute a classic latent group".[127] In contrast, the financial services industry is well organized, has greater resources, can focus on the important issues concerning this industry and has an incentive to maintain a powerful lobbying effort and presence.[128] Therefore, "such latent groups of shareholders or investors tend to be dominated by smaller, but more cohesive and better funded special interest groups, (representing the financial industry) in the competition to shape legislation and influence regulatory and public policy."[129] Professor Coffee further explains that "groups representing U.S. investors and shareholders are likely to be at a severe disadvantage in competing with well-funded business lobbies."[130] However, this relationship and domination by the financial services industry, in Professor Coffee's view, changes following a market crash or financial crisis and creates political pressure for new regulation.[131] This change and political pressure create the right environment for the introduction of a financial reform as well as opportunities for "political entrepreneurs" to promote their agenda. In the words of

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[122] *See* Acharya et al, *supra* note 1.
[123] *See* Coffee, *supra* note 119. For the view that securities regulation, over the last 300 years, has depended on market crashes to fuel it, *See* Stuart Banner, *What Causes New Securities Regulation?*: 300 Years of Evidence,75 Wash. U. L. Q. 849 (1997).
[124] *Id.* In the case of Sarbanes-Oxley certain criminal penalties are set forth in Section 902 to 906 of the Act. In the case of Dodd-Frank Act, Section 748 sets forth elaborate provisions to protect and subsidize "whistle-blowers" who report misconduct to the SEC. Both provisions seek to detect and punish misconducts.
[125] *See* Stephen Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II* (September 7, 2010). UCLA School of Law, Law-Econ Research Paper No. 10-12. Available at SSRN: http://ssrn.com/abstract=1673575; *See* Stephen Choi, *Behavioral Economics and the Regulation of Public Offerings* (November 2005). NYU, Law and Economics Research Paper No. 05-31. Available at SSRN: http://ssrn.com/abstract=849585 or http://dx.doi.org/10.2139/ssrn.849585 (noting that "only after a scandal arises does the SEC and Congress typically move forward with new comprehensive sets of regulations").
[126] *See* Coffee, *supra* note 119.
[127] *Id.*
[128] *Id.*
[129] *Id.*
[130] *Id.*
[131] *See* Larry E. Ribstein, *Bubble Laws*, 40 Hou. L. Rev. 77,79 (2003).

Professor Coffee, “In crises, including market crashes, political entrepreneurs gain attention and electoral success, by exploiting the popular discontent. Essentially, these entrepreneurs assume the transaction costs of organizing otherwise latent interest groups in order to secure election (or re-election) by assisting the public to overcome entrenched business interests.”[132] In other words, the occurrence of a market crash or financial crisis simply interrupts the domination of the latent groups by smaller groups representing the powerful financing industry and creates the right environment for political entrepreneurs to take action, promote their agenda and push for financial reform legislation.

Professor Bainbridge also examines this legislative pattern of post-crisis financial reforms and emphasizes the populist pressure for new regulation following the occurrence of a market crash or financial crisis.[133] It is this public and political pressure for action that drives post-crisis reform legislation. In the words of Professor Bainbridge, “When the bubble inevitably bursts, investigators reviewing the rubble begin to turn up evidence of speculative excess and even outright rampant fraud. Investors burnt by losses from the breaking of the bubble and outraged by evidence of misconduct by corporate insiders and financial bigwigs create populist pressure for new regulation.”[134] Professor Bainbridge also refers to the populist outrage that drives Congress to take action after a market crash or financial crisis. In his words, “It is in the post-bubble environment, when scandals and economic reversals occur and when corporate transactions grab the attention of the American public and the U.S. Congress, that Congress often acts.”[135] He further explains that because such post-crisis periods usually involve “an upswing in populist anger and accompanying intense public pressure for action, they offer “windows of opportunity to well-positioned policy entrepreneurs to market their preferred, ready-made solutions when there is little time for reflective deliberation”.

Professor Larry Ribstein and Professor Roberta Romano have also demonstrated that this post-crisis legislative pattern is a reoccurring phenomenon in U.S. financial regulation going back even before the Nineteenth Century.[136] Professor Stuart Banner also analyzes this post-crisis legislative pattern and explains that: “the reason for the association is that deep-seated popular suspicion of speculation comes in bad financial times to dominate otherwise popular support for markets, resulting in the expansion of regulation. That is to say, financial exigencies embolden critics of markets to push their regulatory agenda. They are able to play on the strand of popular opinion that is hostile to speculation and markets because the general public is more amenable to regulation after experiencing financial losses.”[137] The Dodd-Frank Act is clearly the latest example of this post-crisis legislative pattern driven by the political pressure and public outrage following the 2008 financial crisis and the near-collapse of the entire financial system.

Several commentators and academic scholars have criticized this post-crisis legislative pattern and argued that financial reforms adopted after a financial crisis or market crash are

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[132] Anthony Downs argues that only during periods of intense public pressure for change, can legislative inertia and interest group veto power be overcome and reform legislation passed. *See* Anthony Downs, *Up and Down with Ecology – “The Issue-Attention Cycle*”, 28 Pub. Int. 38 (1972).
[133] *See* Bainbridge, *supra* note 125.
[134] *Id.*
[135] *Id*. *See* also Mark J. Roe, *Washington and Delaware as Corporate Lawmakers*, 34 Del. J. Corp. L. 1, 17 (2009).
[136] *See* Ribstein, *supra* note 131 and Romano, *supra* note 8.
[137] *See* Banner, *supra* note 123.

usually flawed, misdirected, overbroad and excessive. They are not supported by a compelling cost-benefit argument and result in "quack corporate governance"[138] or "bubble laws".[139] These scholars argue that such post-crisis legislation is undesirable and should be discouraged because it tends to be hasty, rushed, populist in nature and enacted in an environment of political pressure that does not facilitate careful consideration of its unintended consequences.[140] Such post-crisis legislation is heavily influenced by the post-crisis political and economic environment and often goes beyond the measures necessary and adopts unwarranted substantive rules, reflecting poor public policy. The claim is that Congress can do substantial harm when it legislates in haste, right after a market crash or financial crisis. The excessive influence over the political process in the aftermath of a market crash or financial crisis usually goes too far and prevents capital markets from realizing their full potential.[141] The result of this legislative pattern is usually over-regulation which is costly, inefficient, unnecessary and counter-productive to the economy as a whole. Additionally, the sense of urgency that is usually associated with "the need to make significant reforms in the near-term greatly increases the chance that policymakers will make consequential mistakes and overlook potential implications."[142]

This criticism has been specifically directed at the Sarbanes-Oxley Act and the Dodd-Frank Act.[143] This part of the paper will examine this criticism in the context of private equity regulation and Title IV of the Dodd-Frank Act. It will analyze the political economy of Title IV and demonstrate that like any other post-crisis legislation, Title IV may have satisfied the political need of the political entrepreneurs and interest groups pushing for private fund regulation, but it will not benefit the financial market or the economy as a whole and will not improve investor welfare. Title IV is an example of this legislative pattern and the notion that legislating in the immediate aftermath of a financial crisis is a formula for poor public policy making as well as excessive, costly, unnecessary, inefficient and overbroad legislation, which is often not supported by any empirical academic literature. It goes beyond the concerns that led to the 2008 financial crisis and does not represent the proper legislative response that is geared toward correcting and mitigating the actual problems and failures that led to the 2008 financial crisis.

In 2005 Professor Roberta Romano described the Sarbanes-Oxley Act as flawed legislation and "quack corporate governance."[144] She observed that post-crisis financial reforms are usually excessive and that "despite Enron and WorldCom being the claimed rationale, the provisions of the Sarbanes-Oxley Act bear absolutely no relation to the source of the firm's demise."[145] The Sarbanes-Oxley Act appeared to be nothing more than a rush and hasty response

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[138] *See* Romano, *supra* note 8.
[139] *See* Bainbridge, *supra* note 125.
[140] *Id.*
[141] *Id.*
[142] *See* Saule Omarova and Adam Feibelman. *Risks, Rules, and Institutions: A process for reforming Financial Regulation* , 39 U. Mem. L. Rev . 881-882 (2009) (discussing the risks of a broad regulatory response to the current financial crisis).
[143] *Id.*
[144] *See* Romano, *supra* note 8.
[145] *Id.*

of regulators “triggered by the immediacy of politics and the panic of American investors”.[146] She also argued that the corporate governance provisions of the Sarbanes-Oxley Act were not supported by any empirical academic literature and resulted in a hasty, burdensome and unwarranted legislation which falls short of achieving its stated objectives.[147] She further suggested that the political pressure after a market crash or financial crisis “tends to give advantages to interest groups and other policy entrepreneurs who have prepackaged purported solutions that can be readily adapted into legislative form.”[148] She explained that “many of the Sarbanes-Oxley’s provisions were recycled ideas that had been advocated for quite some time by corporate governance entrepreneurs.”[149] Professor Bainbridge goes further, and suggests that “Unfortunately, because the policy entrepreneurs tend to be critics of markets and corporations, bubble laws often impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success.”[150] Both Professor Romano and Professor Bainbridge agree that this post-crisis legislative pattern has real adverse economic consequences. They raise concerns that the U.S. dominant position in the global capital markets has eroded and that U.S. capital markets are becoming overly regulated and less competitive.[151] Other scholars have also argued that the provisions of the Sarbanes-Oxley Act created significant new compliance costs that have had a major negative effect on the economy and the competitiveness of the U.S. capital market.[152] These compliance costs are the reason for a major increase in the number of public companies deciding to go private and private companies contemplating a public offering in Europe rather than the U.S.[153] In the wake of the 2002 Sarbanes-Oxley Act “capital flight” was documented in several studies as precipitated by increased regulation and compliance costs in the U.S.[154] It was also observed that U.S. capital markets were likely to be penalized for over regulation.[155]

In 2010 Professor Stephen Bainbridge criticized post-crisis financial reforms and used the corporate governance provisions of the Dodd-Frank Act to demonstrate the concerns associated

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[146] *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 52 (2002) (describing the apparent panic that existed at the time of the passage of the Sarbanes-Oxley Act and the possible political origins of the panic); *See* Jonathan H. Gabriel, Note, *Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud*, 38 SUFFOLK U. L. REV. 641, 641 (2005) (arguing that the public outcry stemming from the corporate scandals “triggered a response by Congress that in some ways favored the immediacy of politics over long-standing policy”).
[147] *See* Romano, *supra* note 8.
[148] *Id.*
[149] *Id.*
[150] *See* Bainbridge, *supra* note 125.
[151] *See* Michael Bloomberg & Charles Schumer, Sustaining New York’s and The US’ Global Financial Services Leadership (2007); See also COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006); *See* also COMM. ON CAPITAL MKTS. REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (2007).
[152] *See* Joseph Piotroski and Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings* (January 1, 2008). Rock Center for Corporate Governance at Stanford University Working Paper No. 11. Available at SSRN: http://ssrn.com/abstract=956987.
[153] *Id.*
[154] *See* Luigi Zingales, *Initiative on Global Markets Is the U.S. Capital Market Losing its Competitive Edge?* 2 (Univ. of Chicago Graduate Sch. of Bus.,Working Paper, Nov. 2006).
[155] *See Capital Flight*, WALL ST. J., Dec. 2, 2006, at A8; *Is Sarbanes-Oxley the Main Reason IPO Business is Going Overseas?*, SEEKING ALPHA, Aug. 7, 2006, http://seekingalpha.com/article/15088-is-sarbanes-oxley-the-mainreason-ipo-business-is-going-overseas.

with the post-crisis legislative pattern. He argued that the corporate governance provisions of the Dodd-Frank Act are excessive, too broad, misdirected and also qualify for the description of "quack corporate governance" or "bubble laws."[156] He noted that "bubble laws often impose regulations that penalize or outlaw potentially useful devices and practices as a result of the political climate in which they are introduced."[157] He further defined the terms "quack corporate governance" and "bubble laws" and identified "eight key characteristics of post-crisis financial reforms: 1) the new law is a bubble act, enacted in response to a major negative economic event; 2) it is enacted in a crisis environment; 3) it is a response to a populist backlash against corporations and/or markets; 4) it is adopted at the federal rather than the state level; 5) it transfers power from the states to the federal government; 6) interest groups that are strong at the federal level but weak at the Delaware level support it; 7) typically, it is not a novel proposal, but rather a longstanding agenda item of some powerful interest groups; and 8) the empirical evidence cited in support of the proposal is, at best, mixed and often shows the proposal to be unwise."[158] Professor Bainbridge uses the corporate governance provisions of the Dodd-Frank Act to demonstrate how post-crisis financial reforms are burdensome, excessive, too broad, fall short of achieving their stated objectives and result in "quack corporate governance" or "bubble laws."[159] For example, one of the provisions he is using in his criticism of the post-crisis legislative pattern is Section 953 of the Dodd-Frank Act.

Section 953 requires additional disclosure about certain compensation matters, including pay-for-performance and the ratio between the CEO's total compensation and the median total compensation for all other company employees.[160] This requirement is extremely cumbersome. In the words of Professor Bainbridge, "it practically means that for every employee, the company would have to calculate and analyze the salary, bonus, stock awards, stock option awards, non-equity incentive plan compensation, change in pension value and all other forms of compensation. This information would be extremely time-consuming to collect and analyze, making it almost impossible for a company with tens of thousands of employees worldwide to comply with this section."[161] The cost of compliance with Section 953 will be enormous with little benefit to investors, the financial system or the economy as a whole.[162] Congress, in adopting Section 953, clearly sought to correct some of the executive compensation abuses believed to have contributed to the 2008 financial crisis (which is a valid and legitimate goal by itself).[163] However, the end result is simply a burdensome and unfeasible provision as well as a great example of Congress's tendency to over-legislate and over-regulate in the aftermath of a financial crisis.[164] Congress clearly did not take into consideration the unintended negative consequences of Section 953 and adopted a substantive rule which is simply too broad, unnecessary and driven by political considerations and agendas.[165] In the words of Professor

[156] *See* Bainbridge, *supra* note 125.
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *See* Coffee, *supra* note 119.
[161] *See* Bainbridge, *supra* note 125, *See* also Coffee, *supra* note 119.
[162] *Id.*
[163] *See* Warren Casey & Richard Leu, *United States: New Executive Compensation Disclosures Under Dodd-Frank* (August 3, 2010), Mondaq.com, http://www.mondaq.com/unitedstates/ article.asp?articleid=106962.
[164] *Id.*
[165] *Id.*

Bainbridge: "this provision is part of a key interest group's agenda and should also be seen as part of the populist backlash against corporations and markets……the law taps into public anger at the increasing disparity between the faltering incomes of middle America and the largely recession-proof multimillion-dollar remuneration of the typical corporate chief."[166]

The following section of this paper will apply Professor Romano's and Professor Bainbridge's criticism of the post-crisis legislative pattern and the theory of "quack corporate governance" and "bubble laws" to Title IV of the Dodd-Frank Act and the regulation of the private equity sector. It will demonstrate that Title IV of the Dodd-Frank Act actually reflects the same legislative pattern of excessive, overbroad, unnecessary and misdirected post-crisis financial reforms or "bubble laws". It was enacted in the aftermath of a massive populist backlash and motivated by the political pressure and public outrage resulting from one of the worst financial crisis in American history. It satisfies all or substantially all of Professor Bainbridge's criteria and represents an example of the danger of hasty, populist and overbroad legislation. It goes beyond the concerns that led to the 2008 financial crisis and the pre-crisis private equity funds' conduct. As this paper demonstrates, in the context of private equity regulation, legislating in the immediate aftermath of a financial crisis is a formula for poor public policy making as well as excessive, inefficient and costly legislation that falls short of achieving the Dodd-Frank's primary objectives of increasing transparency, reducing systemic risk and promoting the stability of the financial system.

i) TITLE IV OF THE DODD-FRANK ACT – THE SAME LEGISLATIVE PATTERN

Title IV of the Dodd-Frank Act and its implementing rules are an example of the same post-crisis legislative pattern, driven by the political pressure and public outrage following the 2008 financial crisis and the near-collapse of the entire financial system. As such, it has the typical characteristics of a post-crisis legislative reform and suffers from the same problems, as discussed by Professor Romano and Professor Bainbridge. It is a reflection of financial market reform legislation that goes beyond the concerns that led to its enactment and represents a mismatch between the actual legislation and the pre-crisis concerns it was trying to address. As this paper shows, by virtue of eliminating the private adviser exemption, Title IV brings the private equity industry within the regulatory purview of SEC scrutiny and oversight in a way that is unnecessary, excessive, costly, has many negative implications and targets more than the pre-crisis private equity activities.[167] The way Congress and the SEC chose to regulate private equity funds under Title IV (through the SEC registration and reporting requirements) demonstrates how in the aftermath of a major financial crisis, regulators and legislators are driven by political pressure and sometimes regulate beyond the pre-crisis conduct and the problems that have to be addressed. This part of the paper will examine the legislative history of Title IV and the

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[166] *See* Bainbridge, *supra* note 125.

[167] *See* Romano, *supra* note 8 (describing the Future Trading Act of 1921 passed in response to the agricultural crisis of the 1920s as "not a solution even remotely addressing the problem at hand"); *id.* at 1593 (explaining that the 1930s securities acts were not targeted toward remedying the economic turmoil of the Great Depression); See also Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of The United States 1867-1960* at 299–407 (1963) (explaining that "the economic problems that attended the Great Depression were caused by mistakes in monetary policy as opposed to fraud in the securities markets and the inappropriate legislative response").

Congressional and SEC response to the financial crisis to ascertain the justification (if any) behind the regulation of private equity funds under Title IV.

The enactment of Title IV was very controversial and produced under enormous public pressure and outrage, following the 2008 financial crisis. Despite reservations on both sides, the regulation of private equity funds and particularly the SEC registration and reporting requirements were eventually included within the scope of Title IV. However, an examination of the legislative history of Title IV indicates very clearly that regulators, including the SEC, were not too concerned about private equity funds and not directly focused on the private equity sector when they analyzed the 2008 financial crisis and spoke against the systemic risk concerns of private investment funds.[168]

During the testimony of Neal S. Wolin, Deputy Secretary of the Treasury, given together with Paul Volcker with regard to private investment funds regulation, Mr. Wolin spoke extensively about the need to adopt the Volcker Rule[169] and the need to control systemic risk in the financial system and systemically risky behaviors.[170] However, the focus of his testimony was the risks associated with hedge funds and nowhere in his testimony did he discuss the risks or concerns associated with the private equity sector. He only mentions private equity funds once, after discussing at length the risky nature of hedge funds and their contribution to the 2008 financial crisis:

> "The activities targeted by our proposal tend to be volatile and high risk. Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms "bailed out" their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised. . . . [Thus], we have concluded that proprietary trading, and the ownership or sponsorship o[f] hedge funds and private funds, should be separated, to the fullest extent practicable, from the business of banking—and from the safety net that benefits the business of banking."

Additionally, the grouping of hedge funds and private equity funds together as private funds or private pools of capital throughout the legislative hearings on Title IV suggests that the private equity sector was not a major concern of regulators:

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[168] *See* Lowenstein, *supra* note 24 (explaining that private equity funds did not contribute to the financial crisis and do not contribute to systemic risk in part because "PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships").

[169] The Volcker Rule targets this systemic risk in two ways: 1) it limits proprietary trading and 2) it tries to eliminate excessive risk taking by restricting investment in private funds. The Volcker rule does this by not only restricting banking entities from investing in private investment funds, but also preventing them from otherwise sponsoring such funds as well; *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 619(a)(1)(B), 619(d), 124 Stat. 1376 (2010).

[170] *See Examining Recent Restrictions Placed on Commercial Banks and Bank Holding Companies' High-Risk Investment Activities: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 55 (2010) (prepared statement of Neal S. Wolin, Deputy Secretary of the Treasury).

> "the financial crisis that erupted in the fall of 2008 exposed numerous vulnerabilities in our present regulatory system for the financial services industry, including a lack of oversight of, and transparency with respect to, private pools of capital. These pools take many forms, including hedge funds, private equity funds, venture capital funds and family officers, among others. While they offer the promise of increased market efficiency and job creation, these pools also pose potential dangers for systemic risk and investor abuse."[171]

In the very next sentence, the section goes on to discuss growing trends in the hedge fund industry that justify further regulation and government intervention.[172] In this report, Representative Barney Frank never once discusses the risks associated with the private equity sector. He explains the growth in the hedge fund industry, the lack of transparency associated with the activities of hedge funds, the "retailization" of hedge funds that has led to the exposure of ordinary investors, and fraud actions that have been brought against hedge funds and their managers in recent years.[173] Private equity funds are only mentioned as an afterthought and while being lumped together with hedge funds. The focus of this report and the primary concern of regulators after the financial crisis were clearly the activities of hedge funds and their contribution to the buildup of systemic risk as opposed to private equity funds.[174]

The essence of this report is that "hedge funds are unregulated and because of minimal transparency in this sector of the financial market, government authorities have limited ability to monitor and constrain systemic risks".[175] While private equity funds and hedge funds share certain characteristics, they have very different business models and distinguishing features, as discussed in Part II of this paper. The legislative history of Title IV indicates that there was a real and legitimate concern for overall lack of transparency in the private funds industry and particularly hedge funds. The specific fundamental difference between hedge funds and private equity funds, as well as the lack of specific instances in which private equity funds created systemic risk concerns prior to the financial crisis tend to suggest that there was nothing about these private equity funds that warranted any government intervention in the private equity sector or their inclusion within the scope of Title IV and its SEC registration and reporting requirements. Instead, the legislative history of Title IV indicates a major concern regarding systemic risk and lack of transparency in the hedge fund sector.

In a 2009 white paper, the Treasury Department supported the SEC registration and reporting requirements of Title IV for the hedge fund industry to "ensure that financial institutions that are critical to market functioning are subject to strong oversight".[176] SEC Commissioner Louis Aguilar also commented: "We're totally unable to discern what is going on in [the hedge fund] market, [we] have no idea how many dollars are involved, [. . .] what type of risk-taking is happening, [we] don't know if they're investing in vanilla securities or investing in

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[171] *See* H.R. Rep. No. 111-686, pt. 1, at 6(2010).
[172] *Id.*
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *See* Department of the Treasury. 2009. *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation*. Available on http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

the riskiest instruments."[177] Still, nothing indicates any specific concern with regard to private equity funds and their pre-crisis conduct that justifies bringing these funds within the purview of SEC registration and reporting. In the word of Professor John W. O'Brien of the Haas School of Business at the University of California - Berkeley: "I don't think private equity and venture capital have been an important part of the problem. It has mainly been the leverage and rapid-trading strategies, and those strategies are primarily housed in hedge funds. I don't think Congress has a clear understanding of the problem so they wrap everybody into the net."[178]

As this paper will show in Part IV, private equity funds pose minimal systemic risk to the financial system and present no threat to the financial stability of the financial system or the economy as a whole. No demonstrable market failure was identified in the context of the private equity industry to justify such regulatory intervention and broad provisions. Additionally, there is no empirical academic literature to support any specific regulatory concern associated with the private equity sector and its pre-crisis conduct in the context of systemic risk and a potential financial crisis. The 2008 financial crisis had very little to do with private equity funds.[179] Private equity funds did not cause the financial crisis and did not play any part in the credit crisis. They did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system and were simply not part of the problem or any market failure, unlike hedge funds.[180] As this paper will show in Part IV, private equity funds present none of the systemic risk factors that led to the financial crisis and thus should have posed very little concern for regulators and policymakers seeking to develop a new regulatory regime to monitor systemic risk and guard against a future financial crisis.

Additionally, according to a study of more than 3200 private equity-backed companies, "during the 'Great Recession' of 2008-2009 private equity-backed businesses defaulted at less than one-half the rate of comparable companies: 2.84 [percent] versus 6.17 [percent]."[181] Also, while both hedge funds and private equity funds experienced losses during the 2008 financial crisis, research indicates that private equity funds have actually performed more than 5% better than hedge funds since 2007.[182] Therefore, it seems very unlikely that regulators viewed private equity funds as excessively risky and were concerned about the risky nature of private equity funds. This is because, "unlike the troubled hedge funds in need of bailouts as discussed in Mr. Wolin's testimony, private equity funds did not pose any unique threat to the financial system and the economy as a whole."[183]

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[177] *See* Zachary Goldfarb and David Cho. *"Hedge Funds Making Way for Government Regulation; Industry Faces New Realities, Investors Who Want Assurances." (2009) Washington Post,* March 14, D.2.
[178] *See* Doug Halonen, *Systemic Risk? Not us, say private equity firms*, Pensions & Investments, April 6, 2009, Vol. 37 Issue 7, available at http://connection.ebscohost.com/c/articles/38902941/systemic-risk-not-us-say-private-equity-firms.
[179] *See* Richard Posner, *A Failure of Capitalism: The Crisis of 08 and the Descent Into Depression*, (Harvard University Press, 1st Ed. 2009).
[180] *See* Acharya, *supra* note 1.
[181] *See* Jason M. Thomas, *The Credit Performance of Private Equity-Backed Companies in the Great Recession of 2008-2008,* at 1 (2010), *available at* http://www.nvp.nl/data_files/credit_performance.pdf.
[182] *See* U.S. Government Accountability Office, GAO-12-324, *Defined Benefit Pension Plans: Recent Developments Highlight Challenges of Hedge Funds and Private Equity Investing*, 9 tbl.1 (2012), *available at* http://www.gao.gov/assets/590/588623.pdf.
[183] As Federal Reserve Board Chairman Ben Bernanke stated in his testimony in front of the House Committee on Financial Services, he "would not think that any . . . private equity fund would become a systemically-critical firm

It is also important to note that the version of Title IV that was approved by the Senate on May 20, 2010, included an exemption from registration to investment advisers of private equity funds.[184] The Senate explained its reasoning behind providing an exemption from registration to private equity advisers as follows:

> "The Committee believes that private equity funds characterized by long-term equity investments in operating businesses do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Private equity investments are characterized by long-term commitments of equity capital - investors generally do not have redemption rights that could force the funds into disorderly liquidations of their positions. Private equity funds use limited or no leverage at the fund level, which means that their activities do not pose risks to the wider markets through credit or counterparty relationships. Accordingly, Section 408 directs the SEC to define "private equity fund" and provides an exemption from registration for advisers to private equity funds." [185]

The Senate further explained:

> "Informed observers believe that in some cases the line between hedge funds and private equity may not be clear, and that the activities of the two types of funds may overlap. We expect the SEC to define the term "private equity fund" in a way to exclude firms that call themselves "private equity" but engage in activities that either raise significant potential systemic risk concerns or are more characteristic of traditional hedge funds. The section requires advisers to private equity funds to maintain such records, and provide to the SEC such annual or other reports, as the SEC determines necessary and appropriate in the public interest and for the protection of investors."[186]

Title IV of the Dodd-Frank Act, as finally enacted, does not contain the private equity exemption that was included in the version approved by the Senate. Instead, it incorporates the broad proposal made by Senator Jack Reed (D-IR). Senator Reed advanced the most aggressive proposal, the Private Fund Transparency Act of 2009, which basically required the registration of all private investment funds, regardless of size, by eliminating the private investment adviser exemption.[187] Senator Reed offered very little reasoning, evidence and support for the inclusion of private equity funds in his proposal.[188] He stated in his proposal that ""[hedge funds, private equity, and venture capital funds' . . . role has grown so have the risks they pose," while at the same time he acknowledged that there is "no reliable data on the number and nature of these firms or ability to calculate the risks they may pose to America's broader economy."[189]

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individually" but rather it remains important for regulators to monitor systemic risk in the financial industry as a whole. Lowenstein, Written Testimony, *supra* note 24.

[184] *See* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010) §§ 401-16. 64. *See* §408 ("Exemption of and Reporting by Private Equity Fund Advisers"), ["Except as provided in this subsection, no investment adviser shall be subject to the registration or reporting requirements of this title with respect to the provision of investment advice relating to a private equity fund or funds."].

[185] *See* S. REP. No. 111-176, 75 (2010).

[186] *Id*.

[187] *See* Private Fund Transparency Act of 2009, S. 1276, 111th Cong. §3 (2009).

[188] *See* Press Release, "*Reed Offers Amendment to Strengthen Rules on Managers of Hedge Funds, Private Equity Funds, and Venture Capital Funds*", (May 10, *2010), (available at* http://reed.senate.gov/newsroom/details.cfm?id=324807) (quoting Senator Reed).

[189] *Id.*

Furthermore, reviewing the SEC adopting releases implementing Title IV and the amendments to the Advisers Act, indicates the same legislative pattern and provides an important insight as to the SEC's view regarding the risks associated with private investment funds and what the SEC was trying to accomplish.[190] It seems from the adopting releases that the activities targeted by the SEC were primarily hedge funds and the systemic risk concerns associated with hedge funds.[191] The adopting releases indicate that there was a real and legitimate concern about the activities of hedge funds, their use of leverage, their trading strategies, their involvement in the 2008 financial crisis and their overall lack of transparency.[192] The focus of the SEC was mainly hedge funds and the need for more oversight over the activities of hedge funds. Private equity funds were not a concern mentioned in the SEC adopting releases and nowhere in the adopting releases was there any discussion about private equity funds and their potential risks to the financial system or the economy as a whole.[193] From the SEC adopting releases it also seems that the SEC was simply not concerned with fraud associated with private equity funds the way that it was concerned with potential hedge fund fraud. Overall, the SEC adopting releases offer very little reasoning, evidence and support for the inclusion of private equity funds within the scope of Title IV and its implementing rules. Additionally, there is no empirical academic literature or other sources mentioned in the SEC adopting releases to support any specific regulatory concern associated with the private equity sector and its pre-crisis conduct in the context of systemic risk and a potential financial crisis.[194]

The specific fundamental differences between hedge funds and private equity funds (as discussed in Part II of this paper), as well as the lack of specific instances in which private equity funds created systemic risk concerns prior to the financial crisis or caused any market failure tend to suggest that there was nothing about these private equity funds that warranted any government or regulatory intervention in the private equity sector or their inclusion within the scope of Title IV and its implementing rules. As discussed later in this paper, the SEC should have implemented Title IV in a way that exempts private equity funds from the SEC registration and reporting requirements. In other words, this paper takes the position that since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth, they had no involvement in the 2008 financial crisis and their investors have the resources and sophistication to 'fend for themselves', these funds and their advisers should be subject to a reduced regulatory regime and exempt from the SEC registration, reporting and disclosure requirements under the Dodd-Frank Act. The SEC should have included a carve-out for private equity funds exempting these funds from the requirements of Title IV while focusing on hedge funds.

