Private Equity and Investor Protection in the United States and in Europe

by

Doris Toyou

Undergraduate degree, Université Paris I Panthéon-Sorbonne, 1996

Master's degree in International Economic Law, Université Paris I Panthéon-Sorbonne, 1999

LL.M. in Banking and Financial Law, Boston University School of Law, 2003

Submitted to the Graduate Faculty of the

University of Pittsburgh School of Law in partial fulfillment

of the requirements for the degree of

Doctor of Juridical Science

University of Pittsburgh

2019

UNIVERSITY OF PITTSBURGH

SCHOOL OF LAW

This dissertation was presented

by

Doris Toyou

It was defended on

October 28, 2019

and approved by

Peter Oh, Professor of Law, School of Law

Kenneth M. Lehn, Professor of Finance, School of Business

Thesis Advisor: Douglas M. Branson, Professor Emeritus, School of Law

Private Equity and Investor Protection in the United States and in Europe

Doris Toyou, S.J.D.

University of Pittsburgh, 2019

This dissertation discusses how securities regulation has expanded to reach sophisticated investors of private funds such as private equity, venture capital, and hedge funds. The Dodd-Frank Act in the United States (U.S.) and the Alternative Investment Fund Managers Directive (AIFMD) in the European Union (EU) embody a shift in securities law. Investment managers of private funds now have to register with regulators and file periodic reports if they manage assets above a set threshold (over $150 million in the U.S. and over 100 million euro ($114 million) in the E.U). Since registration of private equity managers with the Securities and Exchange Commission (SEC), several enforcement actions have been brought against managers. Based on federal securities law, the SEC stresses concerns with conflicts of interest and fiduciary duties managers owe to investors.

Unlike AIFMD, the Dodd Frank Act has not hampered the dynamic of fundraising and activities of private funds. Thus, Dodd Frank Act remains the law of the land within United States.

Table of Contents

List of Tables

List of Figures

Preface

I am indebted to Professor Douglas M. Branson for his guidance during the S.J.D. dissertation process. I acknowledge the great contributions of Professor Peter Oh, from whose classes and discussions I benefited greatly, as well as Professor Kenneth Lehn, whose useful writings cemented my understanding of financial mechanisms discussed in this dissertation. Lastly, I thank Patricia Harrington Wysor for her great editing contributions.

The University of Pittsburgh School of Law, Center for International Legal Education (CILE) and its great professors have enriched my journey.

Introduction

In the fall 2008, Treasury Secretary Geithner painted a bleak picture of the economy, by stating:

> Fannie Mae and Freddie Mac were put into government conservatorship. Lehman Brothers collapsed. Merrill Lynch, Wachovia and Washington Mutual were acquired in distress. A $62 billion-dollar money market fund "broke the buck." The world's largest insurer avoided bankruptcy only with the help of $85 billion in emergency aid. Goldman Sachs and Morgan Stanley announced they would protect themselves by becoming bank holding companies. When Congress' first attempt to pass the Emergency Economic Stabilization Act (EESA) failed, the stock market took a historic plunge. In a matter of just three months, five trillion dollars of Americans' household wealth evaporated. Economic activity and trade around the world ground toward a halt.[1]

The dire economic situation in the United States and in Europe during the years 2007-2008 set the tone for the regulation of private funds. For the first time, governments forced regulation on alternative investments. That is, regulation expanded to venture capital, private equity, and hedge funds. Public markets and private investments both had to comply to the same regulatory system.

---

[1] Press Release, U.S. Dep't. of the Treasury, Secretary Timothy F. Geithner Written Testimony, House Financial Services Committee, Financial Regulatory Reform (Sept. 23, 2009) (on file with the author) https://www.treasury.gov/press-center/press-releases/Pages/tg296.aspx.

In adopting the Dodd Frank and Alternative Investment Fund Managers, questions lingered on the necessity to impose regulation on private equity (or venture capital) since no evidence was put forth that they represented a threat to the financial system or the economy. In addition, the sophistication of private equity investors belied the purpose of securities regulation. Commentators also argued that regulation could represent an impediment to the economy and curb investments.

This dissertation answers these questions in six chapters: 1) I provide definitions of private equity and private funds; 2) I discuss controversial private equity techniques that have attracted the attention of policy makers and the general public; 3) I place private equity investments in the context of corporate governance; 4) I provide a detailed description of the Dodd-Frank Act as well as a comparative analysis of it with the AIFMD; 6) In the last chapter, I explore the transposition of AIFMD to two European countries.

1.0 First Chapter: Private Equity and Private Funds

Private equity funds, a segment of leveraged buyouts ("LBOs"), attracted national attention when in 1989, Kholberg Kravis & Roberts ("KKR") acquired RJR Nabisco, then a conglomerate selling food and tobacco products with iconic brands such as Oreos, Ritz Crackers, and Winston cigarettes. [2] Private equity acquisitions of companies are often associated with greed, lay-offs, asset striping, and bankruptcy, frequently resulting from the need to service leveraged buy-out debts.[3] Buyout activities, which are a segment of private equity, tend to overshadow other positive impact private equity financing can generate.[4]

Private equity can be defined as capital raised by private sources rather than public fundraising to finance the acquisition of companies on behalf of qualified investors.[5] Private equity

---

[2] *See generally* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (20th ed. 2009).

Private equity is remodeling the leveraged buyout business of the 1980s, relying essentially on debt as the pillar of the financing mechanism by using what are essentially junk-bonds. These are high-risk securities (bonds below investment grade of a rating agency) producing high yields (returns). In the 1982s the investment bank Drexel Burnham Lambert ("Drexel"), under the leadership of Michael Milken and Leon Black spurred junk-bonds market by selling junk-bonds to companies to finance leveraged buyouts deals. In the early 1990s, this model was discredited when many deals financed by junk-bonds defaulted, triggering the saving- and-loan crisis and a government bailout. Ultimately, Drexel collapsed and filed for bankruptcy protection, *Id.* at 515.

Because of the collapse of the junk-bond market, LBO principals had to find other venues to finance their deals and ultimately turned to commercial banks. In addition, and to distance themselves from the junk-bonds route and no longer be seen as "Barbarians," LBO principals rebranded their industry and named themselves "private equity" firms in lieu of LBO firms, *Id.* at 537, 542.

Unlike its competitors, Ted Forstmann, another investor of that era and archival of KKR, fervently opposed the excessive use of debt (junk-bonds) to finance deals. He believed the "junk-bond cartel" had risen to prominence since Ron Perelman's took-over Revlon. With KKR bidding RJR Nabisco, Forstmann pictured the "junk-bond hordes" at the city gates and by contrast to junk-bonds, he could use "real money" to stop them once and for all by standing at the bridge of the city gates and push the barbarians back, *Id.* at 308.

[3] *Id.*

[4] *See* CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY, xviii Introduction (1st ed. 2010) (a fundamental difference between US and Europe is the use of private equity to describe buyout transactions whereas, Europeans tend to differentiate buyout with other private equity type capital increases (that includes venture capital and expansion capital), turn-around or other strategies), *Id.* at 15.

[5] *Id.* at 15-16 A comprehensive definition includes a negotiated investment in equity or quasi-equity for a fixed maximum term implying specific risks with high expected returns, undertaken on behalf of qualified investors.

includes several subparts of financing such as venture capital, growth equity, buyout or distressed funds.[6] Private equity and venture capital are often used interchangeably.[7] However, private equity today describes funds using mainly debt to acquire controlling interest in companies, while venture capital funds invest in early stage, mid-stage, and late stage. As we will see, the Dodd Frank Act[8] makes a clear distinction between venture capital and private equity and provides two separate regulatory regimes.[9]

Investment managers, also known as sponsors, raise capital with investors to create one or several private equity funds. Private equity funds are managed by fund managers structured as general partners or other managing entities (collectively designed "GP" or "GPs"). GPs act on behalf of the investment fund.[10] The management company, affiliated with the GP, provides investment advisory services to the fund. The investment advisory, composed with the founders

---

[6] *See e.g.* SCOTT W. NAIDECH, PRIVATE EQUITY FUND FORMATION 1 (2011), https://www.msaworldwide.com/Naidech_PrivateEquityFundFormation_Nov11.pdf (Growth equity funds invest in later stage companies generally before a public offering or for PIPE transactions, which are private investment in public equity. Distressed funds, also called vulture invest in distressed companies to purchase debt securities at steep discount). *See also* Demaria *supra* note 3, at 78 (Angel investors, usually high net worth individuals, provide seed capital for small businesses before venture capital intervene).

[7] *See* PAUL A. GOMPERS AND JOSH LERNER, THE VENTURE CAPITAL CYCLE 3 (2d ed. 1999) (the authors note the "distinction between venture capital and private equity funds is not precise. Private equity funds include funds devoted to venture capital, leverage buyouts, consolidations, mezzanine and distressed debt investments, and a variety of hybrids such as venture leasing and venture factoring. Venture capital funds are those devoted to equity or equity-linked investments in young growth-oriented firms. Many venture capital funds, however, occasionally make other types of private equity investments"). *See generally* GEORGE W. FENN ET AL., THE ECONOMICS OF THE PRIVATE EQUITY MARKET, FED. RES. BULL. 28 (Dec. 1995) (the authors alternate denominations between venture capital and "non-venture private equity"). *See also* HARRY CENDROWSKI ET AL., PRIVATE EQUITY, HISTORY, GOVERNANCE, AND OPERATION 3 (2d ed. 2012) (the introduction chapter includes buyout and venture capital to define private equity transactions).

[8] Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (Title IV: Regulation of Advisers to Hedge funds and Others), [hereinafter *Dodd-Frank* or *Dodd-Frank Act*].

[9] *See infra* Chapter IV.

[10] NAIDECH *supra* note 6, at 1.

and investment professionals of private equity firm, provides daily operational services to the fund (valuation of investment opportunities, administration).[11]

Private equity firms[12] through their affiliates, usually GPs or managers, manage private equity funds. Thus, private equity firms are distinct entities from private equity funds.[13]

Private equity funds are closed-ended investment vehicles wherein fundraising of investors' capital commitment is limited for a period spanning from twelve to eighteen months.[14] After this fundraising period, the fund does not accept additional investor commitments.[15] The fund itself pools capital and has no other operations.

Private equity funds are organized as limited partnerships (LPs) or limited liability companies (LLCs), whose structures provide tax and legal flexibility. LPs and LLCs are pass through entities, meaning they do not pay corporate income taxes. Instead, the corporate income passes through to individual partners and is taxed at the partner individual level.[16] Pass-through structures avoid double taxation (corporate and individual).[17] LPs and LLCs also provide flexibility in organizing the legal structure because most statutory provisions are default rules and can be replaced by agreements. In addition, LPs and LLCs offer limited liability to investors (limited partners or members), meaning they are liable only for their capital contribution and are not personally liable for the fund's debt.[18]

---

11 *Id.*

12 *The Top Five Private Equity Firms*, PRIV. EQUITY INT'L, https://www.privateequityinternational.com/database/#/pei-300 (The top five private equity firms (by capital raised) include The Blackstone Group, Kohlberg Kravis Roberts, The Carlyle Group, TPG Capital, and Warburg Pincus) (last visited Apr. 12, 2018).

13 *See e.g.* Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP., 121, 123 (2009) (distinction made between private equity firms, private equity funds, and private equity transactions).

14 NAIDECH *supra* note 6, at 2.

15 *Id.*

16 26 U.S. § 701 (2018).

17 *Id.*

18 *Id.*

In a typical structure (*See* Figure 1 below), Racketstone Group LP ("Racketstone"), a sponsor, has raised more than $24 billion for its new buyout fund LuvCash Fund LP ("LuvCash Fund" or "Fund"), making it the largest buyout fund in the universe. Investors, a diverse group of wealthy institutions and individuals has committed $24 billion to Luvcash Fund. Twenty investors have committed one billion each and two investors have committed 2 billion each.

Racketstone set up a structure, Management Co. LLC ("Management Co".), to carry management services and receive 2% management fees. Thus, Racketstone anticipates an annual management fee of $ 480,000, 000 until the end of LuvCash Fund which typical to private equity funds shall end in ten years.

Management Co. creates an affiliate partnership, GP, to operate as a general partner for LuvCash Fund and collect carried interest which represent profits realized by the Fund. The amount of carried interest typically reaches 20% of any fund performance.

Now, Racketstone Group through its affiliate Management Co., stands ready to make wonderful profitable investments, turn-around and transform organizations thanks to priceless advice only it can provide.

The figure below represents a typical private equity structure.

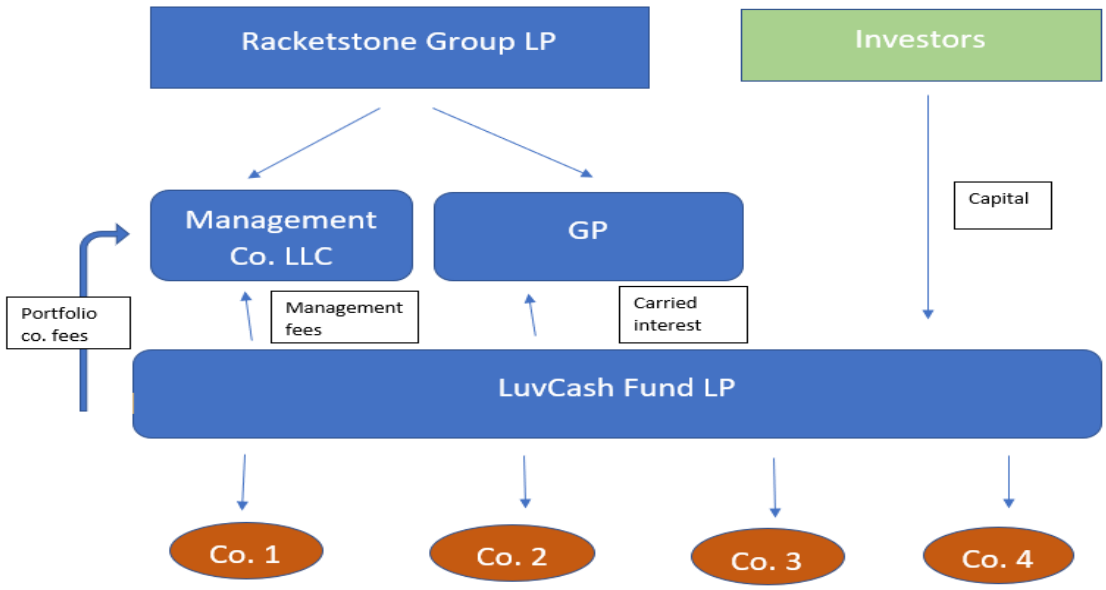


Figure 1 Racketstone Group LP

Since 2007, in order to raise additional cash from traditional venues, three large private equity (Fortress Investment Group, Och-Ziff Capital Management and Blackstone) firms have set a new trend by listing part of their business in public stock exchange.[19] Private equity firms go

---

[19] *See* SEC. & EXCH. COMM'N, THIRD AMENDED AND RESTATED LIMTED LIABILITY COMPANY AGREEMENT OF FORTRESS INVESTMENT GROUP LLC (2008), http://www.sec.gov/Archives/edgar/data/1380393/000095013608001568/file2.htm; SEC. & EXCH. COMM'N, SECOND AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT OF OCH-ZIFF CAPITAL MANAGEMENT GROUP LLC (2007), http://www.sec.gov/Archives/edgar/data/1403256/000119312508064885/dex32.htm; *See also* SEC. & EXCH. COMM'N, FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933: THE BLACKSTONE GROUP L.P. (2007), https://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm; *see e.g.*, Orit Gadiesh et al., *When Private Equity Goes Public*, FORBES (Jun 15, 2007 6:00 AM), https://www.forbes.com/2007/06/14/bain-private-equity-oped-cx_og_0615bain.html#7306fb861bff (for press coverage on private equity going public); Gregory Zucherman, *For Private-Equity Clients, Worries Over Public Listing*, WALL ST.J. (June 25, 2011), (long-term investors worrying that short-term results could hamper focus on long term perspective when private equity and hedge fund firms go public); Jeffrey Goldfarb, *Ten Years After Going Public, Blackstone Stock Hasn't Budged*, N.Y. TIMES: DEALBOOK (June 22, 2017), https://www.nytimes.com/2017/06/22/business/dealbook/ten-years-after-going-public-blackstone-stock-hasnt-

public in two different ways: either by offering a piece of the management company to the public, or by floating shares in the private equity fund. Shares of private equity firms can also be bought and sold freely in the public market.[20] Unlike most companies traded in the stock exchange organized as corporations, private equity firms are listed as unincorporated companies taking the form of limited partnership or limited liability companies. This results in asymmetry between public corporations and unincorporated companies since public corporations are subject to fiduciary duties whereas, at least under Delaware Alternative Entity Acts[21], public nonincorporated can waive these duties.[22]

1.1 Private equity and venture capital

Venture capital and private equity are sometimes used interchangeably to describe a pool of funds that invest in early stage or established companies.[23] Technically, venture capital's monies go towards early, mid, or late stage businesses, but businesses without a significant track record. This presents risk but also high potential rewards.[24] Like private equity, venture capital firms are professionally managed firms taking equity positions in private companies at different stages of

---

budged.html (Blackstone's share trades at the same $31 per share than ten years after the initial public offering. The result seems modest and does not outperform the S&P).

[20] Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 469 (2009) (arguing the 2007 public offerings of Blackstone, Fortress Investment Group and Och-Ziff has democratized private equity).

[21] Delaware Alternative Entity Acts comprise Delaware Revised Uniform Limited Partnership Act, 6 *Del. C.* §§ 17-101, et seq. (DRULPA), and Delaware Limited Liability Company Act, 6 *Del. C.* §§ 18-101, et seq. (DLLCA).

[22] Manesh *supra* note 20 at 470. The structures of Fortress and Och-Ziff resemble the one of a public corporation while Blackstone are closer to privately held company. *Id.* at 486.

[23] *See* GOMPERS & LERNER *supra* note 7 and accompanying.

[24] William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990).

their development.[25] Both venture capital and private equity are intermediaries acting on behalf of investors.