This section of the paper has offered a brief overview of the legislative history of Title IV and its implementing rules and how they follow the traditional post-crisis legislative pattern. An examination of the legislative history of Title IV and its implementing rules indicates that this piece of legislation reflects the same legislative pattern of excessive, overbroad, unnecessary and misdirected post-crisis financial reforms or in the words Professor Romano and Professor Bainbridge "bubble laws". It was enacted in the aftermath of a massive populist backlash and

[190] *See* Schapiro, *supra* note 4.
[191] *Id.*
[192] *Id.*
[193] *Id.*
[194] *Id.*

motivated by the political pressure and public outrage resulting from one of the worst financial crisis in American history. It is not supported by any evidence, research or analysis to justify this government and regulatory intervention and the need to regulate the private equity industry. It satisfies all or substantially all of Professor Bainbridge's criteria and represents an example of hasty, populist and overbroad legislation. It goes beyond the concerns that led to the 2008 financial crisis and the pre-crisis private equity funds' conduct, as clearly, regulators had no specific concerns with regard to the activities of private equity funds or the potential systemic risk associated with the private equity sector. The only reason private equity funds were eventually included within the scope of Title IV is the unique political and economic environment following the 2008 financial crisis, the "emotionally charged" climate, as well as the public outrage and political pressure on Congress to take action, satisfy angry constituents and introduce a comprehensive reform of the financial system. Title IV and its implementing rules are not calibrated to the circumstances that led to the enactment of the legislation as there is very little 'nexus' between private equity activities and the systemic risk concerns underlying the enactment of Title IV.

As discussed in Part II of this paper, Title IV tries to eliminate excessive risk through SEC supervision and oversight. While increased transparency and oversight in the context of private investment funds, and particularly hedge funds, may reduce and control the systemic risk that led to the 2008 financial crisis and the near collapse of the entire financial system, these provisions, insofar as they apply to the private equity industry, go beyond the objectives of the Dodd-Frank Act and the actual concerns that regulators were trying to address. They simply reflect an inadequate, costly and unnecessary legislative response which is inconsistent with the intended purpose of the Dodd-Frank Act. It was all made possible due to the tremendous political pressure on Congress and sense of urgency to introduce a comprehensive reform of the financial system which created the right opportunity for "political entrepreneurs" to push their agenda. The following section of this paper will examine the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable v. SEC[195] and the importance, role and application of cost benefit analysis in financial regulation and particularly private equity regulation under Title IV and its implementing rules.

B. THE POLITICAL ECONOMY OF FINANCIAL RULEMAKING AFTER BUSINESS ROUNDTABLE

We now turn to explore the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable and the importance, role and application of cost benefit analysis in financial regulation as well as private equity regulation under Title IV and its implementing rules. Choosing whether and how to regulate is generally a question of regulators and the implementing agency evaluating alternative regulatory approaches, tradeoffs and whether society, the financial system and the economy gain enough from the regulation to justify its costs. The goal is for regulators to ensure they adequately consider the effectiveness and consequences of their regulatory actions and determine the best course of action. In other words, the benefits must justify and exceed the costs of the proposed legislative action.

[195] *See* Business Roundtable v. SEC, *supra* note 9.

In Business Roundtable, the D.C. Circuit, in striking down the proxy access rule held that the rulemaking process was "arbitrary and capricious and not in accordance with law" and that the SEC had failed to perform an adequate cost benefit analysis of the rule.[196] The court vacated the rule on the basis that it violated the Administrative Procedure Act[197] and that the SEC "failed adequately to consider the rule's effect upon efficiency, competition and capital formation".[198] In concluding that the SEC had failed to meet its cost benefit analysis obligations, the court made clear that the rule required "a far more rigorous economic analysis and cost benefit justification than the SEC had assumed was necessary."[199] In the words of Judge Ginsburg, "the SEC fell far short of its statutory obligation to determine as best it could the economic implications of the rule".[200]

Business Roundtable has become one of the most important financial regulation decisions since cost benefit analysis was developed in the early 1970s by holding financial regulators strictly accountable for the quality of their cost benefit analysis.[201] It established a far more rigorous standard of review than the financial regulators had previously used. The decision appears to require courts to "police the quality of regulators cost benefit analysis and directs judges to look more closely at the analysis to determine whether the relevant regulator has adequately considered and ascertained the rule's costs and benefits based on all the alternatives available."[202]

The decision in Business Roundtable is also significant as it was the first challenge of a rule adopted under the Dodd-Frank Act, based on the implementing agency's failure to perform an adequate cost benefit analysis.[203] It also represents a turning point indicative of an unprecedented level of judicial scrutiny of financial regulation, forcing the SEC and other regulators poised to issue rules and regulations under the Dodd-Frank Act, to take a whole new approach to their rulemaking process.[204] Despite extensive criticism, the decision appears to have mandated more demanding and strict standards of judicial review of the cost benefit analysis of financial regulation.[205] Depending on one's view, such a powerful approach or filter of financial regulation could either "further ossify the financial rulemaking process[206] or make the rules that emerge from the process more rational, efficient, and transparent."[207]

This section of the paper will examine the costs and benefits of Title IV's implementing rules, in light of the decision in Business Roundtable, and show the deficiencies in the cost benefit analysis performed by regulators and particularly the SEC in connection with private equity regulation and the implementation of Title IV. It will demonstrate how cost benefit

[196] *Id.*
[197] *See supra* note 13.
[198] *Id.*
[199] *Id.*
[200] *Id.*
[201] *See* Fisch, *supra* note 17.
[202] *See* Posner and Weyl, *supra* note 18.
[203] *Id*.
[204] *See* Holzer, *supra* note 19.
[205] *See* Posner and Weyl, *supra* note 18.
[206] *See supra* note 20.
[207] *See* Adler & Posner, *supra* note 21.

analysis, when used properly, provides a fundamental decision making tool that helps regulators to ensure that regulatory efforts produce a net positive effect on society and the economy as a whole. It will evaluate whether Title IV's implementing rules i) are supported by the cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable; ii) are tailored to impose the least burden on society, the financial system and the economy; and iii) reflect a regulatory approach that maximizes net benefits. This section of the paper will also discuss how the rigorous cost benefit analysis standards established in the Business Roundtable decision may affect the political economy of financial regulation and how actors in the political economy of financial rulemaking may respond to the Business Roundtable decision. Before we examine the political economy of financial regulation following the Business Roundtable decision and whether Title IV's implementing rules are in fact supported by a cost benefit analysis that is consistent with the standards established in Business Roundtable, it is worth pausing to consider the history of cost benefit analysis and its specific application to financial regulation.

i. <u>THE HISTORY OF COST BENEFIT ANALYSIS AND FINANCIAL REGULATION</u>

Cost benefit analysis is considered to be one of the most important decision-making tools in the context of modern regulation. For more than three decades, under both Democratic and Republican administrations, cost benefit analysis has been a fundamental tool of effective regulation, ensuring that regulators maximize the benefits of the proposed regulatory actions and that these regulatory actions produce a net positive effect on society and the economy as a whole.[208] Both Congress and the Executive have taken numerous steps over the years to require regulators and federal agencies to engage in cost benefit analysis when deciding how to regulate. In the words of Professor Cass Sunstein, "In the past 30 years in particular, cost benefit analysis has become a fundamental part of how federal agencies think about and ultimately select regulatory approaches, with all three branches of government participating in the creation of the cost benefit state."[209] As early as 1902, Congress requested federal agencies to compare costs and benefits of proposed regulatory actions[210], and the New Deal reflected the first large-scale implementation of this regulatory tool, when "the Flood Control Act of 1936 required that the Army Corps of Engineers take regulatory action only where benefits were greater than the costs."[211] The practice of using cost benefit analysis in the context of adopting regulations became more common as a public policy tool in the 1950s and 1960s "with the growth of the administrative state and the development of welfare economics concepts that supported the use of cost-benefit analysis in determining how to implement government policies."[212] The use of cost benefit analysis was in many ways a response to a wave of safety, health and environmental regulations.[213]

[208] *See* Paul Rose and Christopher Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation* (March 10, 2013). Report for U.S. Chamber of Commerce; Law and Capital Markets @ Ohio State, March 2013; Ohio State Public Law Working Paper No. 208. Available at SSRN: http://ssrn.com/abstract=2231314.
[209] *See* Cass R. Sunstein, The Cost Benefit State: The Future of Regulatory Protection (American Bar Association 2002).
[210] *See* River and Harbor Act of 1902, ch. 1079, § 3, 32 Stat. 331, 372 (1902).
[211] *See* Daniel H. Cole, *Law, Politics, and Cost-Benefit Analysis*, 64 ALA. L. REV. 55, 56 (2012).
[212] *See* Adler and Posner, *supra* note 21.
[213] *See* James C. Miller III, *Lessons of the Economic Impact Statement Program*, Reg.: AEI J. on Gov't & Soc'y, July–Aug. 1977, at 14, 15–16.

Supporters of cost benefit analysis argue that it is "a natural filtering tool that makes federal regulations more rational and efficient."[214] It is simply a regulatory tool to ensure that the costs of regulatory actions do not exceed the benefits of such regulatory actions. Opponents of cost benefit analysis argue that it is not a "natural filtering tool but a mechanism designed to further a deregulatory agenda by creating regulatory gridlock, imposing an impossible burden of proof on the regulators or making it prohibitively expensive for agencies to issue regulations."[215] Despite criticism of cost benefit analysis over the years, in the context of regulation, cost benefit analysis has become a major regulatory tool used by regulators, policymakers, Presidents of both parties and members of Congress.

However, it is important to note that the implementation of this major regulatory tool is extremely complicated as the quality of the cost benefit analysis depends on "the good faith of the regulator or agency performing the analysis and on the existence of an effective enforcement mechanism to challenge and invalidate rules that are not supported by an adequate cost benefit analysis."[216] Without an effective mechanism for ensuring the quality or adequacy of cost benefit analysis, this regulatory tool may become "a political cover rather than a genuine check on costly regulations".[217]

Regulatory cost benefit analysis requirements were usually limited to executive agencies and social regulations and substantial or robust cost benefit analysis requirements were not imposed on financial regulations until 1996. It then took nearly a decade for the first challenge of a financial regulation based on the adequacy of its cost benefit analysis to reach the courts.[218] We now turn to examine how cost benefit analysis has evolved as a regulatory tool used by regulators, policymakers and Presidents of both parties to manage and control the rulemaking process by executive agencies. We will also look at the main Congressional mandates governing cost benefit analysis reviews of financial regulations and examine the quality or adequacy of the cost benefit analysis of financial regulation.

Executive Branch Programs

Almost every President since Richard Nixon has had a cost benefit analysis process to review and filter regulations proposed by executive agencies and has urged independent agencies to use cost benefit analysis as well.[219] However, this cost benefit analysis review process had

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[214] *Id.* (noting that "the purpose of cost benefit analysis is making the rulemaking process as rational as possible"); *See* Murray L. Weidenbaum, Reforming Government Regulation, Reg.: AEI J. on Gov't & Soc'y, Nov.–Dec. 1980, at 15, 17 (describing cost benefit analysis as a "neutral policy concept").

[215] *See* Edward M. Kennedy, *Regulatory Reform: Striking a Balance, in Reforming Regulation* 21, 21–22 (Timothy B. Clark, Marvin Kosters & James Miller eds., 1980).

[216] *Id.*

[217] *See* Jonathan David Guynn, *The Political Economy of Financial Rulemaking After Business Roundtable* (May 2013). Virginia Law Review, Vol. 99, No. 3, 2013. Available at SSRN: http://ssrn.com/abstract=2272284.

[218] *Id.*

[219] *See* Exec. Order No. 13,579, 3 C.F.R. 256 (2011) (urging independent agencies to use the same cost benefit analysis review process as executive agencies). President Nixon's program, called the "quality of life" review process, "required executive agencies to consider regulatory alternatives and costs when developing significant regulations." *See* Murray Weidenbaum, *Regulatory Process Reform from Ford to Clinton*, Reg.: AEI J. on Gov't & Soc'y, Winter 1997, at 20. President Nixon put the Office of Management and Budget ("OMB") in charge of enforcing this rule, but most of the agencies just ignored the process because the OMB's enforcement authority "was

only limited impact on financial regulations since most of the federal financial regulatory agencies are independent agencies.[220] President Reagan established the most rigorous cost benefit analysis review program of all the presidents in Executive Order 12,291.[221] The Reagan order prohibited executive agencies "from undertaking any regulatory action . . .unless the potential benefits to society for the regulation outweigh the potential costs" and required them to choose the "alternative involving the least net cost to society of all available alternatives."[222] In other words, when an agency regulates, it must find that the benefits justify the costs of the proposed regulatory action. It also gave the power to enforce compliance with the program and these cost benefit analysis requirements to a powerful new Presidential Task Force on Regulatory Relief.[223]

The Bush Administration continued this approach, but transferred enforcement authority to the Office of Information and Regulatory Affairs ("OIRA") within the Office of Management and Budget ("OMB").[224] President Clinton replaced the Reagan and Bush cost benefit analysis approach with a less robust process outlined in Executive Order 12,866, which remains in effect today.[225] Still, cost benefit analysis remained the central requirement of these orders. The Clinton approach is less demanding than the Reagan and Bush approach in two elements. First, it "directed agencies to consider qualitative measures of cost and benefit in addition to quantitative measures."[226] Second, it "required an executive agency only to provide a reasoned determination that the benefits of the intended regulation justify its costs," rather than "showing that the benefits outweigh the costs."[227] Still, regulators and agencies have to choose the regulatory approach that maximizes net benefits.[228]

The Obama Administration has continued to follow the standards for cost benefit analysis set forth by the Reagan Administration and reconfirmed by the Clinton Administration, which "require an executive agency to adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs"; "base decisions on the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation"; and "tailor its regulations to impose the least burden on society."[229] Additionally, by issuing Executive Order 13,563, the Obama Administration has enhanced the use of cost benefit analysis as a regulatory tool, underscoring that "the benefits must justify the costs of the proposed agency action, that unless the law provides otherwise the chosen approach must maximize net benefits, and that the agency must use the best available techniques to quantify anticipated present and future benefits and costs as accurately as

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very limited." Presidents Ford and Carter implemented more rigorous and effective cost benefit analysis review and enforcement programs. *See* Exec. Order No. 11,821, 3 C.F.R. 926 (1974); Exec. Order No. 12,044, 3 C.F.R. 152 (1978).

220 *See* Guynn, *supra* note 217.

221 *See* Exec. Order No. 12,291, 3 C.F.R. 127 (1981).

222 *Id.*

223 *Id.*

224 *See* Paperwork Reduction Act of 1980, Pub. L. No. 96-511, §§ 3503–3504, 94 Stat. 2812, 2814–15 (codified at 44 U.S.C. § 3503(a) (2006)).

225 *See* Executive Order No. 12,866, 3 C.F.R. 638 (1993), *reprinted as amended in* 5 U.S.C. § 601 (2006).

226 *Id.*

227 *Id.*

228 *See* Guynn, *supra* note 217.

229 *See supra* note 225.

possible."[230] President Obama also issued Executive Order 13,579,[231] which "urges independent agencies to comply with the cost benefit analysis requirements in Executive Orders 12,866 and 13,563, although they are not binding on independent agencies.[232]

Statutes and Financial Regulations

Despite the major support for the rigorous use of cost benefit analysis as a fundamental regulatory tool and its general recognition and acceptance by all three branches of the federal government, financial market regulators have been slower in adopting this approach than their executive agency counterparts.[233] The reasons for this approach are primarily historical, in that the executive orders requiring cost benefit analysis by federal agencies expressly do not apply to independent agencies such as many financial regulators.[234]

The first government regulatory action to impose cost benefit analysis standards in the context of financial regulation was the Unfunded Mandates Reform Act of 1995, or UMRA, (although it is limited to executive agencies).[235] It requires "all federal agencies other than independent regulatory agencies to conduct a cost benefit analysis of significant regulatory actions—that is, regulatory actions that could impose annual costs on the public or private sectors of $100 million or more—and is expressly subject to judicial review."[236] In this legislation Congress actually required agencies to "prepare a qualitative and quantitative assessment of the anticipated costs and benefits of the federal mandate".[237]

The first statute to impose cost benefit analysis requirements on an independent financial regulatory agency was the National Securities Markets Improvement Act of 1996.[238] Section 106 of that Act added certain cost benefit analysis requirements to Section 2(a) of the Securities Act of 1933[239], Section 3(f) of the Securities Exchange Act of 1934[240] and Section 2(c) of the Investment Company Act of 1940.[241] These mandates all require the SEC, when engaged in financial rulemaking under a particular act, to "consider whether the action will promote efficiency, competition, and capital formation."[242] Congress also added a similar cost benefit analysis requirement to Section 15(a) of the Commodity Exchange Act[243] in Section 119 of the

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[230] *See* Executive Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011).
[231] *See* 3 C.F.R. 256 (2011).
[232] *Id.*
[233] *See* Rose and Walker, *supra* note 208.
[234] *Id.*
[235] *See* Pub. L. No. 104-4, 109 Stat. 48 (codified as amended at 2 U.S.C. §§ 1501–1571 (2006)).
[236] *See Id.* (requiring agencies "to identify and consider a reasonable number of regulatory alternatives and from those alternatives select the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule").
[237] *Id.*
[238] *See* Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3424–25 (1996) (codified at 15 U.S.C. § 77b (2006)).
[239] *See* 15 U.S.C. § 77b(b) (2006).
[240] *Id.* § 78c(f).
[241] *Id.* § 80a-2(c).
[242] *Id.* §§ 77b(b), 78c(f), 80a-2(c).
[243] *See* 7 U.S.C. § 19(a) (2006).

Commodity Futures Modernization Act of 2000.[244] This cost benefit analysis requirement provides that "before promulgating a regulation under the Commodity Exchange Act, the Commodity Futures Trading Commission must consider the costs and benefits of the action and evaluate them in light of a variety of factors including the efficiency, competitiveness, and financial integrity of futures markets."[245]

The Dodd-Frank Act has brought the regulatory tool of cost benefit analysis in financial regulation to the forefront by requiring financial regulators and agencies to promulgate hundreds of new rules affecting the U.S. financial market. The Dodd-Frank Act also imposes a number of cost benefit analysis requirements on a wide range of financial regulations. As this legislation was drafted and structured to amend existing laws, the general cost benefit analysis requirements included in the organic acts of each financial regulator (like the Securities and Exchange Act of 1934) apply as well to any Dodd-Frank financial rulemaking since they were not altered or eliminated.[246] Also the Dodd-Frank Act does not exempt any of the regulations issued under the amended provisions from the preexisting cost benefit analysis requirements in the respective securities laws or other financial regulations. Therefore, any regulations implementing the Dodd-Frank Act rules or amendments are subject to the same preexisting cost benefit analysis requirements. The Dodd-Frank Act also incorporates as a structural matter all of the cost benefit analysis requirements that apply to financial rulemaking by the Office of the Comptroller of the Currency ("OCC"), including the one in UMRA. Therefore, any time the OCC issues any financial regulations under the Dodd-Frank Act, such as its regulations implementing the Volcker Rule[247], the OCC must comply with the cost benefit analysis requirements of the UMRA.

The Dodd-Frank Act specifically imposes a cost benefit analysis requirement on all financial rulemaking by the Consumer Financial Protection Bureau ("CFPB") under the consumer protection provisions in Title X.[248] It also imposes an express cost benefit analysis requirement on the Financial Stability Oversight Council ("FSOC") in issuing regulations governing the designation of financial activities as systemically important under Section 120.[249] Additionally, it imposes a cost benefit analysis requirement on the Federal Deposit Insurance Corporation ("FDIC") in issuing rules governing "the recovery of compensation from officers and directors who are responsible for the failure of a systemically important financial company."[250]

Additionally, in 2012, Congress passed the JOBS Act, in which it placed a similar cost benefit analysis requirement on the Public Company Accounting Oversight Board ("PCAOB"), a self-regulated body whose proposed rules are subject to SEC review and approval before taking effect. The JOBS Act provides that any PCAOB rules adopted after its enactment "shall not apply to an audit of any emerging growth company, unless the Commission determines that the

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[244] *See* Consolidated Appropriations Act, 2001, Pub. L. No. 106-554, 114 Stat. 2763 (2000), (enacting, among other bills, the Commodity Futures Modernization Act of 2000).
[245] *See* 7 U.S.C. § 19(a)(1), (a)(2)(B) (2006).
[246] *See* Rose and Walker *supra* note 208.
[247] *See supra* note 169.
[248] *See supra* note 2.
[249] § 120(b)(2)(A) of the Dodd-Frank Act.
[250] § 210(s) of the Dodd-Frank Act.

application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."[251] We now turn to examine the quality and standards of cost benefit analysis reviews of financial regulation.

The Quality of Cost Benefit Analysis Reviews of Financial Regulation

The quality of the cost benefit analysis performed in the context of financial regulation has historically been, to some extent, low and almost never included any empirical evidence to support the proposed regulatory actions.[252] Financial regulators seem as if they were simply going through the motions of performing some form of cost benefit analysis rather than going through a comprehensive and robust analysis of the actual costs and benefits of the proposed regulatory action that actually evaluates whether society and the economy as a whole gain enough from the regulation to justify its costs.[253] This lack of robust cost benefit analysis of financial regulations is consistent with the Business Roundtable decision and the D.C. Circuit's conclusion that the SEC had failed to meet minimum quality standards in the cost benefit analysis review of the proxy access rule.[254] It is also consistent with views recently expressed by the Committee on Capital Markets Regulation ("CCMR"), which is an independent and nonpartisan body dedicated to improving the regulation of U.S. capital markets. The CCMR submitted a letter to the majority and minority leaders of the Senate Banking Committee and the House Financial Services Committee on the lack of adequate cost benefit analysis in the Dodd-Frank rulemaking.[255] The CCMR reviewed 192 of the proposed and final rules that have been issued under the Dodd-Frank Act so far. It found that "fifty-seven of these rules contained no cost benefit analysis at all; eighty-five contained cost benefit analysis, but they were entirely qualitative, and not quantitative; and only fifty rules contained quantitative cost benefit analysis."[256] In the last category, "the most instances of cost benefit analysis were limited to administrative costs like the costs of paperwork, legal and compliance review, technological enhancements, and the like, without any analysis of the broader economic implications of the proposed rules."[257]

Additionally, the Inspectors General of the Securities and Exchange Commission and the Commodity Futures Trading Commission ("CFTC") have found "major deficiencies in the financial regulators' use of cost-benefit analysis after the Dodd-Frank"[258], and the Government

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[251] *See* Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, § 104, 126 Stat 306 (Apr. 5, 2012).
[252] *See* Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626, 71,674–83 (Nov. 18, 2011); Proxy Access Rule, 75 Fed. Reg. 66,622, 66,633–37 (Oct. 28, 2010); Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288 69,389–96 (Dec. 7, 2007); Market Risk Disclosure Rule, 62 Fed. Reg. 6044, 6059–63 (Feb. 10, 1997).
[253] *See* Rose and Walker *supra* note 208.
[254] *See supra* note 9.
[255] *See* Letter from R. Glenn Hubbard, Co-Chair, Comm. on Capital Mkts. Regulation, et al., to Timothy Johnson, Chairman, U.S. Senate Comm. on Banking, et al. (Mar. 7, 2012), http://capmktsreg.org/pdfs/2012.03.07_CBA_letter.pdf.
[256] *Id.*
[257] *Id.*
[258] *See* Office of The Inspector Gen. of The SEC, Report of Review of Economic Analysis Conducted By The SEC in Connection with Dodd-Frank Rulemaking (June 13, 2011), available at

Accounting Office (GAO), Congress's investigative arm has also "faulted financial regulators for failing to monetize or quantify costs and benefits of proposed regulatory actions."[259]

There may be different possible explanations for the low average quality of these instances of cost benefit analysis of financial regulation. First, as explained above, cost benefit analysis requirements are relatively new in the context of financial regulations. The financial regulatory agencies may need more experience using this regulatory tool or more economists rather than lawyers on their staffs.[260] Second, "the financial agencies may view cost benefit analysis as an intrusion into the exercise of their expert discretion rather than a useful regulatory tool to sort out the best regulatory alternative."[261] Third, some of the financial agencies may lack sufficient resources to hire the economists they need to conduct an adequate and robust cost benefit analysis, consistent with the requirements of the Business Roundtable decision. Fourth, "the lack of any independent enforcement body similar to the enforcement arms that have existed in the executive branch may give independent financial regulatory agencies the sense that they are not accountable to anyone except themselves and their allies in Congress."[262]

Academic Reaction to Costs Benefit Analysis

Cost benefit analysis and its importance as a regulatory filter has been the subject of extensive academic debate. Opponents of cost benefit analysis argue that "cost benefit analysis promotes a deregulatory agenda under the cover of scientific objectivity."[263] They further argue that "the motivating factor behind cost benefit analysis in this context is a political bias against regulation."[264] Cost benefit analysis opponents "want to prevent economic considerations from eclipsing other important values that ought to inform agency decision making."[265] In contrast, Professors Matthew Adler and Eric Posner argue that, "when properly used by regulators, cost benefit analysis is consistent with a broad array of popular theories of the proper role of government and is capable of satisfying every political theory that holds that the government should care about the overall well-being of its citizens."[266] In other words, opponents of cost benefit analysis as a regulatory tool use the term "ossification" since they believe that rigorous

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http://www.secoig.gov/Reports/AuditsInsp ections/2011/Report_6_13_11.pdf; Officer of The Inspector Gen. of The CFTC, A Review of Cost Benefit Analysis Performed by the Commodities Futures Trading Commission in Connection with Rulemaking undertaken pursuant to the Dodd-Frank Act ((June 13, 2011) available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents /file/oig_investigation_061311.pdf.

[259] *See* GAO Report GAO-13-101, Dodd-Frank Act Regulations: Agencies' Efforts To Analyze And Coordinate Their Rules (Dec. 2012), available at http://www.gao.gov/assets/660/650947.pdf.

[260] *See* Rose and Walker *supra* note 208.

[261] *Id*.

[262] *See* Robert W. Hahn & Cass R. Sunstein, A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis, 150 U. Pa. L. Rev. 1489, 1496, 1509, 1532–33 (2002) (discussing "cost benefit analysis requirements for executive agencies and arguing for cost benefit analysis requirements for independent agencies").

[263] *See* Frank Ackerman & Lisa Heinzerling, Priceless: On Knowing the Price of Everything and the Value of Nothing 9 (2004).

[264] *See* Daniel A. Farber, *Rethinking the Role of Cost-benefit Analysis*, 76 U. Chi. L. Rev. 1355, 1366 (2009) (reviewing Ackerman & Heinzerling, supra note 254).

[265] *See* Richard L. Revesz & Michael A. Livermore, Retaking Rationality: How Cost-Benefit Analysis Can Better Protect the Environment and Our Health 15 (Oxford University Press 2008).

[266] *See* Adler & Posner, *supra* note 21.

review of cost benefit analysis may overpower or take over other important parameters that ought to determine regulatory choices.[267] Proponents of costs benefit analysis, on the other hand, describe the use of costs benefit analysis as a regulatory tool as the "rationalization of the regulatory process", since they believe that the filtering effect is critical for securing efficient regulatory actions.[268] The following section of this paper will examine the many policy considerations that favor the use of cost benefit analysis as a regulatory tool for more efficient regulatory actions.

ii. <u>POLICY CONSIDERATIONS OF COST BENEFIT ANALYSIS</u>

As the history of cost benefit analysis discussed above demonstrates, cost benefit analysis has developed over the past three decades as one of the most important tools for effective regulation. The acceptance of cost benefit analysis by regulators as a major decision-making tool in the context of modern regulation reflects the many policy considerations that favor its use. These considerations are based on two major premises and can be divided into two groups. First, "cost benefit analysis promotes more rational decision-making and more efficient regulatory actions."[269] It is a tool to measure the economic consequences of a proposed regulatory action and ensure that regulatory actions are the product of reasoned decision-making. Second, "cost benefit analysis promotes good public governance as a transparent, democratic, and accountable regulatory methodology."[270]

Cost benefit analysis improves the regulatory process and ensures that regulators maximize the benefits of the proposed regulatory actions. In the words of Professor Sunstein, "at its core, cost benefit analysis is a tool of rational decision-making."[271] As explained, for example, in a 1772 letter that Benjamin Franklin wrote to his friend Joseph Priestley, "listing the pros and cons of a solution on a piece of paper and carefully weighing them against one another provides a practical method for solving difficult problems."[272] Over the years Franklin's approach has developed into a powerful tool for rational decision-making and efficient rulemaking.[273]

As a matter of policy, cost benefit analysis provides a decision-making process that helps to produce effective regulations and ensures that regulatory efforts produce a net positive effect on society and the economy as a whole.[274] In other words "society and the economy have to gain enough from the proposed regulation to justify its costs."[275] Choosing whether and how to regulate is generally a question of regulators and the implementing agency evaluating alternative regulatory approaches, tradeoffs and whether society, the financial system and the economy gain enough from the regulation to justify its costs. The goal is for regulators to ensure they adequately consider the effectiveness and consequences of their regulatory actions and determine the best course of action. In other words, the benefits must justify and exceed the costs of the

[267] *Id.*
[268] *Id.*
[269] *See* Rose and Walker *supra* note 208.
[270] *Id.*
[271] *See* Sunstein, *supra* note 209.
[272] *See* Euston Quah & Raymond Toh, *Cost Benefit Analysis: Cases and Materials* 3, 8 (2012).
[273] *See* Rose and Walker *supra* note 208.
[274] *See* Sunstein, *supra* note 209.
[275] *Id.*

proposed legislative action. Cost benefit analysis provides regulators a tool that keeps them focused on the following "critical questions in the rulemaking process: What are the actual, quantifiable costs and benefits of the proposed regulation? How do these factors weigh against other values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts? In light of these costs and benefits, how does this regulation compare to other possible solutions?"[276] Cost benefit analysis provides regulators a structured method for addressing these questions ensuring they choose the best regulatory solution and that this choice is in fact justified.