Venture capital and private equity are typically structured as LPs with GPs acting as fund managers, with funds having the same characteristics (same finite life, same institutional investors' profile, and same cyclical fundraising activities).[26] Venture capital and private equity managers are also compensated using the two twenty formula (two percent of assets under management and twenty percent of profits or value creation), but unlike private equity, venture capitalists do not charge their portfolio companies with monitoring or other transaction fees.[27]

Private equity and venture capital also have significant differences. Venture capital and private equity invest in different types of companies: venture capital invests in companies that do not have discretionary cash to back up the service of debt and its objective aims at value creation.[28] Private equity typically invests in companies with solid cash flow, whose cash flow can sustain the servicing of debt. Here the objective aims at streamlining a company's operations for better efficiency and profitability.[29]

---

[25] *Id. See also* JAMES L. PLUMMER, QED REPORT ON VENTURE CAPITAL FINANCIAL ANALYSIS 11-13 (1987) (stages of venture capital include seed investments, stat up, first, second, third, fourth stages and liquidity).

[26] Sahlman *supra* note 24 at 517.

[27] *Id. See also infra* Chapter 2. 2.3.

[28] *Id.*

[29] *Id.*

1.2 Private equity and hedge funds

Hedge funds are often compared to unregulated mutual funds.[30] They are blind pools seeking positive return, with wealthy individuals, trusts, and the like as investors. They differ from private equity by having different features. Hedge funds are funded immediately in cash, contrary to private equity funds that receive both capital contributions and commitments from their investors.[31] Unlike private equity, hedge funds accept new investors into the fund and existing investors can participate in the fund periodically.[32] Unlike private equity, which distributes proceeds to investors after liquidation of an investment, hedge funds usually sell assets and reinvest the funds periodically.[33] While private equity investors are usually not allowed to sell their partnership interest until a period of time (up to ten years), hedge fund investors may redeem their interest after a "lock-up" period typically one year.[34] Hedge funds are private investment funds for the wealthy. Mutual funds are public investment funds generally open to most investors.

Private equity and hedge funds can converge and arguments showing blurring lines between private equity and hedge funds have emerged. In an effort to expand their activities, private equity buyout managers now invest in debt and financial instruments such as options, credit

---

[30] *E.g., Fast Answers: Hedge Funds*, SEC. & EXCH. COMM'N (Dec. 4, 2012), http://www.sec.gov/answers/hedge.htm. Hedge funds are more flexible than mutual funds and use strategies such as leverage, short selling and speculative investment that is not allowed by mutual funds. Mutual funds are regulated unlike hedge funds, which regulation that does provide all the protections to investors (such as disclosure).

[31] NAIDECH *supra* note 6, at 18 (typically, an investor subscribes to capital commitment to a fund. Payment do not occur at once but in installments until fully subscribed).

[32] *Id.*

[33] *Id.*

[34] SEC. & EXCH. COMM'N: OFFICE OF INV'R EDC. AND ADVOCACY, SEC PUB. NO. 139, INV'R BULLETIN: HEDGE FUNDS 2, https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf (2012).

instruments or derivatives,[35] business once essentially done by hedge fund managers. Conversely, hedge fund managers now invest in private funds and compete for the same business.[36]

1.3 Structure of private equity funds and limited investor protection

Private equity funds are structured as LPs and LLCs, formed mostly in the state of Delaware. Delaware statutes[37] have flexible fiduciary rules that codify common law fiduciary duties, that is, the duty of care, the duty of loyalty, and the obligation of fair dealing.[38] In Delaware, fiduciary duties are default rules [39] and may be reduced or eliminated, at least in alternative entities, such as LLCs and LPs. [40]

---

35 William A. Birdthistle & M. Todd Henderson, *One Hat Too Many - Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 48 (2009) (noting big buyouts firms like Blackstone, Apollo, KKR, or Carlyle, raise new funds specialized in alternative assets).

36 *See* Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity*, 54 BUFF. L. REV. 101, 112-3 (2006) (noting that hedge funds take active role in companies' management the same way that private equity managers do).

37 *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974) (Delaware corporate laws has achieved prominence in America because Delaware enables managements of companies to operate without interference and has eliminated the rights of shareholders, leading to "the race for the bottom" to emulate Delaware's success. *See also* Naidech *supra* note 6, at 2 (large and complex transactions occur in Delaware as it is a familiar and safe jurisdiction for investors. Delaware's court have expertise, experience, and the State is considered one of the US most sophisticated State. In addition, the low cost of administrative process and service providers make Delaware an attractive state).

38 *See*, Meinhard v. Salmon, 164 N.E. 545, 546 (1928) (The laws of partnership mirror the agency relationships existing between an agent and its principal, where the agent owes the principal fiduciary duty. The duty of loyalty is met when the partner offers opportunity, full and fair chance to allow its fellow partners to capitalize on the opportunity).

See also Revised Uniform Partnership Act (RUPA) § 404(b)(2) (1997) Under the Revised Uniform Partnership Act ("RUPA"), the only fiduciary duties a partner owes to the partnership and other partners are the duty of loyalty and the duty of care as set forth in subsections (b) and (c), *Id.* The duties of loyalty and care are not waivable, nor can they be eliminated in the partnership agreement, *Id.* at §15-103(b)(3). However, agreements between partners may identify specific types or categories of activities not deemed in violation of the duties, *Id.* at §15-103(b)(3)(i).

39 *See generally* Srinivas M. Raju & Jillian G. Remming, *Fiduciary Duties in the Alternative Entity Context*, A.B.A (Aug. 16, 2012), http://apps.americanbar.org/litigation/committees/commercial/articles/summer2012-0812-fiduciary-duties-alternative-entity.html

40 *See* 6 DEL CODE § 17-1101(d) (for LLCs language almost identical with t section 18-1101(c): "To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner…the partner's or other person's duties may be expanded or restricted or eliminated by provisions

Thus, consistent with the freedom of contract principle, Delaware enables LPs and LLCs, also known as alternative entities, to eliminate fiduciary duties.[41] Parties are only obligated to maintain an implied contractual covenant of good faith and fair dealing in their contractual relationship.

Engendered by contractarian view, some scholars applaud Delaware's flexibility, which they argue best serves the interest of parties, including passive investors. Limited partnership agreements may provide minimal protection for investors. Managers have no legal duty to conduct business in the best interest of their investors.[42] Unlike shareholders, limited partners have less power, since there is no mandatory oversight body akin to a board of directors imposed on managers.[43] Since fiduciary duties are not mandatory in Delaware partnerships, investors may subject themselves to abuse, which can take the form of excessive management fees, self-dealing, or other practices.[44] If an agreement waives fiduciary duty, managers have no other obligations than those expressly put forth in the limited partnership agreement, in addition to good faith and fair dealing.[45] Thus, review of the limited partnership agreement, insistence in traditional safeguards, coupled with "reputational constraints" on managers, are the best protections for investors.[46] The importance of reputation suffices to encourage managers to act in the best interest of LPs.[47] Reputational constraints act as a deterrent that may counterbalance any mistreatment by

---

in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing").

[41] *See* David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 388 (2002) (As documented by the author, an agreement suppressing fiduciary duty may states the following "The general partners assume no duties to the limited partners except those explicitly herein").

[42] *Id.* at 367.

[43] *Id.* at 383.

[44] *Id.*

[45] *Id.* at 390.

[46] *Id.*

[47] *Id.* at 366 (in the context of venture capital, Delaware laws is the best environment to create incentives for managers to well perform because their reputation is at stake).

managers.[48] Likewise, limited partners observe reputational constraints by limiting their interventions in the business of the fund[49] and are "wary of being perceived as litigious," which could limit their participation in future investments.[50]

Other scholars consider private ordering ineffective to solve agency problems created by the limited partnership structure.[51] GPs and LPs often have divergent interests.[52] Resolving agency conflicts can occur with strong legal checks on agents by private enforcement or by monitoring through contract design.[53] Reputation alone cannot deter unscrupulous behaviors from GPs or LPs.[54] Examinations and enforcement activities done by the SEC since 2014[55] confirm that strong enforcement better resolves agency issues. For instance, after the examination of fees and expenses of private equity firms, violations of law or material weakness appeared over 50% of the time.[56]

Since the Dodd-Frank Act, advisers to private equity (and private funds) with over $150 million in assets under management are required to register with the SEC and submit to reporting, recordkeeping, and examination. Below $150 million, registration is with the state, that is, if the

---

48 *Id.* at 373.
49 *Id.* At 394.
50 *Id.*
51 *See generally* Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259 (2010).
52 *Id.*at 263 (GPs might want to hide information, redirect resources for personal benefits or spend more time in other matter not related to current LPs' while LPs GPs to work exclusively for the fund, identify investment opportunity).
53 *Id.* at 263 (resolving agency problems of divergent interests of managers and investors can occur or with strong legal checks on agents or by private enforcement or by monitoring through contract design).
54 *Id.* at 288-90.
55 *See* Andrew J. Bowden, Dir., SEC & EXCH. COMM'N: OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS: Spreading Sunshine in Private Equity, Speech at Private Equity International (PEI) Private Fund Compliance Forum 2014 (May 6, 2014), at https://www.sec.gov/news/speech/2014--spch05062014ab.html (in general, limited partnership agreements are often too vague for important issues such as fees, expenses. Disclosures to investors are minimum. Valuation poses also the issue of clarity for procedures and methods used. Finally, agreements do no provide LPs with enough information and rights to monitor their investments).
56 *Id.* at 5.

state has an investment adviser scheme. The SEC may enforce cases based on violation of fiduciary duties for those investment advisers registered with it. Under the Advisers Act, advisers are prohibited from using schemes or other forms or artifices to defraud their clients or prospective clients.[57] Fraudulent, deceptive and manipulative business conducts are also prohibited. Since 2014, the SEC has used this provision against private equity firms to enforce this aspect of investor protection.[58]

1.4 The sophisticated investor dilemma

Securities regulations require the registration of the offer and sale of securities with the SEC. "Security"[59] has a broad definition that encompasses various types of investment vehicles such as stocks, bonds, and limited partnership interests. The offer of securities, such as a

---

57 15 U.S.C. *§* 80b-6 (2012): the act specifically states: It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

[58] *See generally infra* Chapter 4 at 4.10; *See generally* Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act after Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 410 (2016) (the enactment of Investment Advisers Act and an early U.S. Supreme Court decision has emboldened the SEC to bring actions against fraudulent practices by investment advisers).

[59] *See* Section 2(a)(1) of the 1933 Act, 15 U.S.C. § 77b (1) (statutory definition provided by the Securities Act of 1933).

partnership interest, triggers application of several securities laws:[60] namely, the Securities Act of 1933[61] ("Securities Act"), the Securities Exchange Act of 1934[62] ("Exchange Act"), the Investment Company Act[63] (Investment Company Act"), and the Investment Advisers Act of 1940[64] ("Investment Advisers Act").

The Securities Act requires registration with the SEC, making it unlawful to offer or to sell securities without registration unless an exemption applies. Private equity sponsors have used the private placement exemption by limiting offers and sales to accredited investors. [65] Accredited investors are institutions or individuals with a net worth in excess of $1,000,000.

To avoid registration under the Investment Company Act, sponsors needed to limit the number of beneficial owners to one hundred, plus an unlimited number of "accredited investors."

Under the Advisers Act, private equity firms could avoid registration by relying on the exemption for investment advisers with fewer than fifteen clients, that do not hold themselves out as investment advisers, and that do not register as investment companies.[66] The number fifteen requirement counts the funds as clients, not individual investors in each fund.

Private equity advisers preferred to opt out of securities regulation because regulation triggers obligations to disclose information[67], and to maintain books and records that the SEC can

---

[60] *See* James C. Spindler, *How Private is Private Equity, and at What Cost?* 76 U. CHI L. REV. 311, 320 (2009) (arguing how easy it was for private equity to opt out of securities regulation). *See also* Vijay Sekhon, *Can the Rich Fend for Themselves: Inconsistent Treatment of Wealthy Investors under the Private Fund Investment Advisers Registration* Act of 2010, 7 HASTINGS BUS. L.J. 1, 6 (2011). S*ee also* Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry,* 86 ST. JOHN'S L. REV. 87, 95 (2012) (Hedge funds used the same exemptions than private equity).

[61] Securities Act of 1933, 15 USC § 77 *et seq*.

[62] Securities Exchange Act of 1934, 15 USC § 78 *et seq*.

[63] Investment Company Act of 1940, 15 USC § 80a-1 *et seq*.

[64] Investment Advisers Act of 1940, 15 USC **§** 80b-1 *et seq*.

[65] 17 CFR §§ 230.215

[66] Investment Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3).

[67] Investment Advisers Act § 206, 15 U.S.C. § 80b-4.

inspect.[68] Registration also provides rights of action and penalties if the disclosure obligations are violated.[69]

Prior to Dodd-Frank, exemptions for registration were geared towards sophisticated investors, generally defined according to their wealth (risk bearing ability) and financial education. Because these investors were sophisticated, the rationale was that they did not need the kind of protection registration statement (often a prospectus) offers so long as these investors were "shown to be able to fend for themselves".[70] An investor can fend for himself if he shows access to the same kind of information found in a registration statement and has the ability to evaluate it.

Investors in private equity and private funds tend to be sophisticated investors. There is no statutory definition. However, courts and securities regulations make the distinction between those who possess financial education and wealth sufficient to fend for themselves, that is, able to bear the risk and able to evaluate the merits of the offering as opposed to those who do not.[71] Typically, private equity investors are pension funds, endowments and foundations, banks and insurance companies, and wealthy individuals.[72]

---

[68] *Id.*

[69] Spindler *supra* note 60, at 320.

[70] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[71] *See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1083 (noting that securities laws barely refer to investor sophistication, but in fact, court make a distinction between investors depending on whether they are sophisticated or unsophisticated).

[72] *See e.g.* FENN ET AL., *supra* note 7, at 45-49 (noting the expansion of pensions funds and endowments as the largest group to hold private equity. Investors usually invest alongside a private equity group through a limited partnership, then investors can co-invest to gain experience in deal structuring, monitoring and exit options. Eventually, investors decide to invest directly on their own without intermediary. *Id.* at 45)

The issue of applying wealth as a proxy for sophistication has proven inadequate.[73] If anything, the financial crisis of 2008 has taught us that wealth does not equal sophistication. The same institutions that invested in sophisticated financial products, that is, banks, insurance companies, and wealthy individuals were those begging for government subsidies when investments collapsed.[74] In addition, there is a huge difference of sophistication among those deemed sophisticated investors,[75] within just one category of institution. For instance, a private equity fund can have investors composed of endowments, public or private pension funds, banks, and insurance companies. Endowments have a reputation for selecting the best managers, providing higher investment returns compared to banks or insurance companies.[76] Within the category of endowment, it is also hard to believe that an endowment of ten billion dollars will have the same sophistication as a smaller endowment of three hundred million. In theory, these sophisticated investors are rich enough to invest in private equity or hedge funds, but they do not have the same expertise with investing in funds and do not have the same bargaining power with managers. Yet, they are both sophisticated.

---

[73] Greg Oguss, Notes and Comments, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?,* 107 NW U.L REV. 285 (2012) (arguing that investor sophistication based on wealth is obsolete and dangerous. Wealth and size have proven poor proxies for investor protection and investment products are too many and complicate to provide enough protection).

[74] John E**.** Girouard, *The Sophisticated Investor Farce,* FORBES.COM (Mar. 24, 2009, 12:30 PM), https://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html#42d093ec184b (blaming the financial crisis not to "crooks, risk-junkies or incompetent regulators" but to the legal system that "says people who have or control a lot of money are automatically smarter than the little guy and therefore don't need as much protection").

[75] *See generally* Josh Lerner, Antoinette Schoar & Wan Wongsunwai, *Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle*, 62 J. FIN., 731-764 (2007) (returns limited partners realized from private equity differs across institutions. A reason might be some investors can better understand financial information and make better choice).

[76] *Id.* at 733 (returns are based on internal rate of returns -which can bias results. Other measurements include the value of actual distributions received by investors, or stated value of the fund), *Id.* at 737.

1.5 Proposition

This article argues that the Dodd-Frank Act has fulfilled part of its objective to protect private equity investors by forcing private equity managers to disclose information on their operations. Disclosure has provided greater transparency about how private equity firms conduct their business. The increased SEC scrutiny started in 2014 has uncovered unfair practices and violations of fiduciary duties that sophisticated investors could not detect on their own. Notwithstanding this improved transparency, the Dodd-Frank Act still falls short of imposing the main tool securities law uses to protect investors: that is, full and fair disclosure. In other words, Dodd-Frank does not provide all the required protections that are important for investors to assess the quality of their investments and make informed decisions: first, like public companies, private equity should periodically publish their financial results by using accounting standards that make sense for private equity funds. Second, while the industry uses the internal rate of return ("IRR") to measure the performance of private equity funds, scholars have criticized this measurement and offered the public market equivalent ("PME") that compares private equity funds' return with the public market equivalent.[77][78] Financial results should include the results of companies held in portfolio, fees charged to investors and portfolio companies, and the income of private equity managers. These measures would not add to the current disclosure on FORM PF, but investors and the public could have access to it (it could be 10-K or 10-Q). These disclosures will allow an

---

[77] *See* Ludovic Phalippou, *Beware of venturing into Private equity*, 23 J. ECON. PERSP. 147, 159 (2009) (the IRR provides arbitrary results because funds manager can report the performance by pooling several funds instead of reporting each fund separately. Bias comes in when higher performance, especially obtain in fund early days, can hide bad performance).

[78] *See* EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 288—91 (Russell Sage Foundation ed. 2014) (IRR is not a good measurement for investors because it does not reveal the actual return received by investors and the fund's real worth. Performance are easy to manipulate).

effective alignment of interests between private equity managers and their investors. This information will provide appropriate tools to compare and make sure that what is advertised corresponds to the reality, as seen in financial results.

Since private equity is no longer a niche investment but touches all aspects of the economy, it does not make sense that such as an asset does not have a clear and reliable measurement method to gauge the return on that investment. At minimum, investors should not question the reality of returns their investment generate.

Having access to detailed financial data could enhance the likelihood that investors use the anti-fraud provision under Exchange Act section 10b, Rule 10b-5.[79]. This provision provides a private right of action for private equity investors, regardless of whether the advisers are registered or not. It has nevertheless been largely overlooked by private equity investors who usually do not bring issues to courts to confront GPs;[80] investors dissatisfied with a fund's performance will withdraw from consecutive funds raised by the same GP.[81] One explanation for this absence of lawsuits is the lack of quality information provided by GPs limiting the possibility of litigation. To bring an action 10b-5, investors need to show a material misrepresentation or omission, scienter, in connection with the purchase and sale of a security, and causation. Thus, by limiting

---

[79] *See* Spindler *supra* note 60 at 325 (all a fund has to do to remain exempt from the antifraud provision are the three ingredients of little to no disclosure to investors, provide little to no control and reduce investors exit to a fund). *See also* Kenneth J. Black, Note, *Private Equity & Private Suits: Using 10B-5 Antifraud Suits to Discipline a Transforming Industry*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 271 (2013) (predicting disclosure of private equity advisers will trigger lawsuits by investors).