In choosing the best regulatory approach and considering all the relevant factors in the rulemaking process, regulators and agencies also minimize the risks of unintended consequences that may result from a particular regulatory action.[277] As discussed in Part III of this paper, financial reforms are usually adopted after a major financial crisis or market crash. These reforms tend to be hasty, rushed, populist in nature and enacted in an environment of political pressure that does not facilitate careful consideration of its unintended consequences.[278]

Such post-crisis legislation is heavily influenced by the specific post-crisis political and economic environment as regulators have to respond to a crisis quickly and effectively. For example, a need for regulatory action may present itself because of a major financial crisis or a high-profile securities fraud case in which it is clear that the existing regulatory regime was inadequate. In these circumstances of political and economic urgency and pressure on regulators to act, cost benefit analysis provides an efficient regulatory tool for a measured response and a more rational decision-making process and balanced approach. By conducting a cost benefit analysis of a specific regulatory solution, regulators or agencies "force themselves to quantify risks and reduce the likelihood that cognitive biases will negatively affect regulatory efforts. Cost-benefit analysis thus helps bring to light potential unintended consequences that may result from a particular regulatory action."[279] Cost benefit analysis is designed to solve the problem of hasty regulation that fails to achieve its goals or imposes costs that outweigh its benefits.[280]

Additionally, "cost benefit analysis helps promote rational decision-making by focusing regulators on the need to properly allocate their supervisory and enforcement resources."[281] Regulators must ensure not merely that their regulations provide benefits and justify the costs, but also that they make the most efficient use of their limited resources. In practice, regulators address this task by evaluating regulatory alternatives and ensuring that the most efficient alternative is in place, both from the perspective of the rule's impact on society and the economy and from the perspective of the regulator's own resources, supervisory and enforcement capabilities.[282]

In essence, if a regulator or agency can produce similar regulatory outcomes in multiple ways, they should choose the one that does so at the least cost to society and to the regulator

[276] *Id.*
[277] *Id.*
[278] *See* Bainbridge, *supra* note 125.
[279] *See* Sunstein, *supra* note 209.
[280] I*d.*
[281] *Id.*
[282] *Id.*

itself.[283] Without some form of cost benefit analysis, the regulator has no grounds for making such a decision or regulatory choice. For this reason, the OMB's cost benefit analysis guidelines require regulators and agencies to "compare leading alternatives to the regulator's chosen regulatory solution, including the option of not regulating at all."[284] This process of comparison is critical to efficient regulation and resource allocation.[285] It ensures that the proposed regulatory action reflects the best and most efficient course of action.

In the words of Professor Sunstein, "By requiring regulators to account for and attempt to quantify the anticipated costs and benefits of the rules they promulgate, cost benefit analysis increases the likelihood that rules will take into account all relevant considerations, produce net positive outcomes, protect and enhance agency legitimacy, avoid unintended consequences, and distribute resources efficiently."[286]

Furthermore, the use of cost benefit analysis as a regulatory tool also promotes good governance and democratic accountability. Proper cost benefit analysis reveals to the public the decision making process by which regulators adopt rules. In the words of Professor Posner, "cost benefit analysis opens the decision-making process to public comment and thus encourages the regulatory agency to consider the view of experts outside of the agency and helps mitigate the likelihood of agency capture."[287] Cost benefit analysis when used properly, simply enhances governmental accountability, transparency and legitimacy of the proposed regulatory action.

Among the stated goals of Executive Order 12,866 as discussed above, is "to make the regulatory process more accessible and open to the public."[288] Cost benefit analysis helps bring transparency to the regulatory process in several ways. At the most fundamental level it requires a regulator or agency to formally present and quantify its rulemaking reasoning process.[289] This process reveals what aspects of a regulatory problem the regulator or agency have taken into account and how they address the costs and benefits of a proposed regulatory action. It opens up the rulemaking process to public scrutiny.[290] Cost benefit analysis provides a significant "check" by requiring the regulator or agency to disclose the factors or considerations that underlie their analysis and regulatory decision making. If interest-group pressure has distorted the regulators' or agency's calculations, discretion or consideration of costs and benefits of a specific regulatory proposal, the analysis is likely to reflect such influence and provide Congress, the president, the courts, and the public at large with an opportunity to demand corrections.[291] It is a major tool to monitor and control regulators and agencies in their rulemaking activities.

Another benefit of cost benefit analysis in terms of good governance is that it "leverages the technical expertise of the regulatory agencies and, applies it in a neutral fashion to a

[283] *See* Rose and Walker *supra* note 208.
[284] *Id.*
[285] *Id.*
[286] *See* Sunstein, *supra* note 209.
[287] *See* Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137, 1141 (2001).
[288] *See supra* note 225.
[289] *Id.*
[290] *Id.*
[291] *See* Posner and Weyl, *supra* note 18.

particular regulatory problem."[292] Cost benefit analysis "facilitates the exercise of this expertise by providing agencies a framework that insulates the agencies from powerful political pressures."[293] One way it does so is by "staying focused on the objective effects of the policy in question. It does not take political or interest group preferences into account."[294] The virtue of cost benefit is that "it brings an agency's assumptions and calculations into the light, where interested parties can raise objections, challenge the regulatory action and demand improvements."[295] Additionally, as financial markets and their regulations increase in complexity, regulatory agency expertise, and cost benefit analysis methodologies that facilitate and leverage the exercise of this expertise, become more important and play a critical role in the rulemaking process. Since cost benefit analysis provides a methodology to capture all the costs that can be captured in the rulemaking process, it enables regulators to determine the best course of action.

As Professor Henry Manne recently argued in an article on cost benefit analysis in SEC rulemaking, "cost benefit analysis provides an analytical template for the consideration of any new rule."[296] Regulators will therefore be forced to "give adequate consideration to a variety of significant economic questions that it now regularly sloughs off or to which it simply assumes the answer, by making real-world quantitative comparisons."[297] This analysis provides some form of assurance that regulators will not adopt economically harmful rules. Importantly, cost benefit analysis would also serve a democratic function by making "the discussion of new regulations more open to truly informed community comment as opposed to special-interest pleading. Third parties will know that their comments will be examined by sensible and knowledgeable experts and not bureaucrats interested mainly in the political implications of a new proposal."[298]

In March 2012, the SEC responded to the criticism from the D.C. Circuit, Congress, and its own Inspector General by issuing a Guidance Memorandum outlining a new agency approach to cost benefit analysis in the context of financial rulemaking. Affirming that "high-quality economic analysis is an essential part of SEC rulemaking" and that the SEC "has long recognized that a rule's potential benefits and costs should be considered" in its rulemaking, the memorandum provides specific advice for conducting cost benefit analysis and clarifies that it should be performed in every economic analysis of rulemaking.[299] The SEC's Guidance Memorandum explains that the use of cost benefit analysis in the rulemaking process "ensures that decisions to propose and adopt rules are informed by the best available evidence about a

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[292] *See* John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*,96 COLUM. L. REV. 612, 680-81, 686-90 (1996).

[293] *Id.*

[294] *See* Julie G. Yap, *Just Keep Swimming: Guiding Environmental Stewardship Out of the Riptide of National Security*, 73 Fordham L. Rev. 1289, 1326 (2004). ("This method subjects the government to greater public accountability because the equation is both objective and easy to understand.").

[295] *See* Adler and Posner, *supra* note 21.

[296] *See* Henry G. Manne, *Will the SEC's New Embrace of Cost-Benefit Analysis Be a Watershed Moment?*, 35 Regulation 20, 22 (2012).

[297] *Id.*

[298] *Id.*

[299] See SEC Division of Risk, Strategy and Financial Innovation and SEC Office of the General Counsel, Current Guidance on Economic Analysis in SEC Rulemaking 1, 4 (Mar. 16, 2012), available at http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

rule's likely consequences," and that "economic analysis allows the Commission to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule."[300] The SEC thus recognizes cost benefit analysis as "an important balancing tool for potentially harmful regulation and that effective cost benefit analysis provides a means of protecting against negative unintended consequences of proposed regulatory actions."[301]

CFTC Commissioner Scott O'Malia describes cost benefit analysis as "one of the principle ways in which the CFTC can improve its rulemaking and protect against potential regulatory abuses."[302] He further explains that "the failure to produce a rigorous cost benefit analysis hurts the credibility of this Commission and undermines the quality of our rules."[303] In the words of Professors Rose and Walker[304], "opponents of cost benefit analysis argue that careful, rule-by-rule economic analysis makes it difficult for agencies to create rules, but that is precisely the point: it requires regulators to engage in a transparent, rigorous process that, as President Obama has stated, includes more input from experts, businesses and ordinary citizens."[305] They further explain that "regulating through a careful, focused process, which includes an analysis of the costs and benefits of a particular regulation, will naturally be more time-consuming than hastily pushing through regulations without making the effort to understand their costs, benefits, and effects. However, as President Obama has argued, the resulting rules will be more affordable, less intrusive, more effective, and the product of a more democratic process."[306] Clearly, rather than viewing cost benefit analysis as preventing regulation and slowing down the rulemaking process, rigorous cost benefit analysis creates confidence in the ability of regulators to craft effective and appropriate regulatory solutions to specific market problems.[307]

Professor Cass Sunstein explains that when President Obama was elected, "critics of cost benefit analysis hoped he would jettison it. But rather than doing so, the administration doubled down on cost benefit analysis. First, Obama made an unprecedented commitment to quantification of both costs and benefits. Second, he ordered executive agencies to review all significant rules on the books, largely with the goal of eliminating or streamlining excessive requirements."[308] Professor Sunstein further notes that "the application of rigorous cost benefit analysis deterred agencies from proceeding with rules that promise to impose big economic burdens without corresponding gains."[309] He concludes that "at a time when effective regulation of financial markets is as important and pressing as ever, it is essential not only that regulatory

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[300] *Id.*
[301] *Id.*
[302] *See* Scott D. O'Malia, CFTC Commissioner, Unreasonably Feeble, Opening Statement Regarding Open Meeting on One Final Rule and One Proposed Rule (Feb. 23, 2012), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement022312.
[303] *Id.*
[304] *See* Rose and Walker *supra* note 208.
[305] *See* Barack Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17.
[306] *See* Rose and Walker *supra* note 208.
[307] *Id.*
[308] *See* Sunstein, *supra* note 22.
[309] *Id.*

efforts are appropriately measured and effective, but also that the public and regulated entities have confidence in the ability of regulators to address market problems."[310]

Cost benefit analysis in financial rulemaking has particular importance in the context of the Dodd-Frank Act that follows a "boom-bubble-bust regulate cycle of financial market regulation," and which Professor Larry Ribstein characterized as "bubble laws."[311] In the words of Professors Rose and Walker: "The need for cost benefit analysis is thus especially critical when implementing the Dodd-Frank Act to not only ensure a proper balance between costs and benefits, but also to provide an appropriate regulatory platform for long-term economic prosperity."[312] The scale and scope of Dodd-Frank regulations and the amount of financial rulemaking have made it critical for regulators to apply rigorous cost benefit analysis to the rulemaking process and ensure they adequately consider the effectiveness and consequences of their regulatory actions. Cost benefit analysis provides a regulatory tool designed to ensure that, despite the accelerated pace and amount of financial rulemaking, regulators will not cut corners but will engage in more rational decision-making, will produce better regulations, and will promote good governance.

In essence, from a policy perspective applying economic analysis to financial regulation is the only way of getting to the bottom of the issues regulators are trying to address. It improves the quality of regulation and increases the public confidence in the regulatory process. The following section of this paper will examine the Business Roundtable decision, the rigorous standard of review established by the D.C. Circuit and the SEC's experience in the D.C. Circuit over the past decade.

iii. D.C. CIRCUIT TRILOGY ON SEC COST BENEFIT ANALYSIS

Although the executive orders that require executive agencies to engage in cost benefit analysis have not been extended to independent financial regulators or agencies such as the SEC and CFTC, these financial regulators have statutory obligations under their respective organic statutes and the Administration Procedure Act that require these agencies to engage in cost benefit analysis during the rulemaking process.[313] Additionally, the D.C. Circuit in three major decisions addressed the issue of cost benefit analysis of financial regulation extensively. These decisions and particularly the Business Roundtable decision are the foundation for our analysis of the cost benefit aspects of Title IV's implementing rules and whether they are supported by the cost benefit analysis that would survive judicial scrutiny after Business Roundtable. Before we analyze the costs and benefits of Title IV's implementing rules and whether they are consistent with the standards set by the D.C. Circuit in Business Roundtable, it is worth pausing to consider the SEC experience in the D.C. Circuit over the last decade. In a trio of decisions, the D.C. Circuit has examined the SEC's rulemaking and defined new standards and boundaries for economic analysis of financial regulation and the use of cost benefit analysis in financial rulemaking. This part of the paper explores these decisions and their approach to the economic analysis of financial rulemaking.

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[310] *Id.*
[311] *See* Ribstein, *supra* note 131.
[312] *See* Rose and Walker *supra* note 208.
[313] *See supra* notes 219, 221 and 225.

The first instance indicating that the standard of review of financial regulation would be more rigorous than the one the financial regulatory agencies expected came in Chamber of Commerce v. SEC.[314] In Chamber of Commerce v. SEC, the rule at issue required that mutual fund boards of directors have no less than 75% independent directors and be chaired by an independent director. The D.C. Circuit rejected the U.S. Chamber of Commerce's challenge to the SEC's statutory authority to adopt these two requirements as well as the Chamber's primary challenges to the SEC's reasoning for adopting the rule.[315] The D.C. Circuit, however, agreed with the Chamber that "the SEC did violate the Administrative Procedure Act by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a proposed alternative to the independent chairman condition."[316]

In striking down the proposed rule for failure to conduct an adequate cost benefit analysis, the D.C. Circuit found that "failure to consider reasonable alternatives to the proposed regulatory action may be sufficient to invalidate the whole cost benefit analysis and therefore the rule itself."[317] The D.C. Circuit explained that under the Administrative Procedure Act's "arbitrary and capricious" standard, "the court must be sure the Commission has examined the relevant data and articulated a satisfactory explanation for its action including a rational connection between the facts found and the regulatory choice made."[318] The court further explained that a proposed rule is arbitrary and capricious if the relevant agency fails to consider factors under its organic statute and that the SEC's organic statute requires it to consider costs and stated that "the agency should consider whether the action will promote efficiency, competition, and capital formation."[319]

The D.C. Circuit further held that "the SEC need not conduct an independent empirical study to meet the reasoned decision-making mandate and that it need not provide a comprehensive explanation for discounting or rejecting empirical studies."[320] However, it must "apprise itself—and hence the public and Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure and adequately consider non-frivolous alternatives to the proposed regulation."[321] Specifically, the D.C. Circuit blamed the SEC for failing to consider the costs of compliance that the mutual funds would suffer and found "incredible" the SEC's claim that it had no "'reliable basis for determining how funds would choose to satisfy the condition and therefore it was difficult to determine the costs associated with electing independent directors."[322] It is interesting to note that on remand, the SEC was able to quantify these costs in a matter of weeks. In the words of one commentator, "this rapid about-face must call into question the Commission's diligence with respect to cost benefit analysis before Chamber of Commerce v. SEC forced it to take such analysis seriously."[323]

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[314] *See* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).
[315] *Id.*
[316] *Id.*
[317] *Id.*
[318] *Id.*
[319] *Id.*
[320] *Id.*
[321] *Id.*
[322] *Id.*
[323] *See* Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual*

In 2010, the D.C. Circuit continued with the same aggressive approach with regard to the economic analysis of financial regulation and the use of cost benefit analysis in financial rulemaking. In American Equity Investment Life Insurance v. SEC the rule at issue classified fixed indexed annuities as securities and therefore subject to federal securities laws.[324] The D.C. Circuit deferred to the SEC's interpretation of the federal securities law to classify fixed indexed annuities as securities, but it nevertheless vacated the rule because "the SEC failed to properly consider the effect of the rule upon efficiency, competition, and capital formation."[325] The D.C. Circuit faulted the SEC for a number of errors in its cost benefit analysis. First, the court found the SEC's consideration of "competition" inadequate, concluding that "the SEC purports to have analyzed the effect of the rule on competition, but does not disclose a reasoned basis for its conclusion that the rule would increase competition."[326] Second, and more importantly, the D.C. Circuit faulted the SEC's cost benefit analysis for failing to make any "finding on the existing level of competition in the marketplace under the state law regime."[327] It similarly faulted the SEC with respect to its efficiency analysis as "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors."[328] This criticism as to the SEC's failure to consider the status quo goes to a fundamental principle of cost benefit analysis which is "the need to define a baseline."[329] The D.C. Circuit explained that "without an established baseline, a regulatory agency cannot truly consider the costs and benefits of the proposed regulation over the status quo, much less compare the proposed regulation with other potential alternative regulatory approaches (or no regulation at all)."[330] In other words, "without an empirical baseline, the SEC's assertion, even if based on common sense economic theory, was baseless because it was grounded on speculation alone". [331]

The leading decision on the SEC's use of cost benefit analysis in financial rulemaking is Business Roundtable.[332] In Business Roundtable, the rule at issue was the proxy access rule, which required public companies to provide shareholders with information about, and their ability to vote for, shareholder-nominated candidates for the board of directors by including in the companies' proxy materials the names of any person nominated by a qualifying shareholder for election to the board of directors.[333] The D.C. Circuit vacated the rule based on a number of criticisms of the agency's cost benefit analysis. Similar to its approach in Chamber of Commerce and American Equity Investment, the D.C. Circuit pointed out several steps the SEC had failed to take in the cost benefit analysis. In particular, the court faulted the SEC for "discounting the costs of the proposed rule—but not the benefits—as a mere artifact of the state law right of shareholders to elect directors."[334] In the words of the D.C. Circuit "this is a fundamental error in

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Fund Reform Effort, 12 Stan. J.L. Bus. & Fin. 1, 17 (2006).
[324] *See* American Equity Investment Life Insurance. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010).
[325] *Id.*
[326] *Id.*
[327] *Id.*
[328] *Id.*
[329] *Id.*
[330] *Id.*
[331] *Id.*
[332] *See supra* note 9.
[333] *Id. See* also *supra* note 11.
[334] *Id.*

cost benefit analysis: to only discount for the costs of the existing state law but not even attempt to estimate and discount the benefits of state law”.[335]

The D.C. Circuit reiterated its discussion in Chamber of Commerce that “this type of reasoning, which fails to view a cost at the margin, is illogical and, in an economic analysis, unacceptable.”[336] It further held that the SEC had not “sufficiently examined the relevant data and articulated a satisfactory explanation for its action including a rational connection between the facts found and the choices made”.[337] The D.C. Circuit, however, went beyond its approach in previous cases to actually re-define the cost benefit analysis standards. The court criticized the SEC’s extensive review of the empirical evidence and reached its own conclusion that “the evidence the SEC had relied on was not enough to justify the rule”[338] In the words of judge Ginsburg:

> “In view of the admittedly (and at best) “mixed” empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.”[339]

The D.C. Circuit eventually vacated the rule on the basis that the SEC “failed adequately to consider the rule’s effect upon efficiency, competition and capital formation.”[340] It further concluded that “a cost benefit analysis characterized with such faults rendered the rule arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law”.[341] This approach to judicial review of the SEC’s financial rulemaking appears much more rigorous than the one the D.C. Circuit traditionally applied in other agency cases. Indeed, in a subsequent decision, the D.C. Circuit emphasized that the “evidentiary problem in *Business Roundtable* was not limited to the agency’s insufficient treatment of any one study,” but “it was the agency’s larger failure to deal with the weight of the evidence against it.”[342] Ultimately, the court clarified that “an agency’s action is arbitrary and capricious if it entirely failed to consider an important aspect of the problem or offered an explanation for its decision that runs counter to the evidence before the agency.”[343]

Business Roundtable has become one of the most important financial regulation decisions since cost benefit analysis was developed in the early 1970s by holding financial regulators strictly accountable for the quality of their cost benefit analysis.[344] It established a far more rigorous standard of review than the one the financial regulators had previously used. The decision appears to require courts to “police the quality of regulators cost benefit analysis and directs judges to look more closely at the analysis to determine whether the relevant regulator

[335] *Id.*
[336] *Id.*
[337] *Id.*
[338] *Id.*
[339] *Id.*
[340] *Id.*
[341] *Id.*
[342] *See* Am. Petroleum Inst. v. EPA, 684 F.3d 1342, 1351 (D.C. Cir. 2012).
[343] *Id.*
[344] *See* Fisch, *supra* note 17.

has adequately considered and ascertained the rule's costs and benefits based on all the alternatives available."[345]

The decision in Business Roundtable is also significant as it was the first challenge of a rule adopted under the Dodd-Frank Act, based on the implementing agency's failure to perform an adequate cost benefit analysis.[346] It also represents a turning point indicative of an unprecedented level of judicial scrutiny of financial regulation, forcing the SEC and other regulators poised to issue rules and regulations under the Dodd-Frank Act, to take a whole new approach to their rulemaking process.[347] Despite extensive criticism, the decision appears to have mandated more demanding and strict standards of judicial review of the cost benefit analysis of financial regulation.[348] Depending on one's view, such a powerful approach or filter of financial regulation could either "further ossify the financial rulemaking process[349] or make the rules that emerge from the process more rational, efficient, and transparent."[350] The following section of this paper will examine the SEC response to the Business Roundtable decision and the Cost Benefit Analysis Guidance Memorandum issued on March 16, 2012.[351]

iv. SEC RESPONSE: 2012 COST BENEFIT ANALYSIS GUIDANCE MEMORANDUM

Less than a year after the D.C. Circuit issued the Business Roundtable decision, the SEC released its Guidance Memorandum on the use of cost benefit analysis in financial rulemaking, embracing the cost benefit analysis fundamentals set forth in the D.C. Circuit's trilogy discussed above.[352] These principles are briefly discussed below:

a) Define the Baseline

The SEC proposed that a major step in its cost benefit analysis of financial regulation is to "define the baseline against which to measure the proposed rule's economic impact."[353] The SEC explained that "the baseline serves as a primary point of comparison because an economic analysis of a proposed regulatory action compares the current state of the world to the expected state of the world with the proposed regulation (or regulatory alternatives) in effect."[354] The SEC also noted the American Equity Investment decision and its conclusion that "the SEC's analysis was inadequate because it did not measure the rule's likely effect on efficiency, competition, and capital formation against a baseline that included the existing level of those economic factors."[355]

b) Identify and Discuss Reasonable Alternatives to the Proposed Rule

[345] *See* Posner and Weyl, *supra* note 18.
[346] *Id*.
[347] *See* Holzer, *supra* note 19.
[348] *See* Posner and Weyl, *supra* note 18.
[349] *See supra* note 20.
[350] *See* Adler & Posner, *supra* note 21.
[351] See *supra* note 299.
[352] *Id*.
[353] *Id.*
[354] *Id.*
[355] *Id.*

The SEC Guidance Memorandum also proposed that the SEC's approach to cost benefit analysis must "identify and discuss reasonable alternatives to the proposed rule."[356] The SEC further explained that "the release should identify a range of regulatory alternatives to the approach in the proposed rule in order to make the best regulatory choice," and it quotes the D.C. Circuit's decision in Chamber of Commerce for the proposition that "only reasonable alternatives must be considered: Such alternatives include those that are 'neither frivolous nor out of bounds."[357]

c) Identify Relevant Benefits and Costs

The SEC Guidance Memorandum also underscores that the release must "identify relevant benefits and costs" and then provides a nonexhaustive list of potential benefits and costs.[358] Although the SEC does not specifically cite the D.C. Circuit for this principle, the Guidance Memorandum seems to respond to the Chamber of Commerce decision (failure to consider certain costs) and the American Equity Investments decision (failure to provide a reasoned basis for consideration of a statutory factor). Later in the Guidance Memorandum, the SEC expressly notes that "the release should integrate the cost benefit analysis section with its analysis of the factors set forth in the statute— efficiency, competition, and capital formation."[359]

d) Attempt to Quantify Costs and Benefits and Provide an Explanation in Case Quantification is Not Possible

The Guidance Memorandum also underscores that the SEC should "quantify expected benefits and costs to the extent feasible" and that "if not reasonably feasible, the release should include an explanation of the reasons why quantification is not practicable and include a qualitative analysis of the likely economic consequences of the proposed rule and reasonable regulatory alternatives."[360] This principle is consistent with the D.C. Circuit's decisions in Chamber of Commerce and Business Roundtable and the notion that "the SEC must attempt to quantify anticipated costs and benefits, even where the available data is imperfect and where doing so may require using estimates."[361]

e) Frame Costs and Benefits Neutrally and Consistently

The Guidance Memorandum directly responds to the D.C. Circuit's criticism in Business Roundtable that "the SEC had opportunistically and inconsistently framed the costs and benefits of the proposed rule."[362] It explains that "the release should evaluate the costs and benefits even-handedly and candidly, acknowledging any limitations in the data or quantifiable information. To the extent that the release discusses scenarios that might mitigate the costs or enhance the

[356] *Id.*
[357] *Id.*
[358] *Id.*
[359] *Id.*
[360] *Id.*
[361] *Id.*
[362] *Id.*

benefits, consider and discuss the impact that those scenarios would have on both the costs and the benefits."[363]

f) Shift of Cost Benefit Analysis from Lawyers to Economists

Finally, the SEC also responded to the D.C. Circuit's more general criticism that the SEC should conduct sound empirical analysis that includes proper cost benefit analysis. At the end of the Guidance Memorandum, the SEC includes a separate section titled "Enhanced integration of economic analysis into the rulemaking process and rule releases."[364] Among other things, this section of the Guidance Memorandum underscores that economists from the SEC's Division of Risk, Strategy, and Financial Innovation (RSFI) "should be fully integrated members of the rule-writing team, and contribute to all elements of the rule-writing process."[365] The Guidance Memorandum also goes further and emphasizes that economists—and not just legal professionals —should be heavily involved in all stages of the agency's cost benefit and other economic analysis in rulemaking. In summary, although the SEC's course of action is one that other financial regulators can learn from and should follow, it still remains to be seen whether the SEC will put its Guidance Memorandum into practice in a way that is consistent with the Business Roundtable decision. The following section of the paper will examine the political economy of financial regulation following the D.C. Circuit's decision in Business Roundtable. It will discuss how the rigorous cost benefit analysis standards established in the Business Roundtable decision may affect the political economy of financial regulation and how actors in the political economy of financial rulemaking may respond to the Business Roundtable decision. We will then look more specifically at Title IV of the Dodd-Frank Act and its implementing rules and examine whether they are supported by an adequate cost benefit analysis consistent with the Business Roundtable decision.

V. THE IMPACT OF THE BUSINESS ROUNDTABLE DECISION ON THE POLITICAL ECONOMY OF FINANCIAL REGULATION

We now turn to the impact of the Business Roundtable decision and the rigorous standard of judicial review of the cost benefit analysis of financial regulations on the political economy of financial rulemaking. The most immediate and apparent effect has been to increase the expected administrative and litigation costs of financial rulemaking and in essence, to slow down the rulemaking process, given the scope and nature of the cost benefit analysis regulators and agencies have to go through. This impact is most obvious in the context of the rulemaking process to implement the Dodd-Frank Act.[366] By changing the costs and benefits of the cost benefit analysis process itself, the Business Roundtable decision has actually created incentives for different actors in the political economy of financial rulemaking to react in different ways. This part of the paper analyzes how various actors in the political economy of financial rulemaking may react to the Business Roundtable decision and the rigorous standard of review

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363 *Id.*
364 *Id.*
365 *Id.*
366 *See* Steven Sloan, *Cost-Benefit Analysis Puts the Brakes on Dodd-Frank*, Bloomberg (May 7, 2012), http://www.bloomberg.com/news/2012-05-07/cost-benefitanalysis-puts-the-brakes-on-dodd-frank.html.

established by the D.C. Circuit as well as how these reactions could lead to a wide range of outcomes. Those key categories of actors are the financial industry, financial regulators, Congress and the Supreme Court.

The Financial Industry

The financial industry has already responded to the Business Roundtable decision by emphasizing the focus on regulators' and agencies' compliance with the cost benefit analysis requirements in its comment letters on proposed regulations as well as by filing lawsuits seeking to challenge different rules and regulations based on their failure to perform an adequate cost benefit analysis, consistent with the Business Roundtable decision. It is interesting to note that within just a few months after the Business Roundtable decision, two major financial trade organizations filed legal action seeking to challenge a rule issued under the Dodd-Frank Act, on the ground that it should be vacated because the CFTC had failed to perform an adequate cost benefit analysis.[367] Additionally, a few other major financial trade organizations submitted a comment letter seeking to challenge the quality of the cost benefit analysis review in connection with the proposed regulations implementing the Volcker Rule.[368] In this Comment Letter, these financial organizations actually threatened to "challenge the proposed regulations implementing the Volcker Rule unless the appropriate financial regulatory agencies review and re-submit the proposed regulations after performing a rigorous cost benefit analysis of the proposed regulatory actions.[369]

The Business Roundtable decision clearly sets the foundation for effective challenges to a regulators' or agencies' rulemaking process. During the notice-and-comment period, Business Roundtable actually gives opponents of a particular rule or regulation an incentive to submit detailed comments identifying a wide range of costs—particularly costs that will be difficult for the agency or regulator to quantify and rebut. The financial industry, with its extensive resources and financial expertise, for example, can submit such comments in order to increase the costs incurred by the agency to research and address the comments, and eventually defend itself in court. Given the D.C. Circuit's rigorous standard of review and willingness to intervene and actually second-guess an agency's review of conflicting studies in the Business Roundtable decision, the financial industry is likely to include data, empirical analyses, research and expert witnesses that undercut any unfounded arguments, assumptions, research or reasoning upon which an agency tries to rely on in adopting the proposed rule. By holding regulators and agencies to a much higher standard of review, Business Roundtable actually gives the financial industry a strategic tool to challenge proposed rules the industry considers unfavorable. Business Roundtable in essence provides the industry with an incentive to raise every aspect of the cost

[367] *See* International Swaps & Derivatives Associations v. CFTC, No. 11-1469 (D.C. Cir. Dec 2, 2011) ("challenging a rule issued by the CFTC under the Dodd-Frank Act to impose position limits on swap dealers based in part on failure to perform an adequate cost benefit analysis as required by the organic statute and the Business Roundtable decision").

[368] *See* Comment Letter from Sec. Indus. & Fin. Mkts. Ass'n, Am. Bankers Ass'n, Fin. Servs. Roundtable & The Clearing House Ass'n, to CFTC et al. concerning CFTC RIN 3083-AC et al., Annex C-4 to C-12 (Feb. 13, 2012), http://www.sec.gov/comments/s7-41-11/s74111-210.pdf.

[369] *Id*. *See* also *supra* note 169.

benefit analysis that might be poorly reasoned, insufficiently supported, or procedurally defective because even the smallest flaw could lead to the rule being vacated.[370]

The Business Roundtable decision both reduced the cost and increased the benefits of challenges or attempts to challenge financial regulations. It reduced the costs to challengers by effectively shifting the burden of proof onto the financial regulators or agencies to demonstrate that the quality of their cost benefit analysis satisfies the relevant statutory mandate and is consistent with the D.C. Circuit rigorous standards of review in Business Roundtable.[371] Instead of having to handle the burden of proving that an agency's cost benefit analysis is inadequate, challengers only have to raise sufficient doubt about whether the agency satisfied its burden of proof or considered all the relevant factors.[372] Business Roundtable has clearly increased the likely benefits from such litigation or potential challenges to proposed rules. Through holding regulators or agencies strictly accountable for the quality and standards of their cost benefit analysis reviews, challengers can expect agencies to respond by creating rules that are most narrowly tailored to the regulatory goal and least burdensome on the financial industry, the public and the economy as a whole.[373] This process is very much in line with the language of the executive orders discussed above,[374] ensuring that regulators and agencies actually consider the effectiveness and consequences of their regulatory actions, determine the best course of action and propose rules that produce a net positive effect and are based on a rigorous cost benefit analysis and economic justification. Business Roundtable, and its unprecedented level of judicial scrutiny of financial regulation, also provide a powerful incentive for the financial industry to lobby for more statutory cost benefit analysis mandates. The industry is likely to encourage Congress to enact statutes imposing cost benefit analysis mandates on all financial regulations, particularly now given the implementation of the Dodd-Frank Act.

Financial Regulators

The immediate effect of the Business Roundtable decision is that the financial regulators or agencies may not be able to adopt as many rules and regulations with their current resources. This new cost benefit analysis environment may drive up the costs of the rulemaking process for a couple of reasons. First, the cost of defending rules and regulations in court on cost benefit analysis grounds will become a major administrative cost for financial regulators and agencies. Second, the threat of litigation seeking to challenge and vacate the proposed rules over inadequate cost benefit analysis grounds may become a strong incentive for financial regulators or agencies to spend more time, money and resources in the rulemaking process, conducting more rigorous cost benefit analysis in order to minimize the risk of the rule being challenged or vacated. To avoid the risk of litigation or vacating the proposed rule, regulators or agencies may need to devote more resources to each rulemaking. They may need to hire more economists, or redirect economists already on their staffs and utilize their resources more efficiently in order to improve the quality of their cost benefit analysis and survive judicial scrutiny in a post-Business

[370] *See* Fisch, *supra* note 17.
[371] *See* Rose and Walker *supra* note 208.
[372] *See* Guynn, *supra* note 217.
[373] *See* Rose and Walker, supra note 208.
[374] *See supra* notes 219 and 221.

Roundtable environment.[375] As the rulemaking process is extremely expensive and time consuming, it is expected that agencies and regulators will reduce the number of rules and regulations they adopt. If rulemaking is mandated, as in the case of the Dodd-Frank Act, regulators and agencies are likely to continue to miss deadlines or adopt as few rules as possible, which to some extent defeats the purpose of the whole financial regulatory reform of the Dodd-Frank Act.

Also, it is anticipated that the pace of agency rulemaking procedures will be significantly reduced or slowed down. There is already evidence indicating that the financial regulatory agencies have slowed down the process of issuing rules under the Dodd-Frank Act as a result of the Business Roundtable decision.[376] Clearly, financial regulators and agencies are affected and to some extent pressured by the Business Roundtable decision and the requirement to improve their cost benefit analysis system. As former CFTC Commissioner Bart Chilton explained, "some regulators live in constant fear and are virtually paralyzed by the threat of spuriously filed lawsuits focusing on agency cost benefit analysis."[377] He further explained that "whether challenges to agency rules and procedures are spurious or not, Business Roundtable will open a Pandora's box of challenges to financial regulations going forward. Rules currently in the pipeline will be delayed so regulators can revisit the cost benefit analysis portions of their proposed rules. Therefore, it is better for the agencies to delay a rule and salvage it by performing a sufficient cost benefit analysis than to risk having the rule overturned or vacated in court and begin the entire process over again."[378]

However, it is important to note that despite these implications of the Business Roundtable decision, these agency responses and changes to the political economy environment are overall a positive outcome of the Business Roundtable decision. Agencies and regulators will carefully consider the effectiveness and consequences of their regulatory actions, determine the best course of action and adopt the best rules, based on a rigorous cost benefit analysis and economic justification. This approach will enable them to reach the right regulatory solution, ensuring that the rules will be much more sharply crafted to address the problem to be remedied and are least burdensome to society and the economy as a whole. This also goes to the essence of cost benefit analysis as a fundamental regulatory tool which is to ensure a more rational decision making process, efficient regulatory actions and the best regulatory choices by regulators and agencies. The risk, however, is that certain areas that require regulation may be left unregulated or subject to inadequate regulations, given the slower pace, potential delays and higher cost of financial rulemaking in a post-Business Roundtable environment.

Still, if courts continue to hold regulators and agencies strictly accountable for the quality of their cost benefit analysis review, like in the Business Roundtable decision, regulatory

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[375] *See* Rose and Walker, *supra* note 208.

[376] The pace of rulemaking at the SEC has decreased by about half. SEC former Chairman Mary Shapiro has indicated that "many factors have caused their rulemaking process to slow down, but the cardinal explanatory factor for the hiatus is increased attention to cost benefit analysis." *See* Jesse Hamilton, Dodd-Frank Rules Slow at SEC After Cost Challenge, Bloomberg (Mar. 6, 2012), http://www.bloomberg.com/news/2012-03-06/dodd-frank-rules-slow-at-sec-after-court-cost-benefit-challenge.html.

[377] *See* Silla Brush, U.S. Regulators "Paralyzed" by Cost-Benefit Suits, Chilton Says, Bloomberg (Mar. 8, 2012), http://www.bloomberg.com/news/2012-03-08/u-s-regulatorsparalyzed-by-cost-benefit-suits-chilton-says.html.

[378] *Id.*

agencies are likely to continue to respond to the Business Roundtable decision by improving and enhancing the quality of their cost benefit analysis as well as their cost benefit analysis resources and capabilities. The goal would be to minimize the risk of challenges to the proposed rules and possibly having the rule struck down by the court. As a result, the quality of regulatory actions and their cost benefit backup is likely to improve, leading to much more rational, reasoned, least burdensome and economically efficient regulatory actions.

Case Study: Dodd-Frank Rulemaking - CFTC Positions Limit Rule

In December 2011, the International Swaps and Derivatives Association ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") filed a lawsuit against the CFTC, seeking to challenge the CFTC's Rule, adopted under the Dodd-Frank Act, imposing position limits on swap dealers. The complaint of ISDA focused mainly on the failure of the CFTC to perform an adequate cost benefit analysis, consistent with the standards of the Business Roundtable decision.[379] An opinion granting the plaintiffs' motion for summary judgment was granted by the U.S. District Court for the District of Columbia. The rule was "vacated for failure to conduct an adequate cost benefit analysis and remanded to the CFTC for revision."[380]

The Dodd-Frank Act granted the CFTC the power to create position limits for futures, options, and swaps.[381] The Notice of Proposed Rulemaking ("NPR") for the position limits rule included only a very short discussion of the costs and benefits of the proposed rule.[382] One of the Commissioners who voted in favor of the CFTC's rule stated that "no one has presented this agency any reliable economic analysis to support either the contention that excessive speculation is affecting the market we regulate or that position limits will prevent excessive speculation."[383] Commissioner Dunn further explained, his "fear is that position limits, at best a cure for a disease that does not exist, are a placebo for one that does. At worst, position limits may harm the very markets the CFTC is intending to protect."[384] The Commissioner further stated that he had "voted for the position limits rule solely on the assumption that the Dodd-Frank Act required the establishment of position limits irrespective of cost."[385]

In its efforts to challenge the proposed rule, ISDA alleged that "the Commission grossly misinterpreted its statutory authority by finding that Congress did not require the CFTC to prepare a cost benefit analysis for the rule.[386] ISDA alleged that "the Commodity Exchange Act, as amended by the Dodd-Frank Act, authorized the CFTC to establish position limits only if it first finds that they are necessary to diminish, eliminate, or prevent an undue and unnecessary

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[379] *See* Int'l Swaps & Derivatives Ass'n v. CFTC, 887 F. Supp. 2d 259, 269, 285 (D.D.C. 2012); *See* also *supra* note 367.
[380] *Id.*
[381] *See* Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626, 71,626 (Nov. 18, 2011); *See* also 7 U.S.C. § 6a(a)(1), 6a(a)(2)(A), 6a(a)(3)(B), 6a(a)(5) (Supp. V 2007–2012).
[382] *See* Disclosure for Asset-Backed Securities, 76 Fed. Reg. 4489, 4764 (Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 229, 232, 240, 249).
[383] *See* Transcript of Open Meeting on Two Final Rule Proposals Under the Dodd-Frank Act at 13, Commodity Futures Trading Comm'n (Oct. 18, 2011), http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_101811-trans.pdf.
[384] *Id.*
[385] *Id.*
[386] *Id.*

burden on interstate commerce caused by excessive speculation and are otherwise appropriate."[387] This is an important element of the ISDA's argument because without a cost benefit analysis mandate, the CFTC's alleged deficient or inadequate cost benefit analysis is irrelevant. The statutory language of the relevant provisions in the Dodd-Frank Act does not clearly require a cost benefit analysis and permits the CFTC to "adopt rules or regulations that are necessary or otherwise appropriate to accomplish its statutory mandate."[388] However, although these statutory provisions do not clearly require the CFTC to perform a cost benefit analysis in connection with its rulemaking, this statutory language is very similar and not less clear than the provisions in the Business Roundtable case that were actually interpreted by the D.C. Circuit to mandate a rigorous cost benefit analysis.

ISDA further argued that "the CFTC failed to conduct any substantial cost benefit analysis, much less the rigorous cost benefit analysis required by the Business Roundtable decision.[389] The most critical issue was "the Commission's repeated admission that its final rule lacked empirical evidence for many of the CFTC's assertions."[390] ISDA also argued that "rather than making a genuine effort to estimate the costs, the CFTC cited its own failure to obtain empirical data that would enable it to assess the impact of the Position Limits Rule."[391] It is important to note that the CFTC's cost benefit analysis requirements are far less demanding than the SEC's analysis was in Business Roundtable. Therefore, given that the CFTC's cost benefit analysis of the position limits rule was generally unsupported by adequate evidence, research or analysis, it seems likely to also fail under the standard of review established in Business Roundtable, which "will not credit or accept mere speculation that insufficiently supports an agency's position."[392] The CFTC in this case also engaged in some of the practices that the D.C. Circuit heavily criticized in the Business Roundtable decision. Although ISDA's complaint did not raise these rulemaking flaws, the CFTC "failed to make a good faith effort to quantify the consequences or costs of the rule on market participation or trading strategies."[393] ISDA's successful challenge to the position limits rule demonstrates the effectiveness of challenges to financial rulemaking on cost benefit analysis grounds in the post-Business Roundtable environment.

<u>Congress</u>

The Business Roundtable decision significantly impacts the incentives of lobbyists, political entrepreneurs and members of Congress. There are even strategies that legislative drafters can exploit or use to promote their agenda or interest as well as other purposes like,

[387] *Id.*
[388] *Id.*
[389] *See* Business Roundtable v. SEC, *supra* note 9.
[390] *See supra* notes 379, 381 and 382 (Position Limits) ("At this time, the Commission's data set does not allow the Commission to estimate the specific number of traders that could potentially be impacted by the limits on cash-settled contracts"); ("The Commission is unable to determine or estimate the number of entities that may need to alter their business strategies."); Id. (In discussing the analysis supporting the proposed swaps rule, the Commission stated that "its estimates of the number of affected participants for both spot-month and non-spot-month limits are based on data it currently has on futures, options, and the limited set of data it has on cleared swaps").
[391] *Id.*
[392] *See* Business Roundtable v. SEC, *supra* note 9.
[393] *See supra* notes 379, 381 and 382 (Position Limits).

budgeting, new cost benefit analysis mandates, statutory language, sunset provisions, and rulemaking conditions.[394] Both opponents and supporters of demanding or rigorous cost benefit analysis are likely to engage in strategic budgeting practices or behavior. The increased costs of the rulemaking process resulting from the Business Roundtable decision highlight the effectiveness of strategic budgeting. Republicans in control of the House "are currently trying to starve the ability of regulatory agencies to implement a range of programs and regulations including the Dodd-Frank Act."[395] Supporters of cost benefit analysis may try to increase fiscal pressure on regulatory agencies tasked with implementing the Dodd-Frank Act by reducing their budgets even further.

Business Roundtable highlights the importance of statutory cost benefit analysis mandates. Those who wish to "rationalize" the rulemaking process by driving up rulemaking costs will try to insert cost benefit analysis mandates into new legislation wherever possible. Supporters of cost benefit analysis have already succeeded in imposing cost benefit analysis mandates in the Dodd-Frank Act. For example, the Dodd-Frank Act created the CFPB. In Section 1022 of the Dodd-Frank Act, Congress explicitly required the CFPB to analyze each rule's costs and benefits to consumers, as well as each rule's expected broader economic impact.[396] Supporters of strict cost benefit analysis have tried to "pass blanket cost benefit analysis mandates to reach future and past rules promulgated by independent and executive agencies."[397] Bills proposing such mandates have already been introduced. For example, Senator Shelby introduced the Financial Regulatory Responsibility Act of 2011, which tried to impose rigorous prospective and retroactive cost benefit analysis requirements on all financial regulations.[398] Also, Senators Collins, Portman, and Warner introduced the Independent Agency Regulatory Analysis Act of 2012, which would "authorize the President to require independent financial regulatory agencies, other than the Federal Reserve and the Federal Open Market Committee (FOMC), to comply with the cost benefit analysis mandates applicable to executive agencies under existing Executive Orders."[399] In contrast, opponents of rigorous cost benefit analysis review are likely to try to reduce cost benefit analysis mandates given the strong position of the D.C. Circuit in the Business Roundtable decision. The Business Roundtable decision also gives both opponents and supporters of cost benefit analysis an incentive to fight over the precise language of cost benefit analysis mandates in the context of new legislation.

The hardest-line cost benefit analysis, which demands pure quantitative cost benefit analysis, will probably never prevail since even the strong proponents of cost benefit analysis and the Business Roundtable decision recognize that some costs and benefits associated with the adoption of a new rule cannot be accurately measured. However, supporters of cost benefit analysis would have an incentive to push for language that requires benefits to outweigh the costs of any proposed rule or regulation. Such language would strengthen the D.C. Circuit's holding in Business Roundtable and legislatively shift or allocate the burden of proof onto the regulators or agencies. Opponents of cost benefit analysis, however, would have an incentive to

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394 *See* Fisch *supra* note 17.

395 *See* Bevis Longstreth, Congress and the SEC's Starvation Diet, Huffington Post (Mar. 3, 2011), http://www.huffingtonpost. com/bevis-longstreth/sec-budget_b_830981.html.

396 *See supra* note 2.

397 *See* Fisch, *supra* note 17.

398 *See* Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (2011).

399 *See* Independent Agency Regulatory Analysis Act of 2012, S. 3468, 112th Cong. (2012).

push for vague or even uncertain language in cost benefit analysis mandates requiring that regulators or agencies merely "consider" costs. Vague language in cost benefit analysis mandates may expose the Business Roundtable decision to reversal by subsequent D.C. Circuit decisions or by the Supreme Court itself. Opponents could even try to legislatively reverse the Business Roundtable decision by introducing language shifting the burden of cost benefit analysis to parties challenging a final rule in court.

It is interesting to note that the Supreme Court has never actually addressed the proper scope of judicial review of financial regulation in the context of cost benefit analysis. The Business Roundtable decision presents the court with this opportunity. The D.C. Circuit review in the Business Roundtable decision was performed within the scope of the "arbitrary and capricious" standard of the Administrative Procedure Act,[400] but as discussed above, the court's review was much more rigorous and comprehensive than the traditional standard of review in previous cost benefit analysis cases. It remains to be seen, how the Supreme Court may handle this question as to the review function of the court beyond the Administrative Procedure Act. The following sections of the paper will discuss the costs and benefits of Title IV's implementing rules, whether they are in fact supported by the rigorous cost benefit analysis that would survive judicial scrutiny after the Business Roundtable decision and whether they represent an efficient reform that is consistent with the standard of review set by the D.C. Circuit.

vi. TITLE IV OF THE DODD-FRANK ACT AND COST BENEFIT ANALYSIS AFTER BUSINESS ROUNDTABLE

We now turn to examine the costs and benefits of Title IV's implementing rules and whether they : i) are in fact supported by the rigorous economic analysis that would survive judicial scrutiny after the Business Roundtable decision, ii) represent the best regulatory choice, and iii) represent a rational decision-making and efficient regulatory action that advance the public interest.

The following sections of this paper will demonstrate that Title IV's implementing rules do not represent a rational decision-making or the best regulatory choice in the context of private equity funds. These sections of the paper will further explain that the decision of the SEC to include private equity funds within the scope of the regulations and subject them to extensive SEC registration and reporting requirements is inadequate, unnecessarily costly, inconsistent with the intended purpose of the Dodd-Frank Act and its underlying economic theory of regulation, inefficient, too disclosure-focused, does not improve investor welfare, based on fundamental misconceptions as to the nature of private equity and does not properly address the risk of too much leverage. The rest of this paper will take the position that overall, Title IV and its implementing rules fail to achieve their intended goals and impose costs that exceed their benefits. Society and the economy do not gain enough from Title IV and its implementing rules to justify their costs.

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[400] *See supra* note 13.

The following sections of this paper will also demonstrate that Title IV's implementing rules do not meet the economic analysis and cost benefit justification standards set by the D.C. Circuit in the Business Roundtable decision. They will show that Title IV's implementing rules are not supported by i) any substantial cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable, and ii) any other compelling argument demonstrating that the benefits of Title IV are greater than its costs. This paper takes the position that the SEC, in implementing Title IV, had actually failed to perform an adequate cost benefit analysis, consistent with the Business Roundtable decision, and did not consider any regulatory alternatives or the impact of this legislation on efficiency, competition and capital formation. The SEC also failed to articulate a satisfactory and reasoned explanation for its regulatory actions, including a rational connection between the pre-crisis conduct and failures Title IV and its implementing rules were trying to address, in the context of private equity funds, and the regulatory choices made.

As this paper will show in Part IV, private equity funds pose minimal systemic risk to the financial system and present no threat to the financial stability of the financial system or the economy as a whole. No demonstrable market failure was ever identified in the context of the private equity industry to justify such regulatory intervention and broad regulations. Additionally, the SEC adopting releases provide no empirical academic literature or evidence to support any specific regulatory concern associated with the private equity sector and its pre-crisis conduct in the context of systemic risk and a potential financial crisis. The 2008 financial crisis had very little to do with private equity funds. Private equity funds did not cause the financial crisis and did not play any part in the credit crisis. They did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system and were simply not part of the problem or any market failure, unlike hedge funds. Therefore, private equity funds should have posed very little concern for regulators and policymakers seeking to develop a new regulatory regime to monitor systemic risk and guard against a future financial crisis.

The rest of this paper also demonstrates that like any traditional post-crisis reform legislation, Title IV and its implementing rules may have satisfied a political need, but they will not benefit the financial market or the economy as a whole, will not improve investor welfare and will not reduce the risks that private equity funds may pose to the financial system. I argue, instead, in the following sections of the paper, that since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', these funds and their advisers should be subject to a reduced and different regulatory regime and exempt from the SEC registration, reporting and disclosure requirements under Title IV of the Dodd-Frank Act. Reviewing the SEC adopting releases supports this position as nowhere in these adopting releases was there any discussion of any concerns or risks associated with private equity funds, and their pre-crisis conduct or any benefit to private equity investors or the financial system as a result of adopting these rules.

Part III(a) of this paper has already analyzed the legislative history of Title IV and its implementing rules and demonstrated that the focus of the legislative history and the implementing rules was clearly on hedge funds and the need to address the lack of transparency in the hedge fund sector and control the systemic risk associated with the activities of hedge funds.[401] The examination of the legislative history of Title IV and its implementing rules indicates very clearly that regulators were not at all concerned about private equity funds and not directly focused on the private equity sector when they analyzed the 2008 financial crisis and spoke against the systemic risk concerns of private investment funds. In the implementing rules, there was no empirical evidence, research or analysis discussed with regard to concerns associated with the private equity sector, failures or risks related to the private equity industry or the pre-crisis conduct of private equity funds. Also, there was no analysis or evidence to support or justify the need for this government intervention in the private equity sector, no reasoned explanation for the regulatory actions and no discussion of other regulatory alternatives. In other words, nowhere in the legislative history and particularly the SEC adopting releases was there any discussion about private equity funds. The activities targeted by regulators were only hedge funds.

This approach is inconsistent with the D.C. Circuit position in the Business Roundtable decision. The legislative history of Title IV and its implementing rules demonstrates that there was no credible cost benefit analysis performed in the rulemaking process in the context of the private equity sector, (and definitely not the rigorous economic analysis required by the D.C. Circuit in the Business Roundtable decision) as well as no consideration of alternatives to the selected regulatory choice. The rulemaking process by the SEC was deficient in terms of performing any adequate cost benefit analysis, analyzing the pre-crisis conduct of private equity funds, examining the relevant factors, articulating a reasoned explanation for the regulatory action, establishing the rational connection between the pre-crisis facts the SEC was trying to address and the regulatory choice made and recognizing that the private equity industry had very little to do with the 2008 financial crisis.

Additionally, as will be discussed in Part IV, this paper takes the position that there is no rational connection between the actual facts and the regularity choice made by the SEC as well as no benefit to society or the economy as a whole with respect to Title IV and its implementing rules. One of the primary objectives of the Dodd-frank Act is to control or reduce systemic risk in the financial system and enhance the stability of the financial system.[402] However, as Part IV of the paper demonstrates, private equity funds pose very minimal systemic risk to the financial system and present no threat to the financial stability of the financial system or the economy as a whole. No demonstrable market failure was ever identified in the context of the private equity industry to justify such regulatory intervention and broad regulations. Additionally, there is no empirical academic literature, study or evidence to support any specific regulatory concern associated with the private equity sector and its pre-crisis conduct in the context of systemic risk and a potential financial crisis. As discussed in Part IV of this paper, the 2008 financial crisis had very little to do with private equity funds. Private equity funds did not cause the financial crisis and did not play any part in the credit crisis. They did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system and were simply not part of the problem or any market failure, unlike hedge funds.[403] As Part IV of this paper demonstrates, private equity funds present none of the systemic risk factors that led to the financial crisis and thus should have posed very little concern for regulators and policymakers seeking to develop a

[401] *See supra* notes 4 and 171.
[402] *See* Acharya et al, *supra* note 1.
[403] *See* Posner, *supra* note 179.

new regulatory regime to monitor systemic risk and guard against a future financial crisis. Therefore, from the benefits side perspective, the notion of Title IV as a tool to reduce or control systemic risk and enhance financial stability is questionable, inefficient and does not justify the regulatory actions taken by the SEC.

From the benefits side perspective, Part III(d) of this paper will also challenge the disclosure based approach of Title IV and demonstrate its inefficiency. Using financial regulation like Title IV to protect investors through a disclosure model may be a worthy goal, but this goal, in the context of private equity funds, is clearly ineffective, unnecessary and inconsistent with fundamental principles of U.S. securities laws, which presume that investors in private equity funds, who are necessarily experienced, wealthy and have extensive resources to conduct their own due diligence or retain professional advisors, are able to protect themselves without any regulatory intervention. As discussed in Part II of this paper, private equity investors are usually large, sophisticated institutional investors, capable of identifying, obtaining and processing the information necessary to evaluate an investment opportunity and make an informed investment decision. Additionally, Title IV and its implementing rules require private equity funds to disclose extensive information that is already being provided to private equity investors by the funds voluntarily during the process of raising capital and on a regular basis. Therefore, Title IV, its implementing rules and their registration, reporting and increased disclosure requirements may be viewed as unwarranted and inefficient to the extent that their purpose is to protect private equity investors who are already able to protect themselves. There is simply no additional benefit to investors as a result of Title IV’s implementing rules and their disclosure requirements.

Furthermore, from the cost side perspective, Part IV(d) of this paper demonstrates the failure of the SEC to recognize that private equity is a major driver of economic growth and innovation and plays a key role in the economic recovery of the U.S. Given the importance of private equity as a vital engine that helps drive the American economy, this paper takes the position that subjecting private equity funds to excessive and unnecessary regulatory requirements may jeopardize the nation’s economic growth and recovery and the role private equity funds play in the U.S. economy. Requiring private equity funds to register with the SEC under Title IV will needlessly divert capital, time and effort from productive investment activities that could be creating jobs and drive economic growth. It will simply impose an undue burden on private equity funds (particularly small and mid-size funds), drain their resources and diminish their ability to continue their investment activities at a critical time. Part IV(d) of this paper will show that rather than using their resources to invest in businesses and drive growth, private equity funds will have to use some of their resources to build the necessary compliance infrastructure and comply with the new regulatory regime that imposes tremendous costs, seeking to solve a non-existent problem, as discussed in Parts III and IV of this paper. Additionally, the total cost of compliance with Title IV, a factor that was not considered by regulators in the rulemaking process, for all new private equity funds may reduce returns to private equity investors such as endowments and pension funds and may also hurt the economy in the long run.

The following section of this paper will examine the underlying economic theory of regulation behind the Dodd-Frank Act and Title IV and whether it supports the regulation of private equity funds or any government intervention in the private equity sector.

C. THE DODD-FRANK ACT AND THE UNDERLYING ECONOMIC THEORY OF REGULATION

This part of the paper will examine Title IV of the Dodd-Frank Act in terms of the underlying economic theory of regulation and assess whether it addresses the market failures that led to the 2008 financial crisis and the relevant externalities. It will demonstrate that the economic theory of regulation underlying the Dodd-Frank Act and Title IV does not support the regulation of private equity funds or any government intervention in the private equity sector. This analysis will start with the concept of market failure which is central to regulatory theory and the economic analysis of financial regulation.[404]

The underlying economic theory of regulation behind the Dodd-Frank Act is very clear and its primary focus is on the market failures that led to the near collapse of the entire financial system in 2008.[405] In financial markets, market failure is one of the most important arguments for government regulatory intervention.[406] Regulators and policymakers are concerned with the causes of market failures and possible means of correction through government intervention.[407] Governments usually regulate where there is a market failure and financial regulation is very often the reaction to a market failure. For example, the corporate accounting scandals of the early 2000s resulted in Congress passing the Sarbanes-Oxley Act, creating a new regulatory environment for all public company boards, management and public accounting firms. The Securities Act of 1933 was a response to the stock market crash of 1929, which had precipitated the Great Depression. In the words of Professor Charles Whitehead, "new regulation seals up leaks in the financial system, usually following a crisis that threatens the stability of the financial system."[408] A leading policy analysis textbook by Professor David L. Weimar and Professor Aidan R. Vining asks: "when is it legitimate for government to intervene in private affairs? In the U.S., the normative answer to this question has usually been based on the concept of market failure – a circumstance where the pursuit of private interest does not lead to an efficient use of society's resources or a fair distribution of society's goods."[409] The market failure approach to regulation has become a tool by which policymakers and regulators learn how to objectively determine whether any government intervention is necessary and the exact scope and type of intervention necessary.

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[404] *See* Richard Posner, *Theories of Economic Regulation* (May 1974). Bell Journal of Economics, 1974, v5(2), 335-358. Available at SSRN: http://ssrn.com/abstract=259352.
[405] *See* Acharya et al, *supra* note 1.
[406] *See* Edward Balleisen & David Moss, *Government and Markets: Toward a New Theory of Regulation,* (New York: Cambridge University Press, 1st Ed. 2010).
[407] *See* Acharya et al, *supra* note 1.
[408] *See* Charles Whitehead, *Reframing Financial Regulation* (February 15, 2010). Boston University Law Review, Vol. 90, No. 1, 2010; Cornell Legal Studies Research Paper No. 09-026. Available at SSRN: http://ssrn.com/abstract=1447424.
[409] *See* David Weimar and Aidan Vining, *Policy Analysis; Concepts and Practice*, 2nd ed. Englewood Cliffs, N.J.: Prentice Hall, 1992.

Adam Smith argued that markets by themselves are efficient and that "in an ideal economic market individuals maximize the welfare of all simply by pursuing their own self-interest."[410] This argument has been used as the basis for "unfettered and unregulated markets and the era of free market capitalism."[411] However, history has shown us that the notion that markets can regulate themselves and lead to efficient outcomes without government intervention, has no theoretical or practical justification.[412] Without adequate regulation, markets usually fail to act in an efficient and stable manner or allocate their resources efficiently.[413] They fail to optimize social welfare and do not act in the way they are supposed to.[414] In the words of Professor Joseph Stiglitz, the Nobel prize-winning economist and former Chief Economist at the World Bank: "unfettered markets often fail and do not serve society well."[415]

Market failure is "the inability of an unregulated market to achieve allocative efficiency in all circumstances. In financial industries, market failure includes fraud, manipulation, deception, public loss of funds, and corporate collapse."[416] Market failure can occur due to externalities, market power (such as monopolies), asymmetric information, or common-pool resources/public goods. For example, without environmental regulation, a noisy factory might move next door to a residential area, adversely affecting property values.[417] Anti-trust laws are necessary to prevent the creation of monopolies and anti-competitive practices.[418] The sub-prime mortgage crisis would have been less severe had legislation or regulations to restrict predatory lending been adopted.[419] Therefore, when markets fail to produce efficient outcomes, there is a strong rationale for regulatory government intervention.

Professor Stiglitz argues that "nowhere are market failures more pervasive or more important, with such profound consequences for our economic system, than in the financial sector."[420] Over the past two hundred years, economic theory and financial history have demonstrated that "financial markets often fail to perform their key functions of managing risk and allocating capital well, with severe social and economic consequences."[421] These financial sector market failures are usually the most important justification for regulatory government intervention in the financial system.[422] These regulatory interventions can take different forms including: disclosure requirements, restrictions on incentive schemes, restrictions on ownership, restrictions on particular behaviors and taxes designed to induce appropriate behaviors.[423]

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[410] *See* Adam Smith, *An Inquiry into The Nature And Causes of the Wealth of Nations*, Chicago: University of Chicago Press, 1976 (originally published in 1776).
[411] *See* Balleisen and Moss, *supra* note 406.
[412] *See* Tyler Cowen, *The Theory of Market Failure*: *A Critical Examination*, (George Mason University Press, 1st Ed. 1988).
[413] *See* Balleisen and Moss, *supra* note 406.
[414] *See* Joseph Stiglitz, *"Regulation and Failure,"* in *New Perspectives on Regulation*, edited by David Moss and John Cisternino, Cambridge, Mass., The Tobin Project, 2009, p. 21.
[415] *Id.*
[416] *Id.*
[417] *See* Balleisen and Moss, *supra* note 406.
[418] *See* Stiglitz, *supra* note 414.
[419] *Id.*
[420] *Id*.
[421] *Id.*
[422] *See* Balleisen and Moss, *supra* note 406.
[423] *See* Stiglitz, *supra* note 414.