[80] *See* Rosenberg *supra* note 41 at 367 (investors do not litigate because they rely on "market forces" and "reputational constraints" to force venture capitalist to maximize investment return. Investors are also "wary of being perceived as litigious" which can curtail their chance of additional investment in the future. Thus, the importance of reputation for managers as well as investors, *Id.* at 394). *Contra* Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 312-3 (2010) (market conditions in violation of conflict of interest and anti-fraud statutes may be difficult to detect). *Accord* Black *supra* note 79, at 271 (registration with SEC will enables investors to sue private equity firms based on securities law anti-fraud provision 10b-5).

[81] *See* Ordower *supra* note 80 at 310-11 (even when the investor has a private right of action afforded by securities law, most prefer to "withdraw from the fund quietly).

disclosure and the kind of information provided to investors, GPs also limit the possibility of litigation.[82] The limited options to exit through a secondary market also limit the chance of 10b-5 actions.[83]

In *Litwin v. Blackstone Group, L.P.*,[84] the issue brought by private equity investors related to whether the private equity adviser made material omissions and misstatements in his registration statement and prospectus when he sold common units in an IPO.

The facts concern Blackstone, a private equity adviser, which filed its Form S-1 Registration Statement with the SEC on March 22, 2007, for an initial public offering ("IPO"). Blackstone sold to the public 153 million common units, which raised more than $4.5 billion. Plaintiffs represent investors who bought the IPO common units. Plaintiffs filed a putative securities class action, alleging that at the time of the IPO, the adviser failed to disclose that two of Blackstone's portfolio companies and real estate investments experienced financial difficulties. The consequence of this concealment could subject the adviser to claw-back and reduction of performance fees and could materially affect the future revenues of the adviser.

The U.S. Court of Appeals for the Second Circuit sided with plaintiff investors asserting the adviser plausibly omitted to disclose material information or made a misstatement on its offering documents and, thus, subjected the adviser to civil liability of the Securities Act of 1933 (Sections 11, 12(a)(2), and 15).

---

[82] *See* Spindler *supra* note 60, at 331.
[83] *Id.*
[84] Litwin v. Blackstone Group, L.P., 634 F.3d 706, 2011 U.S. App. LEXIS 2641, Fed. Sec. L. Rep. (CCH) P96,033 (2d Cir. N.Y. February 10, 2011) *cert. denied*, Blackstone Group, L.P. v. Litwin, 132 S. Ct. 242, 181 L. Ed. 2d 138, 2011 U.S. LEXIS 5436 (U.S., 2011).

1.5.1 Private Equity Industry Should Use Rules for Performance Measurement

Private equity managers have come under pressure to justify the reality of their portfolio performance, which some have qualified as misleading or untruthful because it lacks uniformity of performance measurement concerning how managers' report gains made by their portfolio.

Commentators have criticized the use of Internal Rate of Return ("IRR") as a performance measurement for private equity.[85] Another measurement, such as the Rate of Return ("RoR"), differs from IRR because, unlike IRR, it takes into consideration real earning from investor's investments.[86]

The Dodd-Frank Act outlines some principles for private funds valuation.[87] It provides a list of information private funds should provide to the Commission for inspection.[88] Ultimately, legislators give the SEC the mission to issue rules for advisers of a private fund as the "*Commission deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk*."[89]

---

[85] Ludovic Phalippou, *The Hazards of Using IRR to measure Performance: The Case of Private Equity*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111796 (March. 27, 2009).

[86] *Id.* at 3 (IRR is a discount rate that makes the Net Present Value of multiple cash flows equal to zero; *Id.* Using IRR as a performance measurement for private equity has negative consequences. First it misleads investors on their true return because private equity is a volatile asset class and perceive intermediate cash flow; *Id.* at 4. In addition, performance among private equity seems disperse because IRR compares the spread of top private equity performers with the one of bottom line. This allows to compare this spread with the spread of other assets class such as mutual funds. *Id.*).

[87] Dodd Frank Act *supra* note 8, Sec. 404(2).

[88] *Id.* at §3 (the list includes the amount of assets under management and use of leverage, counterparty risk, positions of trading and investment, policies and procedure established for valuation, assets held, side arrangements and side letters, practices of trading. The Commission can decide to discuss with the Council for systemic risk assessment).

[89] *Id.* at §5.

Dodd-Frank does not directly touch upon the valuation of private funds. The Commission has however, issued rules for reporting.[90] These rules center on amendments to Form ADV, specifically FORM PF and large funds with more than $1 billion assets under management. The rules have the advantages of concentrating information on a simple form ADV, attempting to rationalize funds according to their respective strategies (hedge funds, private equity, liquidity) and gathering information in a simple manner. However, Form ADV falls short of providing a uniform and clear valuation methods for private funds.[91]

The lack of uniformity in private equity valuation applies to the Alternative Investment Fund Managers Directive as well. It contains sections for valuation and transparency.[92] The Directive points to "*independent valuation of assets*" in accordance with "*applicable national law and the AIF rules or*[93] *instruments of incorporation*." The Directive provides a general principle and refers to the law of the country for the "*valuation of assets and the calculation of the net asset value per unit or share.*" This posits principles-based regulation as a way to provide a general orientation on how valuations of assets should occur. Valuation should embolden investors in their quest for transparency. Thus, the Directive prescribes an annual report obligation for fund managers.[94]

---

[90] *See* Form PF *infra* note 351.

[91] *See* Amended FORM ADV *infra* note 295 at Sec. 3. Item B (related to assets, financing and concentration of investors. The section list basic accounting items such as gross value, net value of fund, borrowing amounts, assets and liabilities). Item C on fund performance reporting calls on reporting gross and net performance as the adviser reports to current and prospective investors. *Id.* at Item C.

[92] *See* AIFMD *infra* note 446 at art. 19 and 22.

[93] *Id.* at art. 19.

[94] *Id.* at art. 22.

Many investors have endorsed the fee disclosure template issued by Institutional Limited Partners Association ("ILPA"), the main institutional investor trade group.[95] The template aims at promoting better uniformity in reporting practices within the private equity industry. It also participates in enhancing transparency. As such, it prescribes the enumeration of all the fees paid and received by investment managers, portfolio companies and affiliates.[96]

Generally speaking, laws that govern disclosures tend to embrace a rules kind of regulation. The ILPA template offers specific rules that regulators could use for better investor reporting.

Title IV of the Dodd-Frank Act is not the appropriate setting for issues unrelated to the protection of investors, that is, the "public interest," or the "assessment of systemic risk." Applying or enacting legislation concerning tax, labor or bankruptcy laws can better curve controversial practices of private equity firms.

---

[95] *IILPA Fee Reporting Template*, INST. LTD. PARTNERS ASS'N, (Oct. 2016), https://ilpa.org/wp-content/uploads/2016/10/ILPA-Reporting-Template-Guidance-Version-1.1.pdf (last visited Feb. 15, 2019).

[96] *Id.* the template contains two sections: section A for LPs to monitor and view the whole direct costs for a given private equity fund; section B relates to GP's sources of income and details investments made in a given fund; *Id.* at 4. The template has two-tiered reporting: the first level contains data for high-level summary, and the second level goes deeper into details. *Id.* a 7. For instance, level 1 can report total of partnership expenses, while the level two of partnership expenses can add: accounting, administration& IT, audit on tax, bank fees, custody fees, due diligence, legal, etc.). *Id.* Another reporting for total offsets to fees and expenses can constitute a level one of reporting. The level two can detail advisory fees offset, broken deal fee offset, monitoring fee offset, other fee offset. *Id.*

2.0 Second Chapter: Policy Issues with Private Equity Economics

Private equity firms, some of them acting as leveraged buyout ("LBO") firms, attracted attention in the early 1980s, when in 1989, Kohlberg Kravis & Roberts ("KKR") acquired RJR Nabisco, then a Fortune 100 company.[97] Private equity remodels the 1980s' leveraged buyout business, relying essentially on debt as the pillar of the financing mechanism, with great use of junk-bonds. These are high-risk securities (bonds below investment grade) producing high yields (returns). In the 1982s, the investment bank Drexel Burnham Lambert ("Drexel"), under the leadership of Michael Milken and Leon Black, spurred junk-bonds market by selling to companies unrated bonds to finance leveraged buyouts. In the early 1990s, this model was discredited when some junk-bonds financed deals defaulted. Drexel filed for bankruptcy.[98] Because of the collapse of the junk-bond market, LBO principals had to find other venues to finance their deals, ultimately turning to commercial banks. In addition, and to distance themselves from the junk-bonds route and no longer to be seen as "Barbarians,"[99] LBO principals rebranded their industry and named themselves private equity firms in lieu of LBO firms.[100]

Today, the influence of private equity firms goes beyond the circle of American corporate finance. From once being a small niche of finance, private equity has now become a mainstream actor in American society. Companies held by private equity firms affect the lives of millions of

---

[97] *See generally* BURROUGH & HELYAR *supra* note 2.

[98] *Id.* at 515.