This theory of economic regulation is based on the idea that governments must step in to regulate financial markets in instances when "these markets are unable to regulate themselves or where the price mechanism that regulates supply and demand breaks down, forcing governments to take action."[424] In other words, under this theory, government regulation is necessary when markets fail to provide the information that individuals need to protect themselves from harm or to correct for the negative side effects of or externalities of business activity.[425] Therefore, regulatory intervention is critical if the public interest is to be protected and market failures are to be corrected. Regulating financial markets to correct market failures is sometimes referred to as the "public interest theory".[426]

The most common form of market failure, particularly in the context of the financial sector, is negative externalities.[427] An externality or a transaction spillover is "an economic side effect or the effects of an economic activity on unrelated third parties, which are not captured in the price of the activity."[428] It is a situation where an economic transaction imposes costs (or benefits) on individuals who are not parties to the transaction.[429] The classic example of a negative externality is pollution, in which the impact of a firm's industrial activity causes harm to those geographically proximate to the polluting firm.[430] Pollution is an unavoidable byproduct in many industries, and without proper regulation, most polluting companies will do very little to reduce their pollution levels due to the costs involved. Another example of negative externality is the systemic risk associated with a potential broad-based failure of the financial system.[431] In the words of Professor Stiglitz:

> "We have regulations designed to mitigate the extent of externalities. These include, for instance, zoning restrictions and environmental regulations. We have regulations designed to maintain competition (restrictions on anti-competitive practices), and to ensure that natural monopolies do not abuse their monopoly position (utilities regulations). We have a large set of regulations aimed at protecting consumers (ensuring that the banks where they deposit their money are sufficiently sound, that food and products are safe, or that they are not taken advantage of by unscrupulous merchants, advertising or lenders)."[432]

Professor Stiglitz further explains that "the recent financial crisis has highlighted the need for government intervention in the event of a failure of a systemically important institution, recognizing the existence of key externalities – the goal is to prevent the occurrence of these market failures in the future."[433] He further suggests that "one of the big failures that this financial crisis has exposed is that we allowed financial institutions to grow too big to fail. Not only may such large institutions be able to exploit market power, but they also pose systemic risk

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[424] *See* Posner, supra note 404.
[425] *See* Stiglitz, supra note 414.
[426] *See* Posner, supra note 404.
[427] *See* Acharya et al, *supra* note 1.
[428] *See* Balleisen and Moss, *supra* note 406.
[429] *Id.*
[430] *See* Daniel Kelly, *Strategic Spillovers* (September 3, 2010). Columbia Law Review, Vol. 111, No. 8, p. 1641, Available at SSRN: http://ssrn.com/abstract=1671692.
[431] *See* Stiglitz, *supra* note 414. The concept of "systemic risk" and its relationship to the private equity sector will be discussed in part IV of this paper.
[432] *Id.*
[433] *Id.*

to the economy and have perverse incentives which encourage such behavior. They know that if they undertake high risk activities and fail, the government will pick up the pieces, but if they succeed, they walk away with the gains".[434] It is these externalities which traditionally have been viewed as justifying regulatory intervention by the government in the financial sector. Financial regulations are designed primarily to remedy and mitigate the effect of these externalities or side effects and prevent a similar market failure in the future.

In the context of the 2008 financial crisis, the externality that led to the market failure and the near collapse of the financial system, was the enormous buildup and emergence of systemic risk in the financial system, specifically the risk that large financial institutions, funded with short-term debt would fail all at once and cause a credit crisis and a systemic-wide collapse, if there is a correction in the housing market.[435] The market failure here is that, although each financial institution may have been behaving optimally on an individual basis, the firms had no incentive to take into account the effect of their actions on the financial system as a whole.[436] As a result, their actions produced external costs on the overall financial system and a failure of major financial institutions and the economy as a whole.[437]

In the words of Professor Stiglitz: "the key market failure is that there is an important externality from the collapse of the financial system. Just like toxic wastes pollute the environment, America's toxic mortgages polluted the world's financial system."[438] These market failures do not always have clear solutions and much of modern financial regulation involves designing proper arrangements to remedy and mitigate the effects of these externalities. In the financial sector, the purpose of regulatory intervention is to manage systemic risk through regulation and requirements directed at individual firms and their behavior.[439] The 2008 financial crisis has clearly demonstrated the need for government intervention in the financial sector in the event of a failure of a systemically important institution.[440]

Like the regulatory reform of the 1930s or the adoption of the Sarbanes-Oxley Act, the Dodd-Frank Act was passed in response to the 2008 financial crisis and these market failures that caused the near-collapse of the financial system.[441] The Dodd-Frank Act is clearly well intended by focusing regulation for the first time on the negative externality of systemic risk in the financial sector.[442] Additionally, the legislation introduces major reforms in other areas of the financial system that failed and contributed to the financial crisis, like off-balance sheet financing, over-the-counter derivatives, rating agencies and mortgage underwriting.[443] Its primary purpose is to fix the negative externality of systemic risk in the financial industry, enhance financial stability, correct the market failures that led to the 2008 financial crisis and

[434] *Id.*
[435] *See* Acharya et al, *supra* note 1.
[436] *See* Posner, *supra* note 179.
[437] *Id.*
[438] *See* Stiglitz, supra note 414.
[439] *Id.*
[440] *See* Acharya et al, *supra* note 1.
[441] *See* David Skeel et al, *The New Financial Deal: Understanding the Dodd-Frank Act and its Unintended Consequences*, (John Wiley & Sons, 1st Ed. 2011).
[442] *Id.*
[443] *Id.*

reduce the likelihood of a future financial crisis.[444] The question however, is whether this underlying economic theory of regulation and the notion of market failure as a justification for regulatory intervention, support any government intervention in the private equity sector and are even relevant to the private equity industry and the pre-crisis activities of private equity funds.

i) TITLE IV AND THE MARKET FAILURE THEORY OF REGULATION

Viewed using the lens of this economic theory of regulation, this paper takes the position that the Dodd-Frank Act and Title IV do not address any market failure in the private equity sector. They impose substantial new reporting and compliance burdens on all private equity funds, not merely those large financial institutions whose risk-taking activities have been the primary concerns and causes of the market failures that led to the 2008 financial crisis.

As Part IV of this paper will demonstrate, an analysis of Title IV of the Dodd-Frank Act in terms of the economic theory of regulation seems to suggest that unlike other areas that spread systemic risk across the financial system (e.g. derivatives, lending practices), the theory does not apply to the private equity sector at all. It does not support the regulation of private equity funds or any government intervention in the private equity sector. No demonstrable market failure was identified during the financial crisis in the context of the private equity industry to justify such excessive regulatory intervention and broad registration and reporting requirements. Additionally, there is no empirical academic literature to support any direct involvement of the private equity sector in the 2008 financial crisis and any regulatory intervention in the private equity sector. The 2008 financial crisis had very little to do with private equity funds.[445] Private equity funds did not cause the financial crisis and did not play any part in the credit crisis. They did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system and were simply not part of the problem or any market failure.[446] As part IV of this paper will show, private equity funds present none of the systemic risk factors that Congress was concerned about and thus should pose very little concern for regulators and policymakers seeking to develop a new regulatory regime to monitor systemic risk and guard against a future market failure or financial crisis. Private equity funds and their activities prior to the crisis have not produced a convincing case of market failure that justifies government intervention in the private equity sector.

Title IV of the Dodd-Frank Act is clearly well intended by focusing regulation for the first time on systemic risk associated with the activities of private investment funds and the stability of the financial system. However, this paper takes the position that in the context of private equity funds, there is no market failure to correct nor is there any externality that has to be addressed by regulators. As private equity funds pose minimal systemic risk to the financial system, the case for the regulation of private equity funds under Title IV or for any government intervention in the private equity sector is very weak. The following section of this paper will examine Title IV's reliance on disclosure as the primary method of reducing systemic risk and protecting fund investors as well as the inconsistent treatment of private equity funds under Title IV.

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[444] *See* Acharya et al, *supra* note 1.
[445] *See* Posner, *supra* note 179.
[446] *See* Acharya, *supra* note 1.

D. TITLE IV AND ITS UNDERLYING DISCLOSURE-BASED APPROACH

As explained in Part II of this paper, Title IV of the Dodd-Frank Act sets out a major reform of the private investment fund industry and establishes a new framework for regulatory and supervisory oversight of private investment funds. It introduced extensive registration, reporting, disclosure and compliance requirements for private investment funds and their advisors. It requires that investment advisers to private equity funds, hedge funds and certain other funds with assets under management of $150 million or more register with the SEC, comply with certain SEC books, records and reporting requirements, and be subject to extensive periodic SEC examination, unless they qualify for specific exemptions.[447] This new regulatory regime and increased disclosure requirements are designed to bring transparency and oversight to the activities of private investment funds, protect investors, control the build-up of systemic risk in the financial system and address the market failures that led to the 2008 financial crisis.

Using financial regulation like Title IV to protect investors through a disclosure model may be a worthy goal, but this goal, in the context of private equity funds, is ineffective, unnecessary and inconsistent with fundamental principles of U.S. securities laws, which presume that investors in private equity funds, who are necessarily experienced, wealthy and have extensive resources to conduct their own due diligence or retain professional advisors, are able to protect themselves without any regulatory intervention.[448] As discussed in Part II of this paper, private equity investors are usually large, sophisticated institutional investors, capable of identifying, obtaining and processing the information necessary to evaluate an investment opportunity and make an informed investment decision. Additionally, Title IV requires private equity funds to disclose extensive information that is already being provided to private equity investors by the funds voluntarily during the process of raising capital and on a regular basis. Therefore, Title IV and its registration, reporting and increased disclosure requirements may be viewed as unwarranted and inefficient to the extent that their purpose is to protect private equity investors who are able to protect themselves.[449]

This Part of the paper will examine the disclosure philosophy of Title IV and whether it is an effective tool to regulate private equity funds and protect their investors. It will demonstrate that while the disclosure philosophy in general may offer major advantages for regulating securities and financial markets, the reliance of Title IV on this approach, in the context of private equity funds, is practically unnecessary, inefficient, falls short of achieving its purpose and does not contribute anything substantial to the protection of private equity investors who can “fend for themselves”. It is also unlikely to address the risk of excessive leverage which is practically the main risk that Congress was concerned about and perceived as being sufficiently serious to merit direct regulation. Before we examine the underlying disclosure philosophy of Title IV and its drawbacks, it is worth pausing to consider disclosure as the primary method of protecting investors and regulating securities and financial markets in the U.S.

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[447] *See supra* note 5.

[448] *See* Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission,* 2006 U. ILL. L. REv. 975, 991 (2006) ("[T]he notion that investors who can 'fend for themselves' do not need SEC protection is an animating principle of securities regulation that helps demarcate the appropriate boundary of SEC regulation across the federal securities laws.").

[449] *See* Vijay Sekhon, *Can the Rich Fend for Themselves? Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of2010,* 7 HASTINGS Bus. L.J. 1 (2011).

Disclosure is the primary method of protecting investors and regulating the securities and financial markets in the U.S. It has always been the central focus of securities and financial regulations and the regulatory solution to all of the securities market problems. It represents a minimalist form of government intervention and preserves investors' autonomy to make their own investment decisions. In the words of Professor Kathryn Judge, "disclosure is one of the most commonly used tools in financial regulation."[450] For the last eighty years, U.S. securities laws and financial regulations have consistently relied on a disclosure approach as the primary method for protecting investors and regulating securities and financial markets.[451] In the context of regulating these markets the disclosure of information is said to do "everything from producing more transparent and efficient markets, to making corporate executives behave more honestly and diligently, to decreasing investor risks and protecting the public interest. The main goal of the securities laws is to provide sufficient disclosure to enable investors to make informed decisions about the securities they buy and sell."[452] For example, the Securities Act of 1933 and the Securities Exchange Act of 1934 which were adopted following the 1929 stock market collapse are based on a philosophy of disclosure. The fundament goal of this legislation was to eliminate abuses, restore investor confidence and maintain the integrity of the capital markets. The primary method to achieve this goal was through a comprehensive disclosure system.[453] In other words, the goal is to require issuers of securities to fully disclose all material information that a reasonable investor would require in order to make an informed investment decision. So long as corporations disclosed all material information regarding their business and securities, investors could make their own investment decisions.[454]

Another example is the Sarbanes-Oxley Act which was adopted following the collapse of Enron and WorldCom and the corporate accounting scandals of the early 2000s. The goal of the Sarbanes-Oxley Act was "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws" or in other words to improve the disclosure of information about corporate activities and behavior to investors so they are better positioned to make informed investment decisions.[455]

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[450] *See* Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity and Systemic Risk* (January 24, 2012). Stanford Law Review, Forthcoming; Columbia Law and Economics Working Paper No. 406. Available at SSRN: http://ssrn.com/abstract=1894105.

[451] *See* Anne Khademian, *The SEC And Capital Market Regulation: The Politics of Expertise* 83 (1992) (noting that "disclosure-enforcement was the foundation of early securities regulation and remains the main premise of the SEC's regulatory activities today").

[452] *See* Susanna Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

[453] The legislative history of the federal securities laws makes clear that investor protection through disclosure is the main purpose of the laws: "The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; . . . to restore the confidence of the prospective investor in his ability to select sound securities . . . ." Regulation of Securities, S. REP. No. 73-47, at 1 (1933), *reprinted in* 2 Legislative History of The Securities Act of 1933 and Securities Exchange Act of 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

[454] *See* Ripken, *supra* note 452.

[455] The regulation of the stock market assumes that by disclosing all material information to investors, they can make informed and intelligent investment decisions. *See* Thomas Lee Hazen, *The Law of Securities Regulation* 22 (5th ed. 2005) (noting that "federal securities regulation assumes that the full and fair disclosure of all relevant aspects of securities allows investors to evaluate the merits of investments and to fend for themselves); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (describing the purpose of the securities laws as

Clearly, there are several rationales behind the disclosure-based system of regulation. First, a disclosure-based approach can cause corporate executives to behave more responsibly, honestly and ethically since they know that their actions and behavior will be exposed and subject to public scrutiny.[456] The premise is that the potential of public exposure and scrutiny can deter corporate misconduct or fraudulent behavior. It is a tool for inducing corporate executives to manage and behave better.[457] In the words of Justice Louis Brandeis, "sunlight is said to be the best disinfectants; electric light the most efficient policeman."[458] Second, the disclosure-based approach enables investors to make fully informed investment decisions as to whether to buy, sell or hold securities.[459] It provides the basis for forming a judgment as to the value of the securities. In the words of Professor Ripken, "by reducing the information asymmetry that exists between corporations and investors, disclosure levels the playing field so that all market participants have equal access to information about corporations and their securities. Investors can then make informed valuation judgments about the price of securities and determine for themselves whether a certain piece of stock is worthless."[460] The fundamental premise behind the disclosure-based approach is that without it, investors would have inadequate information as to the risks involved with a specific investment and consequently, will not be able to make an informed investment decision.[461] In essence, disclosure promotes fairness, enhances the integrity of the market, increases the transparency and efficiency of the securities market and produces increased price stability.[462] Since there is more accurate public information about a particular security, the price of this security can be expected to shift less.[463] The disclosure-based approach also increases overall investor confidence in the securities market and its integrity by virtue of deterring corporate misconduct and allowing equal access to information.[464] Investors are more

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"substitut[ing] a philosophy of full disclosure for the philosophy of caveat emptor . . . ."). The House Report on the Securities Exchange Act of 1934 explained the significance of providing investors with sufficient information to make intelligent investment decisions: "No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. REP. NO. 73-1383, at 11 (1934), *reprinted in* 5 *Legislative History of The Securities Act of 1933* (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

456 *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1205, 1227 (1999) (describing the historical view of "disclosure as the regulatory means to ensure greater public accountability and ethical behavior in corporate management").

457 *Id.*

458 *See* Louis Brandeis, *Other People's Money and How the Bankers Use It,* 92 (1914); *See* also Louis Loss, Fundamentals of Securities Regulation 36 (1983); *see* also James A. Fanto, *Investor Education, Securities Disclosure, and the Creation and Enforcement of Corporate Governance and Firm Norms*, 48 CATH. U. L. REV. 15, 24 (1998).

459 Congress relied on this rationale in adopting the federal securities laws. *See supra* note 455. The SEC has also explained this disclosure rationale as follows: "[I]f the investor had available to him all the material facts concerning a security, he would then be in a position to make an informed judgment whether or not to buy." Securities Act Release No. 33-5223, 37 Fed. Reg. 591, 592 (Jan. 14, 1972).

460 *See* Ripken, *supra* note 452.

461 *Id.*

462 *Id.*

463 *See* Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 Bus. Law. 61, 61 (1971) (citing H.R. REP. NO. 73-85, at 2 (1933), *reprinted in* 2 Legislative History of The Securities Act of 1933 and Securities Exchange Act of 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

464 *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 692 (1984) (explaining arguments that "[d]isclosure rules both deter fraud and equalize 'access' to information, restoring the necessary confidence in the capital markets").

likely to participate and invest in the capital market when they are convinced that the market will treat them fairly and that the relevant rules are enforced. In the words of Professor Ripken, "investor trust is therefore critical for the securities markets to work, and disclosure helps to facilitate that trust."[465]

Overall, disclosure reduces investor risks, protects the public interest and preserves investor autonomy. It is a tool to remedy "the social and economic wrongs that occur when those with greater information exploit those with less information", and it achieves this goal through a minimalist form of government intervention.[466] Therefore, the key advantage of the disclosure-based approach is that it promotes the protection of investors and the public with minimum intervention in the operation of the free market.[467] The following section will examine the inconsistent treatment of private equity investors under Title IV and demonstrate that while the disclosure philosophy may offer certain advantages for the regulation of securities and financial markets in general, it is the wrong tool for regulating the private equity sector.

i) THE INCONSISTENT TREATMENT OF PRIVATE EQUITY FUNDS UNDER TITLE IV

U.S. securities laws contain many exemptions for wealthy investors who are professional, experienced and have extensive resources to conduct their own due diligence, or retain professional advisors, to evaluate an investment opportunity and make an informed investment decision without any regulatory intervention. The rationale behind these exemptions is that wealthy investors can "fend for themselves" since they have the financial experience, resources, sophistication and other tools to make an informed investment decision or to retain the services of professional advisors who have the necessary experience and sophistication.[468]

For example, under the Securities Act of 1933, (the "Securities Act") a company that offers or sells its securities must register the securities with the SEC or rely on an exemption from the registration requirements.[469] However, the Securities Act provides companies with a number of exemptions for experienced, wealthy and sophisticated investors who satisfy certain requirements. Private equity funds' securities usually fall outside the scope of this registration requirement since these securities are placed with wealthy investors through an exempt private offering under Section 4(2) of the Securities Act.[470] Pursuant to Rule 506 of Regulation D promulgated by the SEC under the Securities Act, the issuance of securities to "accredited investors" is generally not considered a "public offering" and is therefore exempt from the registration requirements of the Securities Act.[471] In essence, Rule 506 of Regulation D provides a "safe harbor" within Section 4(2) of the Securities Act for sales of securities to an unlimited

[465] *See* Ripken, *supra* note 452.
[466] *See* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 345 (1999) (noting that the "great advantage of disclosure-based strategies is that they constitute a minimalist form of government intervention" because "[c]onsumer knowledge is enhanced, while consumer preferences are left largely undisturbed").
[467] *See* Ripken, *supra* note 452.
[468] *See* Paredes, *supra* note 448; *See* also C. Edward Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 Duke L.J. 1081, 1123 (1988).
[469] *See* Section 5 of the Securities Act of 1933 (48 Stat. 74, 15 U.S.C. 77a-77mm).
[470] *See* Section 4(2) of the Securities Act of 1933 (48 Stat. 74, 15 U.S.C. 77a-77mm).
[471] *See* Rule 506 of Regulation D promulgated under the Securities Act of 1933 (17 C.F.R. § 230.506 (2010).

number of "accredited investors", defined as institutional investors and individuals with a net worth in excess of $1 million or annual income in excess of $200,000 or $300,000 with spouse, and most other entities having total assets in excess of $5 million.[472] The rationale behind this exemption is that wealthy investors who meet the "accredited investor" requirements are sophisticated and experienced enough and therefore can "fend for themselves". They simply do not need any regulatory intervention in order to make an informed investment decision.

Another example of the federal securities laws approach to sophisticated, wealthy and professional investors is Rule 144A promulgated by the SEC under the Securities Act. Under Rule 144A, resales of minimum $500,000 units of restricted securities to "qualified institutional buyers" are also exempt from the registration requirements of the Securities Act.[473] Qualified institutional buyers are defined in Rule 144A and include "specified institutional investors that own and invest at least $100 million on a discretionary basis in securities of issuers that are not affiliated with the entity."[474]

The premise underlying these exemptions (and many other exemptions under federal securities laws) for wealthy, sophisticated and experienced investors is the fact that wealthy investors can "fend for themselves" since they have sufficient financial experience, resources, sophistication and other tools to make informed investment decisions or to retain the services of professional advisors who have the necessary experience and sophistication.[475] They can tolerate the economic risk associated with private equity investments. As explained by former SEC Commissioner Troy Paredes "this animating principle reflects an implicit cost-benefit analysis that the costs of SEC intervention in such instances exceed the benefits to wealthy investors of such intervention."[476]

As discussed in Part II of this paper, investors in private equity funds usually include large institutions like corporate pension funds, public retirement plans, foundations, endowments, sovereign wealth funds, insurance companies and to a lesser extent high net worth individuals.[477] These investors have extensive resources, experience and sophistication to "fend for themselves" and make informed investment decisions. They usually go through an extensive due diligence process, prior to making an investment decision, and use professional advisors like accountants, lawyers and other business consultants, as part of their evaluation process. They are very experienced in evaluating risk and are strong enough to absorb significant losses and downturns in the economy. In fact, these professional and experienced investors do not need the registration and reporting requirements of Title IV in order to make an informed investment decision. They rely on their own due diligence efforts to verify or investigate matters of importance and make an informed investment decision. They can simply protect themselves utilizing their own resources and experience.

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[472] *See* 17 C.F.R. § 230.501 (2010).
[473] *See* 17 C.F.R. § 230.144A (2010).
[474] *Id.*
[475] *See* Paredes, *supra* note 448.
[476] *Id.*
[477] *See* Appelbaum and Batt *supra* note 27.

In essence, what Title IV has done, in the context of private equity funds, is to create a regulatory environment where the due diligence efforts of institutional wealthy investors in private equity funds are to some extent subsidized by the public through the SEC enforcement of unnecessary registration and reporting requirements under Title IV.[478] This public subsidy of wealthy institutional, professional and sophisticated investors is completely unnecessary and inconsistent with the principles of federal securities laws and the exemptions available for sophisticated and experienced investors. It is contrary to the fundamental principle that such investors can "fend for themselves" and simply do not need the benefit of any government or regulatory intervention.[479] It also raises the question of why the government is allocating its limited SEC resources in a way that benefits and protects the small number of American investors who can "fend for themselves".[480]

It is important to note that even in instances where investment funds collapsed like in the case of Long-Term Capital Management in 1998 (which due to its highly leveraged nature and the 1998 financial crisis in Russia collapsed and required a $3.6 billion private bailout arranged by the Federal Reserve) or the collapse of the hedge funds of Bear Stearns in 2007 (which required Bear Stearns to incur losses of more than $1 billion), the primary issue was systemic risk and the potential impact of the collapse on the financial system and the economy as a whole.[481] The issue was not investor protection or whether investors were defrauded or misled.

This paper takes the position that Title IV and its registration, reporting and increased disclosure requirements may be viewed as unnecessary, burdensome and inefficient to the extent that their purpose is to protect private equity investors who are able to protect themselves and have the resources to conduct their own due diligence. It offers very little by way of protection for investors in private equity funds. The premise that these investors need protection in the form of regulatory intervention is a misconception and simply incorrect. While the disclosure philosophy in general may offer major advantages for regulating securities and financial markets and protecting investors, the reliance of Title IV on this approach, in the context of private equity funds, is practically unwarranted, falls short of achieving its purpose and does not contribute anything substantial to the protection of private equity investors who can "fend for themselves". It is also unlikely to address the risk of excessive leverage which is practically the main risk that Congress was concerned about and perceived as being sufficiently serious to merit direct regulation. Additionally, there is nothing to suggest that private equity funds and their institutional investors should be subject to inconsistent investor protection regulation under federal securities laws. The inevitable conclusion of this analysis is that the registration and reporting requirements of Title IV may be necessary in order to protect other investors and the financial market from systemic risk that might be caused by private equity funds (since the investors in private equity funds do not actually need the protection offered by Title IV as they can 'fend for themselves'). The following sections will examine the relationship between private

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[478] *See* Sekhon *supra* note 449.

[479] *Id.*

[480] *See*, Daniel Gallagher, SEC Commissioner, "Keynote Address" (speech, Investment Adviser Association Investment Adviser Compliance Conference, Arlington, VA, March 8, 2012), http://www.sec.gov/news/speech/2012/spch030812dmg.htm. Gallagher explains with regard to Title IV of the Dodd-Frank Act that "this expansion of our regulatory reach will not serve to protect ordinary retail investors, but rather investors who could, as the Supreme Court so notably said, 'fend for themselves.'

[481] *See* George, Dymally and Boss, *supra* note 86; *See also* Pierre-Louis, *supra* note 57.

equity funds and systemic risk and analyze whether private equity funds in fact create a systemic risk problem, what risks are truly "systemic", in the context of private equity funds and the use of leveraged buyout techniques, and how (if at all) those risks should be regulated.

IV. THE RELATIONSHIP BETWEEN PRIVATE EQUITY AND SYSTEMIC RISK

This part of the paper examines the relationship between private equity funds and systemic risk and analyzes the use of leverage by private equity funds as well as the risk of excessive leverage. It looks more closely at the question of whether private equity funds create a systemic risk problem (particularly through their use of leverage) in a way that justifies regulatory intervention. It further offers a conceptual framework for examining whether private equity funds create a systemic risk problem, what risks are truly "systemic", in the context of private equity funds and the use of leveraged buyout techniques, how (if at all) those risks should be regulated and whether Title IV of the Dodd-Frank Act through its registration and reporting requirements is the right answer.

This part of the paper takes the position that from a systemic risk perspective, the regulation of private equity funds under Title IV of the Dodd-Frank Act is unwarranted and flawed. It will not accomplish the legislation's purpose of helping identify and reduce systemic risk in the financial system and will not make the financial system more stable or less risky. This part of the paper further demonstrates that i) private equity was neither a cause nor a contributing factor to the 2008 financial crisis which had its roots in the unsound lending practices of the U.S. housing market; ii) private equity funds are not a major source of systemic risk to the stability of the financial system and the failure of a private equity fund would be highly unlikely to trigger cascading losses that would lead to a financial crisis; iii) for regulatory purposes and from a systemic risk perspective, there is no distinction between private equity funds and venture capital funds and therefore, both should benefit from the same exemption from registration under the Dodd-Frank Act (currently available to venture capital funds only); and iv) from an economic policy perspective, private equity funds are a major driver of economic growth and play a key role in the economic recovery of the U.S. Therefore, requiring private equity funds to register with the SEC and be subject to extensive reporting requirements will needlessly divert capital, time and effort from investment activities that could otherwise be creating jobs and drive economic growth.

This part of the paper argues that in the context of private equity funds, Title IV is simply an unnecessary and inadequate legislative response to the 2008 financial crisis and goes beyond the ways in which private equity funds operated prior to the financial crisis. It is based on fundamental misconceptions as to the nature of private equity funds and how they operate. It tries to prevent the rise of systemic risk in investment vehicles that are not a major source of systemic risk problems.

This part of the paper concludes that since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', these funds and their advisers should be subject to a reduced regulatory regime and exempt from the SEC registration and reporting requirements under Title IV of the Dodd-Frank Act. The concerns associated with the use of leverage by private equity funds and the risk of excessive leverage should be addressed through more substantive rules like leveraged lending regulation and tighter underwriting practices, standards and policies. Before we examine the complex relationship between private equity funds and systemic risk, it is worth pausing to briefly analyze the 2008 financial crisis and the near-collapse of the entire financial system which took the concept of systemic risk to a different level and brought it to the attention of regulators and policymakers.

A. PRIVATE EQUITY AND THE 2008 FINANCIAL CRISIS

Although the causes of the 2008 financial crisis are many and complex (and largely beyond the scope of this paper), the general background of the crisis will help shed light on private equity regulation under Title IV and the relationship between private equity and systemic risk.[482] While regulators and scholars have different views regarding the causes of the 2008 financial crisis, it is widely recognized that the primary causes of the financial crisis were the unsound lending practices of the U.S. housing market, the use of securitized products and the build-up of systemic risk associated with derivatives that were the financial tool that enabled the risk to spread, exacerbating the condition of global financial markets.[483] In particular, credit default swaps, financial derivatives that operate like insurance for bondholders, and other related swap instruments played a significant role in creating systemic risk essentially allowing the consequences of the collapse of the U.S. housing market to spread throughout the global financial system.[484] It is now widely accepted that the unregulated multi-trillion dollar over-the-counter credit default swap market helped drive and expand a mortgage crisis[485], then a credit crisis, and finally a once-in-a-century systemic financial crisis that, without a government bailout, would have led the world economy into a major depression.[486] While the financial crisis started due to the unsound practices of the U.S. mortgage lending industry and excessive

[482] *See* Ben S. Bernanke, Chairman Fed. Reserve, Speech at Morehouse College: *Four Questions About the Financial Crisis*, (Apr 14, 2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.html ("what caused our financial and economic system to break down to the extent it has? Not surprisingly, the answer to this question is complex, and experts disagree on how much weight to give various explanations.").

[483] *See* Mark Jickling, "Causes of the Financial Crisis," Congressional Research Service (Jan 29, 2009) *available at* http://assets.opencrs.com/rpts/R40173_20090129.pdf (offering twenty-six causes for the financial crisis, including "imprudent mortgage lending", "Securitization", the "Shadow banking system", "Off-balance sheet finance", credit default swaps, and "over-the-counter derivatives).

[484] *See* John C. Hull, Options, Futures, And Other Derivatives 1 (David Alexander ed., Prentice Hall 6thed. 2006). "A credit default swap (CDS) is a derivative contract that functions like insurance against the default of a company. The buyer of the CDS makes payments to the seller until the CDS expires or the reference entity suffers a "credit event," such as bankruptcy. If the credit event occurs, the buyer is entitled to sell a bond for its face value to the seller."