[99] *Id.* at 308 (Ted Forstmann an investor, fervently opposed to the excessive use of junk-bonds to finance deals the way its competitors d*Id.* He believed the "junk-bond cartel" had risen to prominence since Ron Perelman's took over Revlon. With KKR bidding for RJR Nabisco, Forstmann pictured the "junk-bond hordes" at the city gates and he could – by using "real money" as opposed to junk-bonds- stop them once and for all by standing at the bridge of the city gates and push the barbarians back).

[100] *Id.* at 537, 542.

American workers, communities, and stakeholders. According to one advocacy group, the top five private equity firms are the second largest U.S. employer behind Walmart, employing indirectly 960,231 Americans.[101] In 2016, fewer than 5,000 private equity firms held $2.5 trillion assets under management.[102]

Since the eighties, private equity has displayed a unique model that had been greatly criticized for the negative consequences of using mainly debt, and thus leverage, to finance corporate acquisitions.[103] Today, criticism of private equity economics has resurfaced: Congress has considered regulating the industry. The issues raised in the eighties still resonates today: do private equity economics benefit the economy by improving the operations of the acquired companies and creating jobs and wealth for the community? Or are private equity economics merely a tool for private equity principals and a few investors to enrich themselves at the expense of other stakeholders, workers and taxpayers?

2.1 The use of debt (versus equity) to finance the acquisition of companies

Commentators often compare a private equity acquisition of a new company to a mortgage down payment to purchase a home where the owner puts a percentage of the total amount down, traditionally 20% of purchase price, supplemented by borrowed money.[104] However, contrary to

---

[101] *What They are Saying About Private Equity*, AM. INV. COUNCIL http://www.investmentcouncil.org/private-equity-at-work/education/theyre-saying-private-equity/ (last visited Oct. 18, 2017).

[102] *Id.*

[103] *See generally* Kenneth Lehn et al., *The Economics of Leveraged Takeovers*, 65 WASH. U. L. Q. 163 (1987).

[104] *See e.g.* JOSH KOSMAN, THE BUYOUT OF AMERICA: HOW PRIVATE EQUITY WILL CAUSE THE NEXT GREAT CRISIS (Portfolio ed. 2009), at 2, 9, *see also* APPELBAUM & BATT *supra* note 78 at 47.

the homeowner who has the obligation to pay his mortgage, private equity owners do not pay the borrowed back money themselves; they have the acquired company pay for it instead.

The private equity industry is cyclical with periods of boom and of bust: the first wave started in early 1982 and ended in 1989.[105] The second wave started in 2003 and ended in 2007.[106] Each cycle has used various methods of financing that depended on the availability of credit. In the 1980s, the equity put into a deal equaled ten percent or so and the remaining ninety percent was borrowed. [107] During the second wave, the portion of equity rose to twenty-five to thirty-three percent. Since the financial crisis of 2008, credit conditions have tightened, and the portion of equity now equals forty percent.[108] Thus, in a typical buyout transaction, a private equity firm finances the acquisition of a company with essentially forty percent of equity and sixty percent of borrowed money. That portion of borrowed debt constitutes the leverage in the transaction.

2.1.1 Debt structure

Debt includes loans provided by banks (commercial or investment), hedge funds, and institutional investors. These are short-term loans often repackaged into bonds in the form of collateralized loan obligation ("CMO") or commercial mortgage backed securities ("CMBS").[109]

---

[105] *See* Kaplan & Stromberg *supra* note 13 at 128, 121-46 (2009). *See also* GOMPERS & LERNER *supra* note 7.

[106] *Id.*

[107] Kosman, *supra* note 104 at 19: Jerome Kohlberg Jr conceived the private equity model in the late 1960s while he was running the corporate finance department of the investment bank Bear Stearns. Kohlberg engineered that Bear Stearns could buy companies by putting ten percent down and the acquired company would pay the remaining ninety percent of the purchase price. By 1976, after Kohlberg left Bear Stearns with younger bankers Henry Kravis and George Roberts, they founded Kohlberg Kravis Roberts ("KKR"), KKR which firm is credited for the leverage buyout model.

[108] *See* APPELBAUM & BATT *supra* note 78 at 47.

[109] *Id.* at 47.

A CMO is a debt obligation that pools multiple loans from businesses then sells the asset to different classes of owners in various tranches. A CMBS is a loan secured by a commercial real estate.

Some of these bonds are sold to investors as senior secured notes, which provides a claim on the acquired company's assets.[110] Other bonds include junior, unsecured notes sold to investors as high-yield bonds, or as "mezzanine debt" (subordinated to senior debt). [111]

2.1.2 Agency theories as rationale for the use of debt

The use of leverage coincides with the acquisition of big companies.[112]In other words, the bigger the company, the less equity on percentage basis remains available, and signals greater amounts of leverage needed.[113] In particular, the use of junk-bonds, CMOs, and CMBS to acquire a company makes it possible to purchase larger companies.

The agency theory of public companies advanced by Berle and Means describes the modern corporation as a separation of ownership and control between the owners (shareholders) and those controlling the company's activities (the board of directors). The separation of owners and those controlling the corporation creates a dispersed shareholder ownership structure resulting in the inability of shareholders to monitor managerial decisions. As a result, the task to run the company lies with managers and directors who might be opportunistic, not having the interests of the company or shareholders at heart. A conflict of interests arises between managers and owners

---

[110] *Id.*
[111] Kaplan & Stromberg *supra* note 13 at 124-25.
[112] *See* BURROUGH & HELYAR *supra* note 2 at 141.
[113] *See* Lehn et al. *supra* note 103 at 7.

because managers act opportunistically, at the expense of the monitoring shareholders and do not bear the full financial consequences of their decisions.[114]

The agency theory of corporate takeovers has also stressed shareholders' profit maximization. Shareholders as "principals" have a residual claim on the company, while directors and managers, as "agents" of the company act on behalf of the shareholders to maximize their profits. [115] To do so, managers return to shareholders the free cash flow supplied by the corporation while using debt to finance new company's acquisition.[116] By increasing its debt level, a company increases its efficiency by forcing managers with large sums of cash flow to disgorge cash to investors. Thus, debt forces discipline on managers; [117] debt also prevents wasting resources on low return projects.[118]

Finally, the agency theory of takeovers also examines the corporation as a contractual relation: stakeholders, that is, workers, suppliers, creditors, and bondholders, contribute to the company's resources in exchange for a claim in the company's revenues.[119] Both debtholders and stockholders provide financing to a firm in exchange for revenue. Debtholders receive interest payments until the final payment of principal due at maturity; stockholders receive dividend payments and return residual claim. In many respects, debt and equity financing do not differ much, as they both provide a claim on the company's assets.[120] The difference between debt and

---

[114] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON., 305-360 (1976).

[115] *Id.* at 305.

[116] *See generally* Michael Jensen, *Agency and Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323-329 (1986).

[117] *Id.*

[118] *Id.* at 328.

[119] Lehn et al., *supra* note 103 at 172-73.

[120] *Id.*

equity lies in their protection afforded by the law in case the company goes in default: debtholders enjoy more protection than equity holders.

As noted above, the use of debt or leverage is necessary to finance most corporate acquisitions. Leverage, however, develops into an issue when the level of debt becomes unsustainable for a company. In addition, private equity economics has recently used controversial financial techniques to manage the debt owed by portfolio companies. These "financial engineering" techniques are unrelated to managers' discipline and include dividend recapitalizations, buying one's debt at a discount or through debt exchange, and using bankruptcy for a profit.

2.1.3 Dividend recapitalizations

Dividend recapitalizations ("dividend recaps") correspond to additional debt incurred by a portfolio company to allow the payment of dividends to its principal shareholders (and its investors), and sometimes the company's management team. [121] Private equity firms used dividend recaps extensively during the pre-crisis years 2002-2007. Later, private equity firms used dividend recaps to extract value from companies they considered under-leveraged (due to the additional equity required to finance a deal during the financial crisis). This allowed adding more debt to the under-leveraged transactions (compared to their level of equity).[122]

---

[121] *See e.g.*, Alex Lykken, *Understanding Dividend Recaps*, PITCHBOOK (Jan. 20, 2014), https://pitchbook.com/news/articles/understanding-dividend-recaps

[122] *See e.g.*, Michael Stothard &Dan McCrum, *Private equity eyes dividend 'recaps'*, FIN. TIMES (Oct. 23, 2012), https://www.ft.com/content/eac31cd6-1d12-11e2-abeb-00144feabdc0. *See also e.g.*, Luisa Beltran, *Moody's: PE Firms Took Out at Least 35 Dividend Recaps This year, Worth More than $11 bln*, PE HUB NETWORK (Jul. 12, 2012), https://www.pehub.com/2012/07/moodys-dividend-recaps/. (the article reports some deals done during the

Dividend recaps provide investors (private equity firms and their investors) with the benefit of immediately cashing their investment without waiting for the normal distribution process that usually occurs five-to-seven years after the initial investment, when the private equity sells or take public the portfolio company. Dividend recaps also decrease the risk of private equity firms and their investors from losing their investment on a significant return of it.[123] Last of all, dividend recaps add risk to the portfolio company because they subject it to the potential financial strain of increased leverage.

2.1.4 Buying one own debt at steep discount and debt exchange

Mega deals realized during the boom years between 2002-2007 included a great amount of debt that became unsustainable during the financial crisis. To avoid bankruptcy – and lose the entire equity in the investment- private equity firms had to reduce the debt burden on portfolio companies.[124] One way to do this consists of having a company buy back its own debt on the open market. When a company faces the prospect of bankruptcy, its bonds trade at a steep discount to the face value. The company can take advantage of the discount, buying back its own debt on the open market.[125] It saves the company millions of dollars, while on the in other hand disadvantages bondholders, who will lose the amount saved by the company.

---

peak of the market make distributions in 2012: for instance, a company such as HCA had made more than 6.7 billion in distributions and shares repurchase. To conclude that dividend recaps is a principal way private equity extract cash from their portfolio company).

[123] *Id.*

[124] APPELBAUM & BATT, *supra* note 78, at 80.

[125] Serena Ng, *Firms Move to Scoop Up Own Debt*, WALL ST. J. (Aug. 24, 2009, 12:01 AM), https://www.wsj.com/articles/SB125080949684547827

Debt exchange is another technique offered by the issuing company to exchange its outstanding debt for something else, often cash or new debt. [126] This also benefits the company by reducing its debt load but at the expense of bondholders, forced to forfeit earnings on the company's debt so as not to face the bankruptcy of issuing firms.[127]

2.1.5 Bankruptcy for profit

Private equity firms may use bankruptcy proceedings to alleviate the debt the company has accumulated.[128] In this scenario, the private equity firm takes the portfolio company into bankruptcy, with the plan of buying the company back, taking it out of bankruptcy. When, the company gets out of bankruptcy, it resurfaces with fewer debts and often discharged from pension liabilities, which are transferred to the government (and taxpayers).[129] Bankruptcy for profit occurs generally when a government provides guarantees for a firm's debt obligations, and other forms of guarantees such as deposit insurance, pension obligations of private firms, obligations of large banks, student loans, mortgage finance and influential firms.[130]

In this scenario, bondholders and unsecured creditors lose part of their investment. Workers often lose their jobs, always with part of their benefits and pensions.

---

[126] *See e.g.*, Stephen J. Lubben, *Debt-Exchange Offers Get a New Lease on Life*, NY. TIMES: DEALBOOK/ BUS. & POL'Y (Jan. 20, 2017), https://www.nytimes.com/2017/01/20/business/dealbook/debt-exchange-offers-get-a-new-lease-on-life.html?_r=0

[127] APPELBAUM & BATT, *supra* note 78, at 81.

[128] *Id.* at 82.

[129] *See generally* GEORGE A. AKERLOF & PAUL M. ROMER, LOOTING: THE ECONOMIC UNDERWORLD OF BANKRUPTCY FOR PROFIT, 1-74 (1993), https://www.brookings.edu/wp-content/uploads/1993/06/1993b_bpea_akerlof_romer_hall_mankiw.pdf.

[130] *Id.*

2.2 Private equity and the labor market

Job losses and benefit cuts are often associated with private equity take-overs. These acquisitions can produce benefits. First, even critics of private equity recognize the benefit of private equity economics in small and middle markets – that is, companies valued between $25 million and $1 billion.[131] Second, even when a company eliminates jobs or ceases operations, workers and the community sometimes benefit. Third, private equity transactions can contribute to saving ailing companies, preserving jobs.[132] It is not all one-sided.

Despite some positive outcomes, the overall public perception of private equity remains negative.

High-profile political statements have negatively portrayed the industry. For instance, in 2005, a senior German politician labelled private equity firms as irresponsible "swarms of locusts" interested in short-term profits at the expense of the future of companies they acquire and their employees.[133] During the 2012 U.S. presidential campaign, the private equity industry, labelled as "job-killing vampire," had to defend itself by claimed that the industry does not destroy jobs and communities.[134]

---

[131] APPELBAUM & BATT, *supra* note 78, at 127-160 (the authors credit smaller deal size of middle market to add value because transactions rely less on debt, as these companies have less collateral to offer than larger ones. When a company relies less on leverage, the private equity can contribute to business growth and innovation. There are also opportunities to turn-around the acquired company, long term strategies and operation improvement).

[132] *See e.g.*, SERV. EMPS. INT'L. UNION, BEHIND THE BUYOUTS: INSIDE THE WORLD OF PRIVATE EQUITY 31 (2007) [hereinafter SERV. EMPS. INT'L. UNION]. (Privat equity firm Onex buyout of three Boeing plants initially cut jobs and pay but also offered stocks to employees for the newly created company Spirit AeroSystems. jobs but ultimately added new jobs. When Onex took Spirit AeroSystems public, it provided a windfall for workers). *See also* APPELBAUM & BATT, *supra* note 78, at 238, Appendix Table 7 A.1.

[133] *See e.g.*, *The Locusts*: *Privaty Equity Firms Strip Mine German Firms*, SPIEGEL ONLINE, (Dec. 22, 2006, 07:16 PM), http://www.spiegel.de/international/the-locusts-privaty-equity-firms-strip-mine-german-firms-a-456272.html

[134] *See e.g.*, Jeff Mason & Alister Bull, Obama camp targets Romney firm as job-killing "vampire", REUTERS (May 14, 2012, 10:57 AM) https://www.reuters.com/article/us-usa-campaign/obama-camp-targets-romney-firm-as-job-killing-vampire-idUSBRE8481JD20120514 #Politics. *See also e.g.*, Nathan Vardi, The Obama-Romney War

Few reliable studies exist on employment effects of takeovers, the quality of jobs created, and resulting labor relations. Information on private companies is scarce.[135] Studies sponsored by the private equity industry usually emphasize job- creation-post acquisitions;[136] but the data and methodology used are often biased and questionable.[137] Other studies support the argument that companies post-leveraged-buyouts create fewer jobs than non-leveraged buyouts do,[138] with exceptions in France, in which some evidence of job creation post buyouts exists.[139] In general, findings are consistent with the perceived notion of employment insecurity and destruction resulting from private equity transactions.

There are, however, distinctions among buyout deals. First, going-private deals (when a publicly traded company becomes privately held) cut employment at a steeper rate than private-to-private transactions (independent).[140] Going-private transactions are often associated with poor deal execution, as acquisitions occur at market peaks, producing higher valuations and over-leveraged transactions.[141] When this happens, job losses tick higher because the acquired company divests part of its operations or ceases to exist.[142] By contrast, private-to-private transactions, which represent the majority of buyout transactions, tend to create robust job growth the first two

---

Over Private Equity Is Just Beginning, FORBES (June 8, 2012, 11:41 AM) https://www.forbes.com/sites/nathanvardi/2012/06/08/the-obama-romney-war-over-private-equity-is-just-beginning/#71ae198224c9.

135 APPELBAUM & BATT, *supra* note 78 at 193-238.

136 *See generally e.g.*, ROBERT J. SHAPIRO & NAM D. PHAM, AMERICAN JOBS AND THE IMPACT OF PRIVATE EQUITY TRANSACTIONS (2008) (claiming large private equity firms produce stronger job growth than other companies in a same sector).

137 *Id.* The sponsorship of the study by a private equity trade group and eight large private equity firms raise the question of selection bias.

138 *See generally* Davis et al., *Private Equity and Employment* (Nat'l. Bureau Econ. Research, Working Paper No. 17399, 2011).

139 *See generally* Quentin Boucly et al., *Growth LBOs*, 102 J. FIN. ECON., 432 (2011).

140 Davis et al., *supra* note 137 at 5-6 (Reduction of 10% of initial employment in the first two years after the acquisition of publicly traded firms).

141 *Id.* at 30.

142 *Id.*

years post buyout.[143] In these instances, private-to-private transactions are associated with job reallocation, adjustments, and the acquisition of more companies and divestitures.[144] Second, industry types - manufacturing, retail and service – exhibit different results toward employment.[145] Thus, job losses or created by private equity buyouts are not homogenous. Difference exist based on deal size, type, and industry.

Finally, when a company changes ownership and becomes private equity owned, communication or consultation with workers rarely happens. Private equity owners' attitudes towards the workforce and labor unions varies from being engaging and constructive to the outright hostile.[146]

To conclude this section, consequences of private equity transactions on workers and their communities carry mixed blessings. The impact of private equity deals is clearly negative for workers and their communities when workers lose jobs, pensions, and benefits.[147] In some instances, the government (and taxpayers) bear the cost of a buyout transaction when the private equity owner does not assume the previous owners' responsibilities.[148]

---

[143] *Id.*at 30-31 (Pubic-to-private attract more attention than private-to-private but represent a small portion of buyout deals).

[144] *Id.*

[145] *Id.* at 29 (employment tend to fall moderately in manufacturing jobs after a buyout compared to similar industry; in retail sector, employment falls sharply, by 12 percent following a buyout compared to non-buyout activities; and in service sector, employment grow before buyout but slow after the acquisitions).

[146] *See generally* SERV. EMPS. INT'L. UNION *supra* note 132.

[147] APPELBAUM & BATT, *supra* note 78, at 193-238 (Russell Sage Foundation ed. 2014). (The authors analyze case studies of companies held in private equity portfolio. They document cuts in jobs, wages and retiree benefits including: Five U.S. Steel Legacy companies acquired by Willbur Ross & Co between 2001-2003; Delphi Corporation acquired by John Paulson & Co., and Silver Point Capital in 2009; Hawker Beechcraft acquired by Goldman Sachs Capital and Onex Partners in 2007).