[485] *See* Rene M. Stulz, *Credit Default Swaps and the Credit Crisis* 3-4 (NBER, Working Paper No. 15384, 2009), *available at* http://www.nber.org/papers/w15384 (arguing that derivatives contributed to the financial crisis by: (1) enabling the credit boom; (2) allowing financial institutions to take on massive risk, and (3) providing a total lack of transparency regarding risk exposures and the resulting strength of financial institutions with large positions).

[486] *See* Ben Moshinsky, [*Joe*] *Stiglitz says Banks Should Be Banned From CDS Trading*, BLOOMBERG.COM, Oct. 12, 2009, http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsI.90hs; Paul Krugman, Op-Ed., *Looters in Loafers*, N.Y. TIMES, April 18, 2010, *available at* http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk; Alan S. Blinder, *The Two Issues to Watch on Financial Reform - We need an independent consumer watchdog and strong derivatives regulation. Industry lobbyists are trying to water them down*, WALL ST. J., April 22, 2010, *available at* http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html.

foreclosures resulting from the collapse of the housing market, over-the-counter derivatives and particularly credit default swaps created unwarranted risks that fueled the financial crisis.[487] The massive use of these financial instruments shook the foundation of the most prominent financial institutions that were heavily invested in these markets and took large positions in over-the-counter derivatives in order to hedge or speculate on mortgages.[488] These events exposed the interconnectedness and linkages between financial institutions and the potential such linkages and interconnectedness had for causing extreme damage to the financial system and the economy as a whole.[489] Financial innovation in the form of mortgage securitization, derivatives and other financial engineering products increased the systemic vulnerability to financial shocks that could be spread throughout the entire financial system and create a major financial crisis.

The 2008 financial crisis is a powerful example of systemic risk becoming a major threat to the stability of financial markets. As homeowners defaulted on their subprime mortgages (following the collapse of the U.S housing market), this created a ripple effect through the previously flourishing asset backed security market.[490] Institutions that had purchased protection against mortgage defaults in the form of credit default swaps demanded more capital to back up their contracts, and the undercapitalized investment banks and insurers that had sold this protection were increasingly unable to meet collateral demands.[491] Additionally, the collateralized debt obligation contracts (CDOs) in which these credit default swaps sellers had heavily invested stopped making payments and plummeted in value.[492] As a result, the CDS insurers came under tremendous pressure to compensate banks and other protected buyers for the loss of value in their CDO portfolios from mortgage defaults.[493] However, they were not adequately capitalized to perform their obligations and thus the CDO and CDS markets were completely destroyed.[494] This chain of events caused a major liquidity crunch and led to the near-collapse of the global financial system.

Additionally, there was an overall lack of transparency in the financial market which clearly enhanced the threat of systemic risk. These derivatives transactions were largely invisible

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[487] *See* James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RESERVE BANK ST. LOUIS REV. 403, 403 (2009); Ben S. Bernanke, Chairman, Federal Reserve Board of Governors, Address to Council of Foreign Relations: Financial Reform to Address Systemic Risk (Mar. 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm;

[488] *See* Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 Emory L.J. 1153 (2012). *See* also Stulz, *supra* note 485.

[489] Financial Crisis Inquiry Final Report, Conclusions (Jan. 2011), *available at* http://www.cfr.org/united-states/financial-crisis-inquiry-commission-report-january-2011/p23952.

[490] See Stulz, *supra* note 485.

[491] *See* Martin Neil Bailey et al., *The Origins of the Financial Crisis*, Brookings: Initiative on Business and Pub. Policy, (Nov. 2008), http://www.brookings.edu/-/media/Files/rc/papers/2008/11_origins-crisis-baily-litan/11 origins_crisis_baily_litan.pdf.

[492] See Darrel Duffie, *Innovations in Credit Risk Transfer: Implications for Financial Stability* 12-14 (BIS, Working Paper No. 255, 2008), *available at* http://ssrn.com/abstract=1165484. ("A CDO is created by combining mortgaged-backed securities in a pool with other debt obligations and securitizing that pool, once again, into tranches to be sold to investors with varying risk preferences."); See Frank D'Souza et al., *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market, 12* U. PA. J. Bus. L. 473, 485 (2010). ("CDOs are asset-backed securities that derive their value from a portfolio of underlying assets, such as mortgages.").

[493] *See* Bailey, *supra* note 491.

[494] See D'Souza, *supra* note 492.

to regulators and market participants.[495] This regulatory environment created a situation where neither market participants nor regulators had accurate knowledge of the full range of the exposures and interconnections of the various market participants.[496] Because of this limited transparency it was unclear which banks were exposed and to what degree.[497] Banks and financial institutions as well as regulators did not understand the magnitude of aggregate derivatives exposures in the system and had no basis to measure the risks embedded in their derivatives exposure.[498] Additionally, due to the large derivatives positions the major Wall Street financial institutions like AIG held, there were concerns that if one major financial institution were to default on its credit default swaps, its counterparties would go bankrupt and, as a result, the entire financial system could collapse.[499] This chain of events, combined with tremendous uncertainty and fear in the marketplace, led to the unfortunate failure and near-collapse of the global financial system.[500] It forced the government to step in with a massive bailout program to keep the major banks and financial institutions afloat during this crisis, bring stability to the market and prevent a total collapse of the financial system.[501]

However, these events had very little to do with the private equity industry.[502] It is universally accepted that private equity funds did not cause the financial crisis and did not play any part in the credit crisis.[503] They did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system and were simply not part of the problem.[504] In fact, private equity funds are helping to mitigate the damage of the financial crisis and drive long-term economic growth through their investment activities. As will be discussed in the following sections, the factors which brought down Bear Stearns, Lehman Brothers and AIG and caused a major systemic crisis in financial markets, are simply not present in the private equity sector.[505] Private equity funds did not incur direct losses in the subprime mortgage crisis since they do not invest in asset based securities or the derivatives based on them, nor do they invest or lend funds to other institutions trading in those securities and derivatives.[506] While private equity was a major consumer of cheap debt and created an intense demand for loans (like many other industries), the private equity sector itself did not create or spread systemic risk in the financial system.[507] On the contrary, the structure of most private equity funds and their ring fenced investments actively restricted the spread of risk from excessive borrowing by any of the

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[495] *See* Michael Greenberger, *Make Markets be Markets: Out of the Black Hole: Regulatory Reform of the Over-the-Counter-Derivatives Market,* Roosevelt Institute 99, 99 (Mar. 3, 2010), http://www.makemarketsbemarkets.org
[496] *See* Acharya et al, *supra* note 1.
[497] Rena S. Miller, Key Issues in Derivatives Reform, Congressional Research Service, R40965, at 3 (2009).
[498] *Id.*
[499] *Id.*
[500] *See* Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1184 (2010).
[501] *See generally* Justin Fox, *Why the Government Wouldn't Let AIG Fail, Time,* Sept. 16, 2008, http://www.time.com/time/business/article/0,8599,1841699,00.html; Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, Wall St. J, Sept. 17, 2008, http://online. wsj.com/article/SB122165238916347677.htmi; *See* Holman W. Jenkins, Jr., *The Never-Ending Goldman-AIG Saga*, WALL ST. J., Jan. 27, 2010, at A.13 (stating that one of the primary reasons for the bailout of AIG was fear of a "wholesale run on the nation's banking system").
[502] *See* Jickling *supra* note 483.
[503] *See* Financial Crisis Inquiry Final Report, *supra* note 489.
[504] *See* Elzon, *supra* note 61.
[505] *See* Jickling *supra* note 483.
[506] *Id.*
[507] *Id.*

target companies. In essence, this paper takes the position that the private equity sector did not play any role in the problems and failures that caused the 2008 financial crisis. The leverage ratio of the companies in which the private equity sector invests has averaged 3-to-1, compared to up to 32-to-1 in the financial institutions whose failures triggered the crisis. As will be discussed later in this paper, the banking markets and the lenders were the source of the systemic risk, not the borrowers.[508] This desire to borrow inexpensive capital from banks or other lenders in order to fund leveraged buyout transactions was the only form of involvement private equity funds had in the 2008 financial crisis.[509] This involvement is no different than any other sector or industry using debt in the ordinary course of business.

And yet, Title IV of the Dodd-Frank Act completely ignores the fact that private equity funds were not part of the problem and subjects these firms to extensive SEC registration, compliance and reporting requirements. Title IV therefore raises the inevitable question, which is the essence of this part of paper: *what, if anything, did Congress see about the risk associated with private equity funds that warranted regulatory intervention in the private equity sector, while at the same time granting an exemption to venture capital funds?* In other words, given the original exemption from registration under the Advisers Act,[510] what was the change about private equity funds that generated concerns about the exemption of the private equity industry from registration and ultimately drove the decision to regulate these funds? After all, there were no failures of private equity funds that had a systemic effect or caused damage to the financial system and required any regulatory intervention.

When Congress passed the Dodd-Frank Act, its primary objective was to identify and manage threats to the stability of the nation's financial system, protect investors and control the buildup of systemic risk.[511] In the context of private equity funds, the main concern that drove Congress to regulate these funds was the use of leverage and the risk that too much leverage contributes to the buildup of systemic risk that can potentially lead to a major credit crisis.[512] The premise was that lending connects financial institutions to one another and the failure of a leveraged institution to repay its debt obligations causes risk to spread among the financial institutions that lend capital.[513] Therefore, a failure of a private equity fund could, in theory, trigger cascading losses that would ultimately lead to a financial crisis. Congress operated on the assumption that private equity funds cause systemic risk by virtue of using leverage and therefore should be regulated and subject to SEC oversight. This paper takes the position that these concerns are unfounded and based on fundamental misconceptions as to the nature of private equity funds and the way they operate. In the word of Professor John W. O'Brien of the Haas School of Business at the University of California - Berkeley: "I don't think private equity and venture capital have been an important part of the problem. It's mainly been the leverage and rapid-trading strategies, and those strategies are primarily housed in hedge funds. I don't think

[508] *See* Financial Crisis Inquiry Final Report, *supra* note 489.
[509] *Id.*
[510] *See supra* note 84.
[511] *See* Acharya et al, *supra* note 1.
[512] *See* Lowenstein, *supra* note 24.
[513] *See* Davidoff, *supra* note 23.

Congress has a clear understanding of the problem so they wrap everybody into the net."[514] Private equity funds are not a major source of systemic risk to the financial system and present no threat to the financial stability of the market or the economy as a whole. Therefore, the registration and reporting requirements of Title IV are unwarranted, unnecessarily costly and inconsistent with the intended purpose of the Dodd-Frank Act. The following section examines the relationship between private equity funds and systemic risk and whether private equity funds create a systemic risk problem (particularly through their use of leverage) in a way that justifies regulatory intervention.

B. PRIVATE EQUITY FUNDS AND SYSTEMIC RISK

i) SYSTEMIC RISK

In the aftermath of the 2008 financial crisis regulators and policy makers started to focus on the concept of systemic risk and the potential for systemic failure of the entire financial system. Systemic risk became the primary concern of legislators all over the world.[515] In fact, one of the primary objectives of the Dodd-Frank Act is to reduce and control systemic risk in the financial system, enhance financial stability and thus prevent or reduce the likelihood of a future financial crisis.[516] Nonetheless, there is still a great deal of confusion and academic debate as to the meaning of the term systemic risk, what types of risk are actually systemic, what types of systemic risk should be regulated and whether the concept is even relevant to the private equity sector.[517] Alan Greenspan, former Federal Reserve Chairman, explained the confusion as to the definition of the term systemic risk and stated that "Although it is generally agreed that systemic risk represents a propensity for some sort of financial system disruption, one observer might use the term 'market failure' to describe what another would deem to have been a market outcome that was natural and healthy, even if harsh. As a result, the very definition of systemic risk is still somewhat unsettled."[518]

Systemic risk is the risk that financial problems in one institution or market will spread to other institutions and markets with the result that the losses from a seemingly isolated market event might threaten the entire economy.[519] It refers to the linkages and interdependencies between participants in the financial market, such that "a significant loss initially touching only a small number of participants can spread and threaten the entire system."[520] The essence of

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[514] *See* Doug Halonen, *Systemic Risk? Not us, say private equity firms,* Pensions & Investments, April 6, 2009, Vol. 37 Issue 7, available at http://connection.ebscohost.com/c/articles/38902941/systemic-risk-not-us-say-private-equity-firms
[515] *See* Acharya et al, *supra* note 1.
[516] *Id.*
[517] *See* Judge, *supra* note 450.
[518] *See* George Kaufman, *Bank Failures, Systemic Risk and Bank Regulation,* 16 Cato J. 17, 21 n.5 (1996) (quoting Alan Greenspan, Remarks at a Conference on Risk Measurement and Systemic Risk, Board of Governors of the Federal Reserve System (Nov 16, 1995)), available at http://www.cato.org/pubs/journal/cj16n-2.html.
[519] *See* Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives, 2002* COLUM. Bus. L. Rev. 677, 731 (2002).
[520] This basic concept is captured by a leading scholar in the area who defines systemic risk as:

> [T]he risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to

systemic risk is a chain of failures or losses. It is a "market shock" that triggers institutional failures which in turn lead, or can lead, to a chain of institutional or market failures.[521] In other words, it is "a failure in the functioning of the financial system that imposes significant externalities, adversely affecting persons removed from the financial institutions at the core of the crisis."[522] It is usually created by counterparty credit risk and spreads through the interconnections between financial institutions, for example, in the context of derivatives trading.[523]

Some commentators define systemic risk as "the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of financial institutions or markets comprising….a system."[524] Other scholars define it as "the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses."[525] Alternatively, other scholars and regulators define the concept of systemic risk as "the risk that a default by one market participant will have repercussions on other participants due to the interlocking nature of financial markets. For example, Customer A's default in X market may affect Intermediary B's ability to fulfil its obligations in Markets X,Y and Z."[526] In the words of Professor Katheryn Judge the concept of systemic risk can be understood as "the risk that the financial system will fail to function properly because of widespread distress."[527] Despite the different views as to the concept of systemic risk and the meaning of the term, the essence of the different definitions is very similar. In the words of Professor Steven Schwarcz, the common feature is a "triggering event, such as an economic shock or institutional failure, that causes a domino effect or a chain of detrimental economic consequences like losses, decrease in credit availability, increase in cost of capital or liquidity crisis."[528] It is the risk of a "potential breakdown in an entire financial system as opposed to the collapse of individual participants in the financial system."[529]

> financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.

Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 204 (2008).

[521] *Id.*

[522] *See* Judge *supra* note 450.

[523] *See* Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323 (2011); http://scholarship.law.cornell.edu/facpub/183/ ("The creation of counterparty credit risk remains the basic way in which over-the-counter derivatives contribute to systemic risk").

[524] *See* Kaufman *supra* note 518.

[525] *See* Paul Kupiec & David Nickerson, *Assessing Systemic Risk Exposure from Banks and GSEs under Alternative Approaches to Capital Regulation*, 48 Real Est. Fin & Econ. 123, 123 (2004) ("a key feature in the propagation of such a systemic shock is acute uncertainty regarding an institution's ability to satisfy its immediate payment obligations and a simultaneous inability of counterparties to hedge such risk.").

[526] *See* Nicholas Chan, Mila Getmansky, Shane Haas and Andrew Lo., Systemic Risk and Hedge Funds (February 22, 2005). MIT Sloan Research Paper No. 4535-05; EFA 2005 Moscow Meetings Paper; AFA 2006 Boston Meetings Paper. Available at SSRN: http://ssrn.com/abstract=671443 or http://dx.doi.org/10.2139/ssrn.671443.

[527] *See* Jean Helwege, *Financial Firm Bankruptcy and Systemic Risk*, Regulation, Summer 2009, at 24, 24, *See* also Hal Scott, *Reducing Systemic Risk Through the Reform of Capital Regulation*, 13 J. Int'l Econ. L. 763, 763-764 (2010) (explaining that "systemic risk can be defined in many ways, including, the risk that a national, or the global, financial system will break down"), S*ee* also Judge, *supra* note 450.

[528] *See* Schwarcz *supra* note 520.

[529] *See* Judge *supra* note 450.

It has been noted by regulators and academic scholars that the most severe consequences of systemic risk are "the increase in the cost of capital and decrease in its availability."[530] Accordingly, the concept of systemic risk is usually associated with banks and other financial institutions, as these institutions are providers of capital, and therefore the "failure of such institutions can adversely affect the cost of capital and its availability as well as the entire financial system."[531]

Historically, the main source of systemic risk was a banking failure and the classic example of systemic risk is a "bank run" in which the inability of a bank to satisfy withdrawal-demands causes its failure, in turn causing other banks or their creditors to fail.[532] As more people withdraw their deposits, the likelihood of default increases, thus triggering further withdrawals. This can bring the bank to the point where it runs out of cash. A bank run can lead to a chain of failures very quickly because "banks are closely intertwined financially as they lend to and borrow from each other, hold deposit balances with each other and make payments through the interbank clearing system."[533] A good example of a bank run causing systemic risk is the great depression and the crash of October 1929 when bank depositors tried to convert their bank deposits into cash. Many banks were simply unable to satisfy these demands causing them to fail, therefore leading to a major financial crisis.[534] In the words of Professor Katheryn Judge:

> "Historically, the paradigmatic source of systemic risk was a banking crisis. This is because of the central role banks play in moving capital from savers to productive undertakings and because of instability inherent in their structure. Banks tend to use short-term liabilities like demand deposits, to fund long-term assets, like loans to businesses, so even a solvent bank may lack the requisite funds if too many depositors demand their money back at the same time; and because of the interconnectedness of banks and the potential for problems at one bank to signal problems at others, a run on the bank can lead to the failure of other banks and an overall contraction of the financial system."[535]

While bank failures are still the classic example and a major source of systemic risk, changes in the roles played by banks, the relationship between banks and capital markets and other developments in the financial system have "created an environment in which the potential sources of systemic risk have become much more diverse."[536]

As the 2008 financial crisis demonstrated, extensive speculation in derivatives markets is dangerous for the financial system due to the systemic risk that arises from the complex linkages and interdependencies between participants in the global financial market.[537] For example, if a bank defaults on a derivatives contract, it could cause its transactional counterparty to default on its own outstanding derivatives contracts with third parties (assuming the counterparty was

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530 *See* Schwarcz *supra* note 520.
531 *Id.*
532 *See* Judge *supra* note 450.
533 *See* Schwarcz *supra* note 520.
534 *Id.*
535 *See* Judge *supra* note 450.
536 *Id.*
537 *See* Schwarcz, *supra* note 520.

relying on income from the derivatives contract to meet its obligations to third parties).[538] Therefore, massive derivatives losses at one firm leading to defaults could quickly lead to a chain reaction of defaults among other firms and as a result spread systemic risk throughout the financial system.[539] This is the reason why derivatives have been described by legendary investor Warren Buffet as "financial weapons of mass destruction carrying dangers that, while now latent, are potentially lethal."[540] As evidenced by the 2008 financial crisis, the combined threats of lack of transparency, lack of regulatory oversight and massive systemic risk in the financial system, can be extremely dangerous and jeopardize the entire economy.

In laying out its financial regulatory reform, following the 2008 financial crisis, the Obama administration articulated "three fundamental factors that trigger systemic risk concerns: i) the impact that a firm's failure would have on the financial system and economy; ii) the firm's combination of size, leverage (including off-balance sheet exposures) and degree of reliance on short-term funding; and iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system."[541] This paper takes the position that private equity funds present none of these systemic risk factors and thus "should pose very little concern for regulators and policymakers seeking to develop a new regulatory regime to monitor systemic risk and guard against a future financial crisis."[542]

When applying these systemic risk factors to private equity funds, it is hard to see how any particular private equity fund could be considered a major source of systemic risk that justifies regulatory intervention.[543] It is important to note that the factors which brought down Bear Stearns, Lehman Brothers and AIG and caused a major systemic crisis in financial markets, are simply not present in the private equity sector.[544] Bear Stearns' crisis and later the failure of Lehman Brothers and AIG began with funds these firms formed for the purpose of trading mortgage-backed securities and their derivatives.[545] Private equity funds did not incur direct losses in the subprime mortgage crisis since they do not invest in asset based securities or the derivatives based on them, nor do they invest or lend funds to other institutions trading in those securities and derivatives.[546] Additionally, private equity funds "occupy a place in the U.S. capital market that is simply too small to trigger the elements of systemic risk and a potential financial crisis" (despite the risk of excessive leverage that will be discussed below).[547] The

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[538] *See* D'Souza, *supra* note 492.
[539] *See* Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L.J. 701, 770-71 (1999), (stating that regulators view systemic risk as more perilous than excessive speculation in derivatives trading because of the potential for "cataclysmic derivatives losses" at one institution to pass rapidly to other trading firms).
[540] *See Berkshire Hathaway Inc. 2002 Annual Report*, available at www.berkshirehathaway.com/2002ar/2002ar.pdf.
[541] *See* Lowenstein, *supra* note 24.
[542] *See* Testimony of Mark Tresnowski, Managing Director and General Counsel, Madison Dearborn Partners LLC, on behalf of the Private Equity Council, before the House Committee on Banking, Housing and Urban Affairs, Washington DC, July 15, 2009 available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings. Testimony&Hearing_ID=b4b5348b-ba91-4512-bca2-bf45b2e5fbde&Witness_ID=7bb98dae-f3b1-4585-bf19-a80786f8f196 .
[543] *See* Lowenstein, *supra* note 24.
[544] *See* Jickling *supra* note 483.
[545] *Id.*
[546] *Id.*
[547] *See* Shapiro and Pham *supra* note 31.

sections that follow examine the connection and relationship between private equity funds and systemic risk and further explain why private equity is not a major source of systemic risk. They illustrate that these systemic risk factors have very little to do with private equity funds and the way they operate.

ii) THE USE OF LEVERAGE BY PRIVATE EQUITY FUNDS

The first misconception that drove Congress (and the lobbyists promoting Title IV of the Dodd-Frank Act) to regulate the private equity sector relates to the use of leverage by private equity funds and the risk that too much leverage contributes to the buildup of systemic risk that can potentially lead to a major financial crisis.[548] Congress operated on the assumption that private equity funds cause systemic risk by virtue of using leverage and therefore should be regulated and subject to SEC oversight under the Dodd-Frank Act. The concern was that lending connects financial institutions to one another and the failure of a leveraged institution to repay its debt obligations causes risk to spread among the financial institutions that lend capital.[549] The premise is that leverage amplifies systemic risk in the financial system as a result of connections and linkages among financial institutions.[550] Therefore, a failure of a private equity fund could, in theory, trigger cascading losses that would ultimately lead to a financial crisis.

As high levels of leverage have been a major factor in other instances of systemic financial failures, including the subprime mortgage crisis, high leverage raises legitimate concerns about systemic risk and a potential financial crisis.[551] This is especially true when leverage is used to speculate on highly volatile instruments like derivatives and credit default swaps. The collapse of Bear Stearns, Lehman Brothers and other financial institutions heavily invested in mortgage backed securities and subprime mortgage derivatives involved extremely high levels of leverage. On February 29, 2008, the leverage ratios for Bear Stearns and Lehman Brothers were nearly 33-to-1.[552] With such levels of leverage and extensive speculation on volatile instruments, major losses that occur suddenly can trigger a chain of systemic failures as the use of leverage amplifies losses well beyond a financial institution's capital resources.[553]

Nonetheless, these conditions for systemic financial failures are simply not present in the private equity sector. The leverage ratio of private equity transactions is substantially lower, usually 3-to-1.[554] The business and nature of private equity funds (as will be discussed below) are very different and do not fit this pattern of systemic financial failures. Also, private equity funds "occupy a place in the U.S. capital market that is simply too small to trigger the elements of systemic risk and a potential financial crisis."[555] The failure of private equity portfolio

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[548] *See* Lawale N. Ladapo, *Private Equity in a Deleveraged Economy: Lessons from the Financial Crisis* (May 18, 2010). Available at SSRN: http://ssrn.com/abstract=1610087.
[549] *See* Davidoff, *supra* note 23.
[550] *See* U.S. Government Accountability Office, GAO-09-739, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and Across the System*, 7, 67–71 (2009), *available at* http://www.gao.gov/new.items/d09739.pdf.
[551] *See* Shapiro and Pham *supra* note 31.
[552] *Id.*
[553] *Id.*
[554] *See* Appelbaum and Batt, *supra* note 27.
[555] *Id.*

companies is simply not large enough to jeopardize the viability of the financial system and the economy as a whole.[556]

Private equity funds almost never use debt or leverage at the fund level.[557] This is a fundamental premise in the way private equity funds operate. Where debt is used in private equity transactions, it is taken on by the target companies that are acquired, not by the fund itself.[558] Also, the institutional investors who are the limited partners in private equity funds are not highly leveraged themselves. In fact, it is common for private equity fund managers to commit to their investors that the fund will not incur any debt at the fund level. This is due to the requirements imposed by tax-exempt investors like pension funds, endowments and foundations that are nevertheless, required to pay taxes on income from debt financed investments.[559] Thus, the target companies, those in which private equity funds invest, are responsible for the debt obligations.

Additionally, the debt used in private equity transactions is secured against the assets or cash flow of the target companies. Therefore, if a target company defaults on its debt obligations, the banks or lenders can look only to the assets of the target company not the fund or its investors for recourse.[560] The default is contained and losses are absorbed by the fund investors.[561] This is a very isolated and non-systemic exposure as losses do not compound beyond the amount of capital committed by each investor in the fund.[562] Thus the risk of debt used in private equity transactions is on the portfolio companies, not the economy as a whole. As a result, there is no systemic risk concern that interconnections or linkages between financial institutions, resulting from the use of leverage, could spread systemic risk throughout the financial system, cause a chain of failures and eventually lead to a financial crisis.[563] In essence, the risk with private equity funds is limited entirely to the operational success or failure of the target companies in which the private equity funds invest. The investment is based on a long-term relationship and partnering with the management team of the target company with the objective of building or restructuring a company as discussed in Part II of this paper. This risk is very different from the systemic risk that was the basis for the 2008 financial crisis and the Dodd-Frank legislation.[564]

For example, a million dollar mortgage can create a multiple of assets flow because of derivatives and bets regarding interest rates of that mortgage pool.[565] In the context of private equity funds, the exposure associated with a million dollar investment is limited to a million

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[556] *See* Lowenstein, *supra* note 24.
[557] *Id.* ["private equity funds almost never borrow because of the particular tax concerns of tax-exempt LPs concerning – unrelated business taxable income."].
[558] *Id.*
[559] *See Accommodating Tax-Exempt Investors: Understanding UBTI*, Morgan Lewis, available at http://www.morganlewis.com/documents/vcpefdeskbook/vcpefdeskbookAccomodatingTaxExemptInvestors.pdf.
[560] *See* Tresnowski, *supra* note 542.
[561] *See* Elzon, *supra* note 61.
[562] *Id.*
[563] *See* Testimony of Pamela B. Hendrickson, Chief Operating Officer, The Riverside Company, before the House Committee on Financial Services, Washington DC, March 16, 2011 available at www.acg.org/UserFiles/file/global/Capital%20Views/Dc98.pdf.
[564] *See* Tresnowski, *supra* note 542.
[565] *Id.*

dollars.[566] There is no multiplier effect because there are no side bets or other unmonitored derivative securities based on the transaction. When a portfolio company fails the investment is gone but the losses end there and the financial exposure is self-contained. No outside parties are betting on the success or failure of the private equity industry and hence cannot be affected. Additionally, the potential losses of a private equity fund are known with some degree of certainty and the underlying assets (the portfolio companies) are much less affected by sharp and sudden shifts in value or fluctuations like in the case of highly speculative investments. The value of the investments made by private equity funds in various target companies is much less volatile and much more limited and certain than those seen in cases of systemic financial failures like Bear Stearns and Lehman Brothers.[567]

Therefore, the concern about systemic risk associated with the use of leverage by private equity funds and a potential chain of financial failures is simply unwarranted and unfounded. There is a complete lack of direct nexus between private equity investments and the systemic risk concerns underlying the enactment of Title IV of the Dodd-Frank Act. There is nothing unique about a lender's loan to private equity portfolio companies that would make them more risky than a wide range of other types of loans made by a bank or other lender, in the ordinary course of business, to other companies owned by public shareholders, public companies or other institutional investors.[568] The way in which private equity portfolio companies use leverage is no different from the way in which companies backed by private or public investors use leverage in the ordinary course of business. In case a private equity portfolio company defaults on its debt obligations, lenders and investors in the private equity fund may not be repaid in full but this is no different than any other company defaulting on its debt, which is addressed as a regulatory matter through federal bankruptcy law.[569] Also, there is no modern instance of a financial crisis or a major systemic failure triggered by the failure of a private equity fund or a failure of its portfolio companies. Therefore, the SEC registration and reporting requirements of Title IV seem misplaced and disproportionate in the absence of evidence showing that private equity portfolio companies are more likely to default on their debt obligations and create systemic financial failures.

This paper takes the position that private equity funds are not a major source of systemic risk and do not present a threat to the financial system or the economy as a whole. Unlike the 2008 financial crisis where the potential losses were virtually unlimited due to the use of excessive leverage and highly speculative financial instruments, the losses that could arise from the failure of private equity portfolio companies are self-contained, non-systemic and limited to the amount of capital committed by these funds. Private equity funds, however, do present certain concerns with regard to the use of excessive leverage which will be discussed in the following section.

iii) THE RISKS ASSOCIATED WITH EXCESSIVE LEVERAGE

[566] *Id.*
[567] *See* Appelbaum and Batt, *supra* note 27.
[568] *See* Lowenstein, *supra* note 24.
[569] *Id.*

Private equity funds and their leveraged buyout activities have been the subject of some controversy and extensive criticism due to their use of leverage and the risk of excessive leverage. This paper recognizes the concerns associated with the use of leverage by private equity funds and the risk of excessive leverage which are valid and legitimate concerns, although unlikely to cause cascading losses and systemic failures in the US financial system. Nonetheless, this paper suggests that the regulatory approach of Title IV of the Dodd-Frank is not the right answer to address these risks and concerns.[570] Perhaps a better approach to control the risk of excessive leverage is to enhance leveraged lending regulation and foster an environment in which the discipline of banks and other lenders constrains excessive leverage and risk-taking by private equity funds.[571]

The 2008 financial crisis clearly underscores the risk of excessive leverage and how leverage can amplify systemic risk in the financial system as a result of connections and linkages among financial institutions. The notion that excessive leverage by financial institutions was one of the key contributing factors to the 2008 crisis financial is widely accepted and has generated widespread support.[572] In the words of Professor Steven L. Schwarcz: "excessive leverage can increase the likelihood of a general breakdown in the functioning of financial markets by increasing the likelihood of transmitting problems."[573] He further explains that "high leverage, however, can cause institutions to absorb losses exponentially in the sense that losses beyond a certain level—depending on the institution's size and leverage—will precipitously degrade an institution's ability to pay its debts. Default in paying debts might well cause the institution's failure, as well as trigger a potential chain of defaults as other institutions are not paid amounts owed to them (and in turn, if highly leveraged, such other institutions might then be unable to pay amounts owed to yet other institutions)."[574] The risk of excessive leverage is well illustrated by the collapse of the hedge fund Long-Term Capital Management in 1998, which had a leverage ratio of twenty five to one shortly before it was bailed out with the assistance of the Federal Reserve of New York. The fund had $125 billion of investments financed with $5 billion of assets under management.[575] This is clearly not the case with private equity funds and their use of leverage in the context of leveraged buyout transactions. Private equity portfolio companies use significantly less leverage than the financial institutions that collapsed in the 2008 financial

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[570] For a discussion of an alternative approach to the regulation of private equity funds, *see* Part V of this paper.
[571] *Id.*
[572] *See Basel Comm. on Banking Supervision, Bank for Int'l Settlements, Strengthening the Resilience of the Banking Sector 1* (2009), available at http://www.bis.org/publ/bcbs164.pdf ("one of the main reasons the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on and off balance sheet leverage."); Inst. Of Int'l Fin., *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability 43* (2009), available at http://www.iif.com/download.php?id=/11YetxP3hE= ("there is agreement that excessive leverage had developed in the financial system, and this must be controlled in the future."); Philipp M. Hildebrand, Vice Chairman of the Governing Bd., Swiss Nat'l Bank, Financial Markets Group Lecture at the London School of Economics: *Is Basel II enough? The benefits of a leverage ratio 3* (Dec 15, 2008), available at, http://www.snb.ch/en/mmr/speeches/id/ref_20081215_phm/source/ref_20081215_pmh.en.pdf ("there is increasing international recognition that excessive leverage has been a crucial contributing factor to the current crisis.").
[573] *See* Schwartz, *supra* note 520.
[574] *Id.*
[575] *See* Sean M. Donahue, *Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors From Problems Created By Hedge Funds*, 55 CLEV. ST. L. REV. 235, 247 (2007); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 686-87 (2000).

crisis. The average gross leverage ratio of private equity deals is usually about 3:1 while Lehman Brothers was leveraged at approximately 32:1.[576] With such levels of leverage, major losses that occur suddenly can quickly trigger a chain of systemic failures as the use of leverage amplifies losses well beyond a financial institution's capital resources.

Private equity owned buyout companies have significantly higher levels of debt than other comparable publicly traded companies.[577] As discussed in Part II above, the use of leverage in private equity transactions is a key element to enhance the potential return for investors.[578] Financial leverage magnifies the potential positive or negative impact that any change in the Company's earnings has on the return on equity. Therefore, high levels of leverage "increase the risks of financial distress, debt restructuring, bankruptcy, or even liquidation, particularly in economic downturns and periods of slow growth such as the 2008 financial crisis."[579] The risk of financial distress associated with high levels of leverage is well known in finance and economics. Greater leverage increases the odds of financial distress, high default levels and even insolvency by magnifying lenders losses relative to equity. In the words of Professor Appelbaum: "as the debt ratio rises, the probability of bankruptcy rises and the expected value of bankruptcy costs increase. Even companies that are able to restructure their debts and avoid insolvency bear costly expenses – legal fees and other costs associated with restructuring debt as well as higher borrowing costs in the future."[580] The less equity invested in any given private equity buyout transaction, and the higher the amount of debt, the greater the risk of losing the equity.[581] Furthermore, the less equity that a company has, the smaller the cushion against banking problems, adverse market conditions, economic downturns and insolvency or failure. Therefore, high leverage increases both the risk of losing the equity invested and the risk that a company becomes unable to repay its lenders and therefore becomes insolvent.[582]

In the context of leveraged buyout transactions, portfolio companies are under pressure to continue to service high levels of debt, which makes them very vulnerable to changing market conditions and even defaults during economic downturns. The actual benefits of using debt to the balance sheet, as discussed in Part II of this paper, diminish as debt rises to an excessive level thereby making borrowers very vulnerable to interest rate rises, unexpected business events, economic downturns or adverse market conditions. A financial crisis affecting target companies that are carrying high levels of debt on their balance sheet could have serious repercussions for investors, many of whom are themselves highly leveraged hedge funds or pension funds seeking higher returns. In other words, leverage creates an externality and the stakeholders who usually bear the costs of this externality are the creditors.[583] The concern associated with the use of leverage is also the fear that excessive leverage might lead to costs that have to be borne by the rest of the economy.

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[576] *See* Shapiro and Pham, *supra* note 31.
[577] *See* Appelbaum and Batt, *supra* note 27.
[578] *See* Kaplan & Stromberg, *supra* note 39.
[579] *See* Appelbaum and Batt, *supra* note 27.
[580] *Id.*
[581] *Id.*
[582] *See* Per Strömberg, Edith Hotchkiss and David Smith, *Private Equity and the Resolution of Financial Distress* (April 7, 2011). AFA 2012 Chicago Meetings Paper; ECGI - Finance Working Paper No. 331/2012. Available at SSRN: http://ssrn.com/abstract=1787446 or http://dx.doi.org/10.2139/ssrn.1787446.
[583] *Id.*

Additionally, the effect of financial distress and bankruptcy resulting from excessive leverage and the failure of a portfolio company may be devastating for other stakeholders in the leveraged buyout environment like managers, employees, customers, suppliers and bond holders of the affected company. For the individual portfolio company, bankruptcy and financial distress usually mean a disaster for managers, employees, creditors and suppliers whose jobs and livelihood depend on the success or failure of the company.[584] Many private equity portfolio companies also struggle with high levels of leverage and debt-financed dividend payouts to private equity investors that put tremendous pressure on cash flow and limit the ability to adapt during economic downturns.[585] Clearly, excessive leverage used by private equity funds can leave the portfolio company in a weaker financial position. Net worth is lower since the target company has not retained the proceeds of the loans. Profits are reduced by the burden of the new interest payments and cash flow is down even further due to the payments of principal on the leveraged loans. Also, funds for new developments, business growth or investments may be unavailable.

It is important to note that leverage plays an important role in financial markets. Former Treasury Secretary Timothy Geithner explained that "stripped of its complexities, the purpose of a financial system is to let those who want to save…save and let those who want to borrow – whether to buy a house or build a business – borrow. The use of significant amounts of debt to finance the acquisition of a company has a number of advantages, as well as risks. The most obvious risk associated with a leveraged buyout is that of financial distress. Unforeseen events such as recession, litigation, or changes in the regulatory environment can lead to difficulties meeting scheduled interest payments, technical default (the violation of the terms of a debt covenant) or outright liquidation."[586]

This paper takes the position that the possibility of financial distress and even bankruptcy is built into the business model of private equity funds. The primary goal of private equity funds is to maximize returns for investors through investments in underperforming, undervalued and undermanaged companies and the turnaround and restructuring of their business and operations.[587] In the words of Professor Appelbaum: "The expectation that some portfolio companies may need to restructure their debt or even default on their debt obligations is inherent in the private equity model whereby funds hold a portfolio of companies, some of which may yield spectacular gains when sold and some of which will not succeed. The high risks faced by highly leveraged firms are more than offset by the very large payoffs from successful portfolio companies."[588] Occasional bankruptcies of portfolio companies have little effect on the overall return of private equity funds that are usually diversified over different industries and geographic regions.

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[584] *Id.*
[585] *See* Appelbaum and Batt, *supra* note 27.
[586] *See* Press Release, U.S. Dep of Treasury, Secretary Timothy F. Geithner Written Testimony, House Financial Services Committee, Financial Regulatory Reform (Sep 23, 2009) (available at http://www.treas.gov/press/release/tg296.htm). ("Regulating the extent to which funds can use leverage could have the effect of altering the trading practices that these funds can employ, thereby causing fund managers to seek other jurisdictions where more flexible structures and leveraging practices are permitted.").
[587] *See* Appelbaum and Batt, *supra* note 27.
[588] *Id.*

Additionally, as discussed above, this paper takes the position that private equity investors are in fact protected from the effects of financial distress, default or bankruptcy of companies in the fund's portfolio. When a portfolio company fails the investment is gone but the losses end there and the financial exposure is self-contained. The potential losses of a private equity fund are known with some degree of certainty. The legal structure of private equity funds limits their investors losses to the equity capital invested in the portfolio company. The financial exposure associated with private equity owned companies is very different from the unlimited risks associated with the pre-crisis activities of Bear Stearns, AIG, Lehman Brothers and other major financial institutions prior to the 2008 financial crisis. The value of investments made by private equity funds is much less volatile and much more limited than those seen in the cases of systemic capital market failures.

This paper argues that the risk in private equity leveraged buyout transactions and their use of leverage is not the systemic risk regulators were seeking to control through Title IV of the Dodd-Frank Act. The default, bankruptcy or failure of a private equity portfolio company (which may be devastating for different groups of stakeholders) are unlikely to cause cascading losses, present a threat to the financial system or shake the economy. Also, there are no modern instances of a systemic failure or financial crisis triggered by a bankruptcy or failure of a private equity fund or its portfolio companies.

In the final analysis, as this paper argues throughout, the regulatory environment has to change and constrain the kind of financial engineering and excessive leverage by private equity funds that raises the probability of financial distress and bankruptcy. This approach will protect the different groups of stakeholders whose interests may be adversely affected by financial distress, default and bankruptcy of a portfolio company. Nonetheless, this paper takes the position that Title IV fails to achieve this purpose and is not the right regulatory approach. Regulating the source or providers of debt capital is much more likely to reduce the externality associated with the use of leverage and control the risk of excessive leverage in leveraged buyout transactions.

iv) Financial Interconnections or Linkages

Financial interconnections or linkages among financial institutions are a key feature of modern financial systems and systemic risk. They facilitate risk sharing, investment opportunities and access to capital by financial institutions and market participants. They are the result of a wide range of transactions and relationships between banks, financial institutions and other market participants. They are also the mechanism through which systemic risk spreads over the financial system and subsequently creates a financial crisis. These financial interconnections of the modern financial system are generally viewed as a key contributing cause of the 2008 financial crisis. Due to the complex network of connections between market participants and financial institutions, failure of one financial institution can spread to other financial institutions very quickly through these interconnections and lead to a system-wide threat to the financial system and the economy as a whole.[589]

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[589] *See* Paul Glasserman and H. Peyton Young, The Office of Financial Research, *How Likely is Contagion in Financial* Network, June 21, 2013, Working Paper 0009, available at http://csfme.org/News/TabId/120/ArtMID/983/ArticleID/18/Causes-and-Cures-for-Financial-Contagion.aspx.

In 2000 Professor Franklin Allen and Professor Douglas Gale developed an important model of financial networks that explains how complex financial networks and interconnections can influence systemic risk and lead to a financial crisis.[590] In their analysis "systemic risk arises through liquidity shocks that can have a domino effect, causing a problem at one bank to spread to others, potentially leading to failures throughout the system."[591] They further explain that "interbank deposits and interconnections between financial institutions are the primary mechanism for the transmission of liquidity shocks and systemic risk from one financial institution to another."[592] In essence, financial shocks and systemic risk are magnified and spread rapidly through the economy via financial interconnections, linkages and a complex network of financial connections between participants in the financial system.

This paper takes the position that private equity funds do not pose systemic risk because they are not interconnected with other financial institutions or market participants and have no counterparty exposure.[593] Although there are different lines of interconnections in the financial system, interconnectedness usually refers to "institutions' connections by virtue of derivatives positions, brokerage relationship, counterparty exposure relating to, for example, swaps or securities lending, reliance on short-term credit for operations, or the provision of credit to financial system participants."[594] Private equity funds simply do not use these financial instruments or strategies and therefore are not interconnected with other financial institutions or market participants. They do not hold derivatives positions, do not have counterparty exposure and do not rely on short-term credit for their operations.[595] As discussed in Part II of this paper, private equity funds usually acquire a majority interest in mature operating companies. Therefore, private equity portfolio companies that fail are very unlikely to be interconnected to other financial institutions or market participants so as to cause systemic failures and a potential financial crisis.

Interconnectedness is a critical element of systemic risk. It creates the risk of "spillover" namely, that the failure of one financial institution will have cascading negative effects on other financial institutions or market participants and the entire financial system.[596] In the absence of this interconnectedness between financial institutions (like in the case of private equity funds), there is no element of spillover risk that can lead to a systemic failure and eventually a financial crisis. Furthermore, private equity funds are not interconnected with each other, because they neither pledge their assets as security for, nor do they guarantee, each other's obligations. Therefore, a failure of a private equity fund could not create cascading losses that would lead to a systemic failure and eventually a financial crisis.[597] A highly leveraged financial firm that is interconnected with other financial firms is less likely than an unleveraged firm to be able to absorb massive losses and the spillover effects if another financial system participant fails.[598] However, this is not the case with private equity funds as they are not interconnected with other

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590 *See* Franklin Allen and Douglas Gale, *Comparing Financial Systems*, MA, MIT Press, 2000.
591 *Id.*
592 *Id.*
593 *See* Appelbaum and Batt, *supra* note 27 .
594 *See* Acharya et al, *supra* note 1.
595 *See* Lowenstein, *supra* note 24.
596 *Id.*
597 *See* Ladapo, *supra* note 548.
598 *See* Lowenstein, *supra* note 24.

financial institutions. Additionally, they do not lend to financial system participants and are not operationally linked to other financial institutions. Unlike hedge funds which generally rely on derivatives, leverage and short-term credit, private equity funds do not use these financial tools and therefore, pose no systemic threat to the financial system. The links or "channels of contagion, by which one financial institution's failure spreads to other financial institutions", are simply not present in the context of private equity transactions.[599]

Private equity funds are also organized and structured in such a way that the funds owning the portfolio companies are limited partnerships, with no interconnections even between other portfolio companies managed by the same private equity firm.[600] Furthermore, private equity investments are not cross-collateralized. Neither private equity investors nor debt holders can force a fund to sell unrelated assets or another portfolio company to satisfy debt obligations resulting from the default of a portfolio company.[601] In essence, private equity investments in portfolio companies are protected and separated from one another so that a non-performing investment does not affect any other investment in the portfolio of the fund. The failure of one portfolio company does not impact the fund's other portfolio companies. Losses are limited to the underlying value of the original capital investment.[602] Thus in the context of private equity funds, the concern about systemic risk resulting from financial interconnections or linkages between financial institutions and the potential for systemic-wide failure are simply nonexistent.

v) LONG-TERM ILLIQUID ASSET CLASS

Liquidity, which is a major component of systemic risk and a potential financial crisis, is not a practical concern in the context of private equity funds. Liquidity generally refers to how quickly and cheaply certain assets can be converted into cash. Generally, institutions that offer highly liquid investments, such as banks, pose more systemic risk because they are more susceptible to runs during times of financial distress.[603] However, liquidity is not a systemic risk concern in the context of private equity funds because they require long-term capital commitments from investors and do not offer their investors redemption or withdrawal rights that could force the fund into liquidation.[604] Private equity investors usually cannot exit a fund without giving considerable notice, even when major losses occur. Also, the pension funds, endowments and other institutional investors that invest in private equity funds are much less susceptible to selling pressure resulting from sudden financial losses or failures. Therefore, private equity funds don't have to sell assets to fund investors' redemptions. Additionally, private equity funds invest in long-term illiquid assets that are typically the equity securities of operating companies, as opposed to highly speculative financial instruments, like in the case of hedge funds.[605] They rely on long-term, stable financing in the form of capital commitments from their investors and do not normally invest in short-term securities such as derivatives, options or swaps.[606] In the word of the economist Dr. Robert Shapiro "In good and bad times, the

[599] *See* Hendrickson, *supra* note 563.
[600] *See* Ladapo, *supra* note 548.
[601] *Id.*
[602] *See* Lowenstein, *supra* note 24.
[603] *Id. See* also Judge, *supra* note 450.
[604] *See* Elzon, *supra* note 61.
[605] *See* Appelbaum and Batt, *supra* note 27.
[606] *See* Lowenstein, *supra* note 24.

core business of private equity funds is to identify firms with long-term potential for higher productivity, sales and profits, secure the capital to purchase these firms, and inject additional capital, improve their strategies and reorganize their operations, to achieve higher returns."[607] The investment focus of private equity funds on undervalued operating companies simply limits the fund's downside exposure and largely precludes a systemic failure or systemic-wide financial crisis.

Also, private equity funds do not rely on short-term financing that can dry up and therefore a lender's liquidity shortage will not affect the operations of a private equity fund. Rather private equity investors commit their capital for approximately 10-12 years thus making the risk of a run on the bank (the same risk that forced Bear Stearns into a desperate fire-sale in March 2008) impossible.[608] Private equity funds simply cannot be forced to rapidly unwind their portfolios and sell assets to satisfy investor or other claims, thus driving down investment values and potentially adversely affecting other financial institutions, creating a systemic financial crisis.[609] The risk of systemic failure resulting from a liquidity crisis, in the context of private equity funds, is therefore non-existent.

vi) MARKET CONCENTRATION AND DIVERSIFICATION

Market concentration and the potential of creating systemic risk are also not a practical concern in the context of private equity funds. Market concentration refers to the extent to which a given institution is concentrated within a given industry or geographic region.[610] The failure of such an industry or geographic region would signal a near-certain failure of an institution that is concentrated in such an industry or geographic industry. However, this is not generally a concern for private equity funds as they are diversified geographically and across multiple sectors and industries.[611] Private equity funds pursue a variety of investment strategies (e.g., growth capital, venture capital, buyout, real estate, distressed and mezzanine investing) and invest in a broad range of industries and geographic regions.[612] While a specific private equity fund may hold a limited number of investments, and while some private equity funds have an industry or geographic focus, private equity funds in general are diversified across different industries and geographic regions and thus lack concentrated exposure in any single region or sector.[613] If the investment in a particular region or sector becomes unattractive or fails, only a portion of the private equity sector will be adversely affected, because private equity investments are not concentrated in any one sector or region and most importantly, private equity funds are not interconnected with other financial institutions or market participants, as discussed above.[614] Therefore, as there is no over-exposure to any single sector, the concern about systemic risk or a systemic-wide failure associated with market concentration is simply non-existent.

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[607] *See* Shapiro and Pham *supra* note 31.
[608] *See* Hendrickson, *supra* note 563.
[609] *Id.*
[610] *See* Elzon, *supra* note 61.
[611] *See* Hendrickson, *supra* note 563.
[612] *See* Appelbaum and Batt, *supra* note 27 and Lowenstein, *supra* note 24.
[613] *Id.*
[614] *Id.*

As described above, this paper takes the position that private equity funds do not pose systemic risk and present no threat to the financial stability of the economy as a whole because: i) they do not use leverage at the fund level; ii) losses do not spread throughout the financial market but are contained and handled by the fund investors; iii) their activities are not interconnected or linked with the financial system; iv) they offer long-term illiquid investments; and v) they are not concentrated in any one market. It is simply hard to see how any particular private equity fund or its failure could be considered a systemic threat that justifies regulatory intervention. The organization of private equity funds and the nature of their investments and operations are fundamentally different from the circumstances and conditions that led to the 2008 financial crisis and the near-collapse of the entire financial system.[615] The diversified portfolios of private equity funds make it extremely unlikely that problems or failures with some portfolio companies could trigger systemic failures in the financial system. The diversification of private equity funds and their portfolios provides another barrier to broad, systemic and cascading losses or financial failures that can create a major crisis. Therefore, this paper argues that private equity funds should pose very little concern for regulators and policymakers seeking to develop a new regulatory regime to monitor systemic risk and prevent the next financial crisis.[616] The following section examines the regulatory distinction between private equity and venture capital funds under Title IV of the Dodd-Frank Act, from the perspective of systemic risk, and argues that both should enjoy the same exemption from the SEC registration and reporting requirements and be subject to a reduced regulatory regime.

C. THE REGULATORY DISTINCTION BETWEEN PRIVATE EQUITY AND VENTURE CAPITAL

As noted in Part II of this paper, Title IV of the Dodd-Frank Act and its implementing rules amended the Advisers Act to exempt from SEC registration advisers that only manage venture capital funds.[617] The implementing rules adopted by the SEC in order to give effect to the provisions of Title IV of the Dodd-Frank Act, among other things, defined the term "venture capital funds" for purposes of the new Investment Advisers Act exemption available for advisers to venture capital funds under Title IV. Venture capital fund advisers who satisfy the exemption must still comply with certain SEC reporting and recordkeeping requirements. This Part of the paper argues that for regulatory purposes, there is no distinction between private equity and venture capital funds and therefore both should be treated in the same way, enjoy the same exemption from registration and be subject to a reduced regulatory regime.

The exemption granted to venture capital funds under Title IV of the Dodd-Frank Act appears to be motivated by the lack of systemic risk posed by venture capital funds.[618] Congress was operating on the assumption that venture capital funds do not present the same risks as the large private funds whose advisers are required to register with the SEC under Title IV of the Dodd-Frank Act.[619] This is because venture capital funds do not use leverage or borrowed capital, their activities are not interconnected with the global financial system, they offer long-

[615] *Id.*
[616] *See* Tresnowski, *supra* note 542.
[617] *See supra* notes 82 and 84.
[618] *See* Testimony of Terry McGuire, Co-Founder and General Partner, Polaris Venture Partners and Chairman of the National Venture Capital Association, before the House Financial Services Committee, Washington DC, October 6, 2009, available at www.house.gov/.../testimony_of_terry_mcguire_final_10-6-09.pdf.
[619] *Id.*

term illiquid investments, and they generally rely on equity funding so that losses that may occur are born by the fund investors and do not spread throughout the world financial markets.[620] Unlike hedge funds, venture capital funds do not trade complex financial instruments such as credit default swaps and do not utilize short-selling strategies. Therefore, they present no threat to the financial stability of the economy as a whole. Additionally, venture capital funds had very little to do with the 2008 financial crisis.[621] It is universally accepted that venture capital funds did not cause the financial crisis and did not play any part in the credit crisis. They had no involvement in the mortgage-backed securities market, either directly or indirectly, and did not contribute to the build-up of systemic risk that eventually led to the near-collapse of the financial system.[622] They were simply not part of the problem.[623] The exemption granted to venture capital funds under the Dodd-Frank Act and the logic behind it, as described above, clearly validate and strengthen the argument presented in this paper that private equity funds should also be exempt from SEC registration and should be included within the scope of the venture capital exemption.

Venture capital is a subset of private equity and the key difference between the two types of funds lies in their investment focus.[624] Whereas venture capital funds usually invest in early-stage startup companies, private equity funds invest in companies along all stages of a company's life-cycle (usually more mature companies with an established business model). In all other respects, however, private equity funds and venture capital funds are not so different and share the same characteristics. The primary goal of both venture capital and private equity funds is to build and develop companies for an initial public offering or an acquisition. They have virtually the same business model, skill set and compensation structure.[625] In essence, private equity and venture capital funds are two sides of the same coin. Both made no contribution to the 2008 financial crisis, do not use leverage at the fund level, are not interconnected to other financial institutions or market participants, offer illiquid long-term investments and are typically funded by equity.[626] They contain none of the systemic risk factors that led to the 2008 financial crisis and pose no viable threat to the financial system. The risk associated with both private equity and venture capital funds is non-systemic, contained and limited entirely to the operational success or failure of the portfolio companies in which these funds invest.[627] Therefore, these funds should pose very little concern for regulators seeking to develop a new regulatory regime to monitor systemic risk and guard against cascading losses that can lead to a financial crisis. The ability of private equity and venture capital funds to contribute to systemic financial risk or systemic failure is simply non-existent.[628]

Given these similarities between private equity and venture capital funds, this paper takes the position that there is no justification for the regulatory distinction between the two under Title IV of the Dodd-Frank Act.[629] Private equity and venture capital funds should be regulated

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[620] *Id.*
[621] *See* Jickling, *supra* note 483.
[622] *See* Bailey, *supra* note 491.
[623] *See* McGuire, *supra* note 618.
[624] *See* Elzon, *supra* note 61.
[625] *See* Lowenstein, *supra* note 24.
[626] *Id.*
[627] See Ladapo, *supra* note 548.
[628] *Id.*
[629] *See* Lowenstein, *supra* note 24.

in the same manner and enjoy the same exemption from the SEC registration and reporting requirements. The fact that private equity funds usually invest in more mature and developed companies while venture capital funds invest in early stage startups, is irrelevant for regulatory purposes and from a systemic risk perspective. The distinction that the Dodd-Frank Act makes between private equity and venture capital funds, for regulatory purposes, is simply artificial, inadequate and inconsistent with the intended purpose of the Dodd-Frank legislation, given the similarities discussed above. In the words of Douglas Lowenstein, former President and CEO of the Private Equity Growth Capital Council: "Twin brothers, both productive and contributive to the common good, unjustly subjected to different standards. Why should Abel's gifts be accepted, while Cain's gifts are rejected?"[630] It is important to note that these similarities have in the past caused the SEC and other regulators to focus regulation on hedge funds and to exempt private equity funds for the same reasons discussed above.[631]

Furthermore, on June 22, 2011, the SEC adopted final rules implementing the private fund registration requirements and exemptions under Title IV of the Dodd-Frank Act.[632] These final rules define the term "venture capital" as a fund that: i) invests primarily in "qualifying investments" (generally, private operating companies that do not distribute proceeds from debt financings in exchange for the fund's investments in the company); may invest in a "basket" of non-qualifying investments of up to 20 percent of its committed capital; and may hold certain short-term investments; ii) does not incur leverage apart from a limited amount of short-term borrowing; iii) does not offer investors non-extraordinary redemption rights; iv) represents itself as a venture capital fund to investors; and v) is a private fund.[633] This definition is designed to clearly distinguish such investment vehicles from other types of private funds, such as hedge funds and to address valid concerns about systemic risk.

The distinguishing features of the SEC definition, which qualify venture capital funds for the exemption from SEC registration under Title IV of the Dodd-Frank Act, are primarily the non-use of leverage and the lack of redemption rights. The premise behind this definition is that these features eliminate any potential systemic risk to the stability of the financial system and the risk that a failure of a venture capital fund could trigger cascading losses that might lead to a financial crisis. Given the similarities between venture capital and private equity funds, as discussed above, the same logic applies to private equity funds too and therefore, they should qualify for the same exemption from the SEC registration and reporting requirements. This paper argues that from a regulatory perspective and for the purpose of monitoring systemic risk, there is no difference between private equity and venture capital funds that justifies the different regulatory treatment under the Dodd-Frank Act.

Unfortunately, the failure of regulators to recognize the similarities between venture capital and private equity funds from a regulatory perspective, has led to overly broad, unwarranted and costly regulations and registration requirements that try to prevent the rise of systemic risk in investment vehicles (private equity funds) that do not pose any systemic risk

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[630] *Id.*
[631] *See* the discussion of the Hedge Fund Rule background, *supra* notes 89, 91 and 92.
[632] *See* Schapiro, *supra* note 4.
[633] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011). 17 C.F.R Parts 275 and 279.

problem.[634] They try to protect investors whom the system of securities laws views as capable of protecting themselves. This is counterproductive since both private equity and venture capital funds are helping to mitigate the damage of the financial crisis and drive long-term economic growth and innovation through their investment activities. The following section examines the role of private equity as a major driver of economic growth and argues that requiring private equity funds to register with the SEC and subjecting them to extensive and unnecessary reporting requirements will needlessly divert capital, time and effort from investment activities that could be creating jobs and drive economic growth.

D. POLICY CONSIDERATIONS - PRIVATE EQUITY AS A DRIVER OF ECONOMIC GROWTH

Private equity funds are a major driver of economic growth and job creation and play a key role in the economic recovery of the U.S. They are an important source of capital for companies undertaking restructuring or operational changes and a major component of a dynamic and efficient capital market. They have a long track record of preserving and generating jobs by providing capital and management resources to small and mid-size American businesses (that otherwise might have gone into bankruptcy).[635] They simply deliver the capital necessary for companies to compete, succeed, and grow. In the words of Professor Eileen Appelbaum "private equity is an integral part of the everyday lives of millions of Americans. When you buy coffee in the morning at Dunkin' Donuts, you are interacting with private equity; when you see a movie produced by MGM Studios and buy a pizza at Domino's afterwards, you are interacting with private equity. When you shop at Toys R Us for the hottest new video game or the latest "must have" doll or when you buy a new outfit at J. Crew, you are touching private equity."[636] By creating stronger companies and businesses "private equity funds create an economic ripple that flows through the economy, saving and creating jobs and driving long-term growth."[637]

Between 2002 and 2012, 2,400 U.S.-based private equity funds invested more than $1.6 trillion in 15,200 U.S.-based companies which employ more than eight million people.[638] By investing in promising companies and those needing a turnaround, private equity has helped grow key sectors of the economy including manufacturing, technology, health care, automotive, energy and retail. In 2011 alone, the private equity industry invested more than $150 billion in U.S. companies, creating jobs and driving long-term economic growth.[639] Throughout 2013 2,830 private equity-backed buyout deals were announced with an aggregate value of $274 billion, the highest value since $661 billion worth of deals were announced in 2007.[640] North America experienced its strongest year in 2013 since 2007 in terms of total value of buyout

[634] *See* Hendrickson, *supra* note 563.
[635] *See* Testimony of Andrew M. Bursky, Chairman of Atlas Holdings LLC, before the House Committee on Financial Services, Washington DC, January 26, 2011, available at www.financialservices.house.gov/media /pdf/012611abursky.pdf.
[636] *See* Appelbaum and Batt, *supra* note 27.
[637] *See* Laffer et al, *supra* note 38.
[638] *See* Steve Judge, *Private Equity is Good for America,* March 30, 2012, available at http://www.msnbc.msn.com /id/46908064/ns/business-motley_fool/
[639] *Id.*
[640] *See* 2014 Preqin Global Private Equity Report, available at https://www.preqin.com/.../ The_2014_Preqin_ Global_Private_Equity_Report _Sample_Pages.pdf.

deals, with 1,516 deals valued at $171 billion, a 10% increase compared to the total value of private equity-backed buyout deals in 2012.[641]

The business model of private equity funds is based on long-term investments in businesses and people (not publicly traded securities) with the objective of building and growing companies.[642] As discussed in Part II of this paper, private equity funds raise capital from institutional investors such as pension funds and university endowments to invest in underperforming, undermanaged or undervalued companies.[643] The fund managers work to increase the value of the companies they buy through capital investment and managerial expertise. With infusions of capital, talent and strategy, private equity funds improve the productivity, performance and financial strength of the companies in which they invest with the objective of turning these companies around. Among other things, they improve business strategy, purchase more efficient machinery and equipment, commercialize new technologies, streamline the operations, cut costs and expand product distribution in an effort to strengthen companies and build shareholder value.[644] Within several years after the initial investment, private equity funds usually look to sell the portfolio companies or take them public with the objective of generating superior returns to their investors.[645]

Private equity funds only make money for their investors and partners when the companies they acquire grow, increase earnings and become more successful.[646] This business model is clearly beneficial for the companies in which private equity funds invest, their employees, the communities in which they operate and, of course, the economy as a whole. Despite the common perception that most of the earnings and growth of private equity come from cutting costs and eliminating jobs, it is important to note that most of these target companies might have gone into bankruptcy without the capital infusion of private equity funds and the restructuring and reorganization efforts of the fund managers. The long-term focus of the private equity business model aligns the interests of private equity funds with the portfolio companies they buy and ensures that these companies have lasting success.[647] Professor Josh Lerner of Harvard Business School and Professor Jerry Cao of Boston University reported that "based on an analysis of 496 acquisitions between 1980 and 2002—companies that went public again after being acquired by private equity firms and operated by them for more than a year consistently outperformed the market and other IPOs."[648] Additionally, private equity funds provide their institutional investors various investment opportunities that otherwise would be unavailable to most institutions, as well as high net-worth individuals, namely, the opportunity to take part in the reorganization, restructuring and turn-around of privately owned operating companies.[649]

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641 *Id.*
642 *See* Hendrickson, *supra* note 563.
643 *Id.*
644 *See* Laffer et al, *supra* note 38.
645 *See* Bursky, *supra* note 635.
646 *See* Hendrickson, *supra* note 563.
647 *See* Bursky, *supra* note 635.
648 *See* Lowenstein, *supra* note 24; *See* Josh Lerner and Jerry Cao, *The Performance of Reverse Leveraged Buyouts* (October 15, 2006). Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market. Available at SSRN: http://ssrn.com/abstract=937801 or http://dx.doi.org/10.2139/ssrn.937801.
649 *Id.*

A real life example of how private equity funds turn around and restructure underperforming operating businesses is Commonwealth Laminating and Coating (CLC), a small company based in Martinsville, Virginia. CLC manufactures, sells and distributes solar control window films that help shield cars, houses and commercial properties from the sun's heat. Its products are sold all over the world.[650] In 2006 CLC needed additional capital to fund its continued growth and operations. However, the company's existing shareholders were not able or willing to provide the necessary capital and the company's future was at risk. CLC then approached the Riverside Company, a major private equity fund and over time Riverside acquired a majority ownership interest in CLC and invested an additional $16 million to improve the company's production capacity. Through various restructuring efforts, investments in equipment and reorganization measures, the company improved its product quality and strengthened its market position and customer base. By the time Riverside sold CLC 4 years later, the Company had grown its earnings by 277%.[651] Together, Riverside and CLC grew jobs by 73%, adding 61 jobs in Martinsville, Virginia and provided a major return to the teachers, firefighters and government employee pensions funds that invested through Riverside. With the help of Riverside's capital, management expertise and restructuring and reorganization experience, CLC became a great success.[652]

Another example of how private equity funds restructure, reorganize and turnaround operating companies is Burger King. In 2002 several major private equity funds acquired Burger King, seeing an opportunity to restructure and turnaround the world's second largest fast-food chain.[653] At the time of the transaction, Burger King was struggling and its financial performance was weak due to various operational and business challenges. Despite these tremendous challenges, the private equity funds recognized an opportunity to reorganize the company and revive the brand through various investments, operational and restructuring measures. Following a major infusion of capital, the private equity funds recruited a new management team and developed a new strategic plan for the business. The company implemented major cost reductions, large-scale operational improvements, restructuring measures and invested heavily in sales and marketing. These restructuring efforts resulted in reversing the decline in overall restaurants and opening nearly 1,000 international stores. Over time these measures drove outstanding financial results and profitability across the business.[654] As a result of these efforts, the chain performance and customer experience improved significantly. Revenues grew considerably, increasing earnings by 37%. The chain had a successful public offering in 2006.

Additionally, through superior investment returns, private equity funds deliver important financial support for universities, research institutions and pension funds that benefit tens of millions of Americans.[655] The private equity investor base is dominated primarily by pension funds of such household names like GM, GE, IBM and Boeing as well as private and public universities. Public pension and retirement funds also invest heavily in private equity funds. In

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[650] *See* Hendrickson, *supra* note 563.
[651] *Id.*
[652] *Id.*
[653] *See* Shapiro and Pham, *supra* note 31.
[654] *Id.*
[655] *Id.*

short, the largest beneficiaries of private equity returns are the millions of Americans who rely on pensions, college endowments, and other charitable foundations as well as leading universities and other foundations.[656] In the words of economist Dr. Robert Shapiro, "in good and bad times, the core business of private equity funds is to identify firms with long-term potential for higher productivity, sales and profits; secure the capital to purchase these firms; and inject additional capital, improve their strategies and reorganize their operations, to achieve higher returns. Public policy should support these activities, especially during the current crisis and refrain from imposing additional burdens that could hamper these activities or redirect them to other economies."[657]

Given the importance of private equity as a vital engine that helps drive the American economy, this paper takes the position that subjecting private equity funds to excessive and unnecessary regulatory requirements may jeopardize the nation's economic growth and recovery and the role private equity funds play in the U.S. economy.[658] Requiring private equity funds to register with the SEC under the Title IV of the Dodd Frank Act will needlessly divert capital, time and effort from productive investment activities that could be creating jobs and drive economic growth. It will simply impose an undue burden on private equity funds (particularly small and mid-size funds), drain their resources and diminish their ability to continue their investment activities at a critical time.[659] Rather than using their resources to invest in businesses and drive growth, private equity funds will use some of their resources to build the necessary compliance infrastructure and comply with the new regulatory regime that imposes tremendous costs, seeking to solve a non-existent problem, as discussed in Parts III and IV of this paper. Additionally, the total cost of compliance with Title IV of the Dodd-Frank Act for all new private equity funds is estimated to be as much as $500 million (at least $500,000 per year for each private equity fund that has to comply with Title IV of the Dodd-Frank Act).[660] These costs may reduce returns to private equity investors such as endowments and pension funds and may also hurt the economy in the long run. According the Congressional Budget Office, the SEC is expected to expend approximately $140 million from 2010 through 2015 to implement Title IV and private investment funds are expected to expend approximately $130 million per year to comply with the requirements of Title IV.[661] It seems that these resources can be put to a much better use.

Therefore, this paper takes the position that from an economic recovery perspective, there is no compelling argument to justify the excessive regulation of private equity funds and their advisers under Title IV of the Dodd-Frank Act, particularly since Title IV does not add anything from an investor protection standpoint and does not solve a systemic risk problem. The regulatory approach adopted by Congress is clearly detrimental to the U.S. economy and may decrease the capital available to drive economic growth and job creation. This over-regulation of

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[656] *Id*.
[657] *See* Dr. Robert J. Shapiro, *The Role of the Private Equity Sector Promoting Economic Recovery*, Private Equity Council, March 2009, available at www.pegcc.org/wordpress/wp.../pec_economic-recovery_032309a.p...
[658] *See* Lowenstein, *supra* note 24.
[659] *Id.*
[660] *See* Bursky, *supra* note 635.
[661] *See* House of Representative Report (113-276), Small Business Access to Capital and Job Preservation Act, available at www.gpo.gov/fdsys/pkg/CRPT.../html/CRPT-113hrpt276.htm.

private equity funds is expected to slow down the funding activities of the private equity industry and adversely affect long-term economic growth.

V. RECOMMENDATIONS

A. LEVERAGED LENDING STANDARDS - AN ALTERNATIVE APPROACH TO THE REGULATION OF PRIVATE EQUITY FUNDS

The essence of the discussion to this point has been the problems associated with Title IV of the Dodd-Frank Act and its implementing rules, the SEC registration and reporting requirements and the overall approach to the regulation of private equity funds. This paper has taken the position that the decision of Congress and the SEC to regulate private equity funds and subject them to extensive SEC registration and reporting requirements is inadequate, unnecessarily costly, inconsistent with the intended purpose of the Dodd-Frank Act and its underlying theory of regulation, too disclosure-focused, based on fundamental misconceptions as to the nature of private equity and does not properly address the potential risk of too much leverage. It does not add anything substantial to the protection of private equity investors and in fact, tries to prevent the rise of systemic risk in investment vehicles that do not pose systemic risk problems. Since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', this paper takes the position that these funds and their managers should be subject to a reduced regulatory regime and exempt from the SEC registration, reporting and disclosure requirements under Title IV of the Dodd-Frank Act. For purposes of Title IV, there is a compelling argument why private equity funds should be lumped together with venture capital funds and benefit from the same exemption from SEC registration available for venture capital funds.[662]

The concerns associated with the use of leverage by private equity funds as discussed in Part IV of this paper and the risk of excessive leverage (which are valid and legitimate concerns, although unlikely to cause a systemic-wide failure of the financial system) should be addressed through more substantive rules like leveraged lending regulation and tighter and prudent underwriting practices, standards and policies. This paper takes the position that by setting new standards for underwriting of leveraged loans by banks and other lenders engaged in leveraged financing activities, regulators and policymakers can ensure that private equity firms will have to meet higher standards when seeking buyout loans, therefore, reducing the risk of high leverage and the remote probability of a systemic financial crisis. This approach will: i) eliminate the unnecessary, costly and burdensome compliance requirements of Title IV; ii) reduce and mitigate the potential risk posed by private equity funds and their use of leverage; and iii) protect and preserve the benefits that private equity funds offer the financial system and the economy. This approach is already being implemented by regulators in the form of leveraged lending guidelines.[663] It is actually causing banks and other lenders to tighten the underwriting of

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[662] *See supra* note 104. *See* discussion in Part IV (C) of this paper as to the regulatory distinction between private equity and venture capital for purposes of Title IV of the Dodd-Frank Act.

[663] *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (March 22, 2013), available at http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-9.html. *See* also Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2014),

leveraged loans, be more cautious about leveraged lending and change the decision making process as to leveraged lending transactions.[664]

For example, in May 2014, three major banks for the private equity fund KKR & Co., (formerly known as Kohlberg Kravis Roberts & Co. and one of the largest and most prominent private equity funds in the world) denied a request for a $725 million buyout loan due to concerns that the loan was too risky and inconsistent with leveraged lending standards and guidelines issued by regulators.[665] The same banks had actually funded a similar transaction six months earlier. In December 2013, Morgan Stanley, Credit Suisse and Goldman Sachs were among the banks that helped finance KKR's $1.6 billion leveraged buyout of landscaping company Brickman Group Ltd. Morgan Stanley and Credit Suisse acted as the lead bankers in this leveraged buyout transaction.[666] The leverage component of the transaction was based on 6.8 times the Company's annual earnings before interest, tax, depreciation and amortization (EBITDA).[667] However, under the recently issued leveraged lending regulatory guidelines, leverage in excess of six times EBITDA should raise concerns and be subject to additional scrutiny.[668] Accordingly, the same three banks decided to deny KKR's request for a similar buyout loan as it is inconsistent with the latest leveraged lending guidelines. The decision by these three major banks not to back one of their largest, most profitable and most prominent private equity clients clearly demonstrates how leveraged lending regulation implemented after the 2008 financial crisis is in fact reshaping the leveraged lending environment and how banks and lenders are becoming more cautious about leveraged lending. This paper supports this regulatory approach and recommends that the primary mechanism for regulating the risk of excessive leverage by private equity funds should be tightening underwriting practices and fostering an environment in which the discipline of banks and other lenders constrains excessive leverage and risk-taking by private equity funds.

Prompted by the concerns about increasing leveraged lending volumes over the last decade and deterioration of prudent underwriting practices, on March 21, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation issued joint guidance on leveraged lending, replacing the regulatory interagency guidance in effect since 2001.[669] This guidance seeks to establish a risk management obligation or framework for banking institutions and lenders engaged in leveraged lending activities. The guidance specifically identified: "i) debt agreements that included features that weakened lender protection by excluding meaningful maintenance covenants and included other features that could limit lenders' recourse in the event of weakened borrower performance; ii) aggressive capital and repayment structures for some transactions, whether originated to hold or to distribute; and iii) less than satisfactory management information systems that were unable

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"Credit Risk in the Shared National Credit Portfolio Is High; Leveraged Lending Remains a Concern," joint press release, November 7, 2014.

[664] *Id.*

[665] *See* Lauren LaCapra, Greg Roumeliotis and Michelle Sierra, "*Banks Deny KKR Buyout Loan Amid Regulatory Crackdown",* (May 29, 2014), Thomson Reuters (US), available at *http://www.reuters.com/article/2014/05/29/us-kkr-loan-idUSKBN0E92BS20140529*.

[666] *Id.*

[667] *Id.*

[668] *Id.*

[669] *See supra* note 663.

to aggregate exposure on a timely basis."[670] Under the guidance banks are required to define leveraged lending in their policies and procedures to ensure consistent application across all business lines using criteria appropriate to the lending institution.[671] The guidance further provides the following examples for a bank to consider in developing its definition of leveraged lending activities: "i) proceeds used for buyouts, acquisitions, or capital distributions; ii) transactions where the borrower's total debt divided by EBITDA or senior debt divided by EBITDA exceeds 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector; iii) a borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio; and iv) transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels."[672]

The guidance includes key areas to be addressed by banks and other financial institutions engaged in leveraged lending, such as:

- Establishing a sound risk-management framework: The regulators expect that management and the board of directors of the lending institution will identify the institution's risk appetite for leveraged finance, establish appropriate credit limits, and ensure prudent oversight and approval processes.[673]

- Underwriting standards: An institution's underwriting standards should clearly define expectations for cash flow capacity, amortization, covenant protection, collateral controls, levels of due diligence and the underlying business premise for each transaction, and should consider whether the borrower's capital structure is sustainable, regardless of whether the transaction is underwritten to hold or to distribute.[674]

- Valuation standards: An institution's standards should concentrate on the importance of sound and clear methods in the determination and periodic revalidation of enterprise value.[675]

- Pipeline management: An institution should be able to accurately measure exposure on a timely basis, establish policies and procedures that address failed transactions and general market disruptions, and ensure periodic stress tests of exposures to loans not yet distributed to buyers.[676]

- Reporting and analytics: An institution should ensure that management information systems accurately capture key borrower characteristics and aggregate them across business lines and legal entities on a timely basis, with periodic reporting to the institution's board of directors. The guidance further imposes a duty on institutions to analyze the viability of a

[670] *Id.*
[671] *Id.*
[672] *Id.*
[673] *Id.*
[674] *Id.*
[675] *Id.*
[676] *Id.*

borrower within the context of the borrower's industry, and integrate that information into both general risk and stress assessments. This analysis should include: cash flow analysis, liquidity based upon metrics in the industry; merger and other corporate transactions; variations in the borrower's business and operating plans (performed on a quarterly basis); collateral shortfalls; changes in the debt and equity markets; and interest and foreign exchange risk. [677]

- <u>Risk rating leveraged loans</u>: An institution's risk rating standards should consider the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time.[678]

- <u>Participations</u>: An institution that participates in leveraged loans should establish underwriting and monitoring standards similar to those for loans underwritten internally.[679]

- <u>Stress testing</u>: A lending institution should perform stress testing on leveraged loans held in a portfolio as well as those planned for distribution, in accordance with existing interagency guidelines.[680]

Under the guidance, financial institutions engaged in leveraged lending must review and revise their leveraged lending policies and procedures, underwriting standards, and management processes to ensure they address the specific areas covered in the guidance and required by regulators. Failure to follow these standards could result in a finding that "a bank or lending institution is conducting lending activities in an unsafe and unsound manner."[681]

While the full implications of this guidance and the changes that will be made by banks and other lenders remain to be seen, it seems that this regulatory approach is already starting to reshape the leveraged lending environment and how banks underwrite leveraged loans. It shows "a clear intention by regulators to control and constrain aggressive and risky leveraged lending practices" which is in line with the intended purpose of the Dodd-Frank Act.[682] The main policy recommendation of this paper is for regulators to continue to tighten underwriting practices and foster an environment in which the discipline of banks and other lenders controls excessive leverage and risk-taking. Going forward, financial institutions engaged in leveraged lending will clearly have to reevaluate their internal procedures and tighten their underwriting standards to ensure that they are in compliance with the new leveraged lending requirements imposed by regulators. The following section of the paper explores some of the recent challenges of implementing leveraged lending regulation.

[677] *Id.*
[678] *Id.*
[679] *Id.*
[680] *Id.*
[681] *Id.*
[682] *Id.*

B. THE CHALLENGES OF LEVERAGED LENDING REGULATION

While the guidance on leveraged lending discussed above is definitely a step in the right direction in terms of regulating leveraged lending and reducing the risk of excessive leverage, it seems that the implementation process is still in its early stages. Now, almost two years after the initial implementation of the guidance, we continue to see robust leverage markets and highly leveraged mergers and acquisitions. A combination of vague and inconsistent regulations, creative banking practices and a wide range of alternative non-bank lenders have slowed down and to some extent inhibited regulators' ability to control and manage leverage levels. In essence, banks and other lenders continue to try to retain the profitable business of leveraged lending and meet demands from clients and investors as leveraged lending is one of the most lucrative forms of loans for banks.

As discussed above, the fundamental purpose of the guidance on leveraged lending was simple: "to promote safe-and-sound leveraged activities by providing restrictions on credit and underwriting policies, institutional risk appetite, stress testing, approval processes and internal management and reporting."[683] However, it appears that over the past two years, banks have been selectively ignoring the restrictions, and using the guidelines themselves to find loopholes for funding non-compliant deals.[684] For example, the new regulations state that transactions in excess of 6X total debt/EBITDA raise concerns for most industries.[685] However, the term "most industries" has never been defined or clarified in this context. Also, it has never been determined who makes the decision as to which industries are regulated and how are banks supposed to know which industries are considered exempt.

Banks and lenders are also becoming more creative in their lending strategies in order to circumvent the new restrictions entirely. Reuters recently reported on banks looking into arranging Paid-in-Kind (PIK) bonds that would split overall debt between the holding company and its operating subsidiaries.[686] Some banks are even exploring partnerships with Business Development Companies (BDCs) and participating in "unitranche" deals, whereby the banks hold the senior loan and the BDC issues the subordinated debt, thereby allowing the banks to hold less leverage.[687] It is clear that as leveraged lending is an extremely lucrative business for banks and lenders, these institutions are starting to think outside the box in order to maintain their market share and prevent alternative lenders from entering the lucrative market of leveraged loans.

Also, non-bank lenders have always been a viable alternative for obtaining leveraged financing, but with the new guidelines in place, their value has increased. In fact, non-bank players handled 83% of total middle-market volume in 2013, up from 77% in 2012 and 70.6% in

[683] *Id.*
[684] *See* Greg Roumeliotis and Lauren Tara LaCapra, *Banks Search for Loopholes in Leveraged Loans Guidelines*, Reuters (June 10, 2014), available at http://www.reuters.com/article/2014/06/10/us-banks-regulations-insight-idUSKBN0EL08X20140610.
[685] *See supra* note 663.
[686] *See* Roumeliotis and Lacapra, *supra* note 665.
[687] *Id.*

2011.[688] It is very likely that as leveraged lending restrictions continue to increase and banks pass on more and more deals, non-banks such as finance companies, hedge funds and insurance companies among others, will become the alternative lenders for mid-market firms to secure leveraged financing.

The Federal Reserve is now increasing its oversight of high-risk leveraged loans, shifting to a deal-by-deal review after its previous guidelines were largely ignored by banks. The Federal reserve is now examining leveraged loans as they are made, demonstrating a sense of urgency in avoiding the kind of overly risky lending that was one of the causes of the 2008 financial crisis. In the event this regulatory approach does not work, regulators have other options. They can change supervisory ratings on banks, which could limit leveraged transactions and they could also resort to fines or other sanctions for failure to comply with the guidance. However, despite the efforts of regulators, it remains to be seen how the new leveraged lending regulations will reshape the leveraged lending environment and regulate the risk of excessive leverage. Thus far, these regulations do not seem to have a major effect on banks and lenders and big leverage deals are still being funded. It is anticipated that Wall Street banks will continue to play "cat-and-mouse" with regulators over leveraged lending rules as they try to retain a very profitable business and meet demands from clients and investors.

C. RECENT LEGISLATIVE INITIATIVES

It is interesting to note that there is a recent legislative initiative to amend the Advisers Act and exempt private equity funds from the SEC registration and reporting requirements under Title IV of the Dodd-Frank Act.[689] The Small Business Capital Access and Job Preservation Act, H.R. 1105, was introduced in the House of Representatives by Congressman Jim Himes, a Democrat from Connecticut, and Congressman Robert Hurt, a Republican from Virginia in March 2013. The bill has 12 cosponsors: seven Democrats and five Republicans. It seeks to expand the scope of the venture capital exemption under Title IV of the Dodd-Frank Act and include private equity funds within the same category.[690] Private equity funds that have outstanding debt or leverage in excess of two times their invested capital commitments would not be able to benefit from this exemption and would still be required to register with the SEC. The bill further requires the SEC, within six months of enactment, to publish rules defining the term "private equity fund" and requiring exempted fund managers to "maintain records and provide reports that the SEC determines are necessary and appropriate in the public interest and for the protection of investors."[691] In establishing these rules, the SEC will take into account factors like "fund size, governance, investment strategy and risk."[692]

This bill is designed to reduce the regulatory burden of Title IV in order to facilitate access to capital, economic growth and job creation. It is expected to help private equity funds by

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[688] *See* Kelly Thompson, *Leveraged Loans: Banks' Share of Middle Market Pie Shrinks Further in 2013,* Forbes (January 29, 2014), available at http://www.forbes.com/sites/spleverage/2014/01/29/leveraged-loans-banks-share-of-middle-market-pie-slips-further-in-2013/.
[689] *See* H.R. 1105 (113 Congress 2013-2015), The Small Business Capital Access and Job Preservation Act, available at https://www.govtrack.us/congress/bills/113/hr1105/text.
[690] *Id.*
[691] *Id.*
[692] *Id.*

removing costly and unnecessary regulatory requirements that tie up financial resources and may even waste investor capital that would otherwise be used to grow and develop small businesses. This proposed legislation (which is consistent with the arguments presented in this paper) is based on the premise that i) private equity funds did not contribute to the 2008 financial crisis, ii) these funds are not a major source of systemic risk, iii) the risk associated with private equity funds is very different from the systemic risk that was the basis for the 2008 financial crisis and the Dodd-Frank legislation, iv) many of the rules and requirements of Title IV have no relevance for the private equity sector, and v) the registration and reporting requirements of Title IV interfere with the flow of capital and do not provide any protection to investors in private equity funds, who can fend for themselves. This proposed legislation confirms the position taken in this paper that private equity funds pose no systemic risk to the U.S. economy nor do they raise investor protection concerns that justify regulatory intervention.

Rep. Jeb Hensarling (R-Texas), Chairman of the House Financial Services Committee said after the House vote in favor of the bill in December 2013 that "many of us would argue on a bipartisan basis that part of the Dodd-Frank Act that requires small-business investors who are private equity advisors to register with the SEC is perhaps one of those provisions that is in need of reform. This is a provision that many of us believe was aimed at Wall Street but it ends up hurting Main Street."[693] Nonetheless, the prospects of the bill are still uncertain. On December 3, 2013, President Obama released a statement strongly opposing the bill and threatening to veto it. Also, the bill was never passed by the Senate. It remains to be seen whether Congress is going to accept the idea that private equity funds are not a major source of systemic risk and therefore, should be exempt from the SEC registration and reporting requirements and subject to a reduced regulatory regime.

VI. CONCLUSION

Douglas Lowenstein, the former President of the Private Equity Growth Capital Council indicated in his Congressional testimony in 2010 that "private equity investments do not create systemic risk. Private equity firms invest in companies, not exotic speculative securities and their investors are long-term investors, eliminating the 'run on the bank' type of risk that helped create the 2008 financial crisis."[694] As this paper demonstrates, the decision of Congress to regulate private equity funds under Title IV of the Dodd-Frank Act and the implementation of Title IV through the SEC rules are inadequate, unnecessarily costly and inefficient. Title IV and its implementing rules follow the traditional post-crisis legislative pattern which is usually excessive, burdensome, flawed and populist in nature. They are based on fundamental misconceptions as to the nature of private equity and the alleged systemic risk associated with private equity funds. They try to prevent the rise of systemic risk in investment vehicles that do not pose any systemic risk problems. Additionally, they fall short of achieving the objectives of the Dodd-Frank Act and are inconsistent with the underlying theory of regulation. They are is too disclosure-focused and do not add anything significant to the protection of private equity investors who are financial institutions who can fend for themselves. Like any other excessive post-crisis financial reform, Title IV and its implementing rules may have satisfied a political need, but they will not benefit the financial market or the economy as a whole and will not improve investor welfare. This government intervention in the private equity sector was simply

[693] *Id.*
[694] *See* Lowenstein, *supra* note 24.

driven by the political pressure on Congress to quickly launch a comprehensive reform of the financial system, and reflects a poor public policy decision. It has gone beyond the concerns that led to the 2008 financial crisis and the measures necessary to address and control the risks associated with private equity funds. It seems to fall within the definition of "quack law" or "bubble laws" in the words of Professor Romano and Professor Bainbridge.[695]

As a matter of economic theory and history the activities of private equity funds to turn around, restructure and reorganize existing operating companies are very unlikely to pose systemic risk to the financial system and the economy as a whole. As discussed throughout this paper, the business of private equity funds is simply very different from the patterns of cascading losses and failures that led to the 2008 financial crisis.

Additionally, Title IV's implementing rules do not meet the economic analysis and cost benefit justification standards set by the D.C. Circuit Court in the Business Roundtable decision. The SEC, in implementing Title IV, had failed to perform an adequate cost benefit analysis and to consider the impact of this legislation on efficiency, competition and capital formation. It failed to articulate a satisfactory and reasoned explanation for its regulatory actions, including a rational connection between the pre-crisis conduct and failures it was trying to address and the regulatory choices made. In essence, Title IV's implementing rules are not supported by any substantial cost benefit analysis that would survive judicial scrutiny after the decision in Business Roundtable or any other compelling argument demonstrating that the benefits of Title IV's implementing rules are greater than its costs.

Since private equity funds are not a major source of systemic risk, they play a critical role as a driver of economic growth and their investors have the resources and sophistication to 'fend for themselves', this paper takes the position that these funds and their managers should be subject to a reduced regulatory regime and exempt from the SEC registration, reporting and disclosure requirements under Title IV of the Dodd-Frank Act and its implementing rules. The concerns associated with the use of leverage by private equity funds and the risk of excessive leverage, which are valid and legitimate concerns, should be addressed through more substantive rules like leveraged lending regulation and tighter underwriting practices, standards and policies. This is especially true since there is nothing unique about a lender's loan to private equity portfolio companies that would make them more risky than a wide range of other types of loans made by a bank or other lender, in the ordinary course of business, to other companies owned by public shareholders, public companies or other institutional investors. By setting new standards for underwriting of leveraged loans by banks and other lenders, regulators and policymakers can ensure that private equity funds will have to meet higher standards when seeking buyout loans, therefore, reducing the risk of high leverage and the remote probability of a systemic financial crisis.

The alternative approach suggested in this paper, namely exempting private equity funds from the SEC registration requirements under Title IV of the Dodd-Frank Act and its implementing rules, is supported by precedents. On October 26, 2001 President Bush signed into law the USA Patriot Act in response to the terrorist attacks of September 11, 2001.[696] The

[695] *See* Romano, *supra* note 8 and Bainbridge, *supra* note 125.
[696] Pub. L. No. 107-56, 115 Stat. 272 (2001).

primary purpose of this legislation was to combat terrorism and money laundering activities. Among other things, the legislation imposed anti-money laundering compliance obligations on financial institutions, including broker-dealers, commodity trading advisors, commodity pool operators and investment companies.[697] Although the term "investment companies" was not specifically defined, most legal opinions concluded that the term was intended to include both registered investment companies and private investment funds.[698] In addition to compliance with the new anti-money laundering regime, the new legislation imposed significant and costly new obligations, including designating a compliance officer, establishing training programs and arranging independent audits to ensure compliance. However, as the regulatory process unfolded, legislators recognized that private equity and venture capital funds did not meet the requirements for money-laundering risks and concluded that funds which do not permit investors to redeem the investment within two years, would not be required to comply with the anti-money laundering regime of the Patriot Act.[699] Thus the regulations were adjusted to address the fact that there was no money-laundering risk involved in the investment activities of private equity and venture capital funds. This is exactly the position this paper takes with regard to the regulation of private equity funds. U.S. regulators should use the same approach in the context of Title IV of the Dodd Frank Act and its implementing rules. They should recognize that private equity funds pose no systemic risk to the stability of the financial system and therefore, should be exempt from the SEC registration and reporting requirements and subject to a reduced regulatory regime. The potential risks of excessive leverage should be regulated through leveraged lending regulations as discussed above.

From a financial regulation perspective, this paper has argued that overall financial regulators should ground their rulemaking in rigorous cost benefit analysis and standards, consistent with the Business Roundtable decision, to arrive at more rational decision-making and efficient regulatory actions that advance the public interest. This legislative approach, unlike Title IV's implementing rules, will avoid hasty regulation that fails to achieve its goals and imposes costs that exceed its benefits. It will ensure that society and the economy gain enough from the regulation to justify its costs. In the words of Professor Cass Sunstein, "rigorous cost benefit analysis creates confidence in the ability of regulators to craft effective and appropriate solutions to market problems. It also deters regulators from proceeding with rules that promise to impose big economic burdens without corresponding gains."[700]

The ultimate effect of Title IV and its SEC registration and reporting requirements is difficult to predict at this point and it is impossible to determine with certainty whether regulators made the right decision to include private equity funds within the scope of Title IV. Nonetheless, it still seems that until Congress eliminates or reduces this unnecessary and costly regulatory burden, these registration and reporting requirements are expected to have an adverse impact on the private equity sector and possibly the U.S. economy in the long run.

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[697] *See* McGuire, *supra* note 618.
[698] *Id.*
[699] *Id.*
[700] *See* Sunstein, *supra* note 22.