[148] *See e.g.*, Greg Palast, *Mitt Romney's Bailout Bonanza*, NATION (Nov. 5, 2012), https://www.thenation.com/article/mitt-romneys-bailout-bonanza/; *See also Delphi FAQs - General*, PBGC, https://www.pbgc.gov/wr/large/delphi/delphifaq (PBGC started to assume responsibility of the pension plans after the parent company General Motors and Delphi went into bankruptcy and accepted the government bailout). *See also, e.g.*, for Hawker Beechcraft Patrick Fitzgerald, *PBGC Will Take Over Hawker Pensions*, WALL ST. J. (Dec. 26, 2012,

2.3 Investment Return on Private Equity Funds

For many years, industry insiders, bolstered by the media, have contended that private equity is a profitable investment producing superior investor returns. The profitability, they argue, comes from expertise and risk-taking decisions private equity advisors make. Risk-taking produces above-average investment returns. Claims of superior investment returns have influenced many to invest in private equity and other private funds. These investors include many public pension funds. Thus, private equity fund investment return has become a matter of public policy for local governments such as the State California.

Because of the lack of public data from private equity, no conclusive and reliable information to confirm or invalidate these assertions exist. There are, however, empirical studies that have questioned returns stated by the industry. These studies show that returns on private equity investments are lower than initially thought. In fact, investing in the public market with the Standard and Poor 500 index produces better returns than private equity.

This lower investment return is partly due to compensation agreements that do not clearly state what fees investors and portfolio companies may pay during the fund's investment cycle.

8:51 PM), https://www.wsj.com/articles/SB10001424127887323530404578203933755282340, *See also Hawker Beechcraft Plan Overview*, PBGC, https://www.pbgc.gov/wr/large/hawker-beechcraft-plan-overview (last visited Feb. 16, 2019).

2.3.1 The complexity of compensation agreements

Compensation agreements for private equity and venture capital are complex. The exact amount of fees investors and portfolio companies must pay has proven difficult to evaluate.[149]

General partners receive income from their investors (Limited Partners) and portfolio companies. Investors provide management fees and share the profit, called carry interest. Management fees usually represent two percent of the committed capital, paid quarterly by investors. Management fees occur according to various formulas that can include committed capital, cost basis of capital, or a combination of both.[150] In addition to management fees, General Partners receive carried interest, which correspond to an incentive fee based on a fund's performance. Measurement of carried interest can be misleading because the apparent simple formula (usually a flat percentage) often leads to various interpretations.[151] The timing of a carried interest payment is also a factor in considering the compensation received by General Partners.[152]

General partners receive an additional stream of income from portfolio companies. These are fees paid directly to General Partners and entirely controlled by them. General Partners notify when Limited Partners receive these fees and normally share them according to the rules defined in their agreements. These fees include transaction and monitoring fees.[153] Other fees can be added depending on the agreements' provisions.

---

[149] *See generally* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 218 (2009). *See also* Phalippou *supra* note 77 at 147-166.

[150] Litvak *supra* note 149 at 169.

[151] *Id.* at 175.

[152] *Id.* (the author considers the timing of the distribution of carry interest is a third element of compensation – management fees and carried interest being the first and second respectively).

[153] Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN.STUD., 2313, 2303-2341, (2010)

Transaction and monitoring fees, though, arise only out of buyout agreements. They seem not to exist with venture capital.[154] General Partners charge transaction fees when buying or selling a company, and they resemble to fees investment banks charge for mergers and acquisitions.[155] Monitoring fees represent the time and effort General Partners spend working alongside a company.[156]

2.3.2 The Lower Performance of Private Equity Returns

Evidence suggests that private equity returns do not outperform the Standard and Poor's 500 index ("S&P 500").[157] Results consistently show that private equity returns drift lower (net of fees) than the S&P's 500. The funds do outperform the S&P's 500 when adding the fees (gross amounts as a percentage of buyout cost). In other words, only by adding fees charged to investors and portfolio companies do private equity funds and venture capital exceed S&P 500 returns.

Surprisingly, the bulk – or two-thirds- of private equity income derives from non-risky portion of the compensation package, that is management fees and portfolio companies' fees (transaction and monitoring).[158]

The question then arises, why do sophisticated investors put so much money into this type of investment when it offers no liquidity (it cannot be sold), or has long-term lockups (for example

---

[154] *Id.* at 2313.
[155] *Id.*
[156] *Id.* at 2314.
[157] *See generally* Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FIN., 1791, 1791-1823 (2005). *See also* Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, *22* REV. FIN. STUD., 1747-1776 (2009) (the authors use a slightly improved methodology than Kaplan & Schoar using the same funds and additional non-US funds for a total of 314 funds).
[158] Metrick & Yasuda, *supra* note 153 at 2320 (these results are equal whether the fund is a venture capital or buyout).

ten-year), with compensation terms difficult to understand? Some authors argue that sophisticated investors might be fooled or they might misunderstand the information provided,[159] particularly for the calculation of fees and returns.[160] Since Dodd-Frank, a flurry of negative press has erupted on the fees that private equity firms levy on their investors and portfolio companies.[161] Investors and regulators now question whether private equity investment worth the risk taking into account the enormous fees investors pay. For instance, the State of California now requires its state pension to disclose fees paid to private equity and other private funds.[162] Starting in 2017, California public pension plans must disclose fees and expenses reported by private equity funds in which the pension plans have invested.

---

[159] *See generally* Josh Lerner, Antoinette Schoar, & Wan Wong, *Smart Institutions, Foolish Choices?:The Limited Partner Performance Puzzle*, 62 J. FIN., 731-764 (2007).

[160] *See* Kate Litvak, *supra* note 149 at 175: the author finds the simplicity in drafting carry interest is deceiving because leads to interpretation errors. *See also* Phalippou, *supra* note 77 at 155-162 The author cites the statement of CALPERS, one of the largest private equity investors. In 2008, CALPERS made a statement that it is satisfied with the returns received by private equity investments: from 1990 to 20007, CALPERS has invested $25 billion and has received $19 billion back. This represents 1.5 return, which would be the same than investing in the U.S. stock market index fund for the same period. Thus, the author is perplexed on why CALPERS would be so satisfied for what appears to be a disappointing rate of return).

[161] *See e.g.*, Gretchen Morgenson, *The Deal's Done. But Not the Fees*, N. Y. TIMES (May 24. 2014), https://www.nytimes.com/2014/05/25/business/the-deals-done-but-not-the-fees.html?_r=0; Mark Maremont & Mike Spector, *Blackstone to Curb Controversial Fee Practice*, WALL ST. J., Oct. 7, 2014, https://www.wsj.com/articles/blackstone-to-curb-controversial-fee-practice-1412714245, *See also*

[162] *See* CAL GOV'T CODE § 7514.7 ("California Assembly Bill 2833." Introduced February 19, 2016) also available at http://www.leginfo.ca.gov/pub/15-16/bill/asm/ab_2801-2850/ab_2833_bill_20160219_introduced.pdf. (Public investment fund must require disclosures by alternative investment vehicles and report the information). *See also* James Rufus Koren, Calpers' *Private Equity Fees Under the Microscope*, L.A. TIMES (Jul. 8, 2016, 3:00 AM), http://www.latimes.com/business/la-fi-pe-disclosure-20160706-snap-story.html. *See also* ILPA, *ILPA Publishes Landmark Guidance On Private Equity Fee Reporting*, INSTITUTIONAL LTD. PARTNERS ASS'N (Jan. 29, 2016) https://ilpa.org/wp-content/uploads/2015/06/ILPA-Fee-Reporting-Template_Press-Release-FINAL1.pdf. (Institutional Limited Partners Association ("ILPA") is a trade association group for limited partners).

2.4 Private Equity Tax Gamesmanship

In the 1980s, tax loopholes stimulated leveraged buyout growth.[163] Today, private equity firms employ the most sophisticated tax professionals to take advantage of existing tax laws. Tax planning is fair game in commercial dealing. But questions of fairness arise when the private equity industry games the system.[164]

The taxation of carried interest, that is, profit sharing, embodies the biggest loophole that the private equity industry has - successfully[165] - fought to preserve. That is, carried interest benefits owners and managers with favorable tax rate of long-term capital gains rather than ordinary income. [166] Other tax issues associated with fees received by private equity firms include fee conversion and deferral.

2.4.1 List of taxable fees

Private equity fund managers receive several streams of income, using different entities to collect that income.[167] The income comes from limited partners in one part, and in another part,

---

[163] BURROUGH & HELYAR, *supra* note 2 at 23 (Kohlberg had identified the tax law allowed new owners to sell off business divisions without paying taxes on gains and claiming borrowed money to finance takeovers as depreciations. The government ended these loopholes in 1987).

[164] *See e.g.*, EILEEN APPELBAUM & ROSEMARY BATT, FEES FEES, AND MORE FEES: HOW PRIVATE EQUITY ABUSES ITS LIMITED PARTNERS AND U.S. TAXPAYERS (2016).

[165] *See* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat 2054 (2017) [hereinafter *TCJA*] (the new tax law has not ended the carried interest loophole). See also *e.g.*, Sahil Kapur et al., *How the Carried Interest Break Survived the Tax Bill*, BLOOMBERG: POL. (Dec 22, 2017, 11:26 AM), https://www.bloomberg.com/news/articles/2017-12-22/cohn-mnuchin-split-helped-break-trump-s-carried-interest-pledge.

[166] *See generally* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1-59 (2008).

167 Gregg D. Polsky, *A Compendium of Private Equity Tax Games* 2 (UNC Legal Studies Research Paper No. 2524593, 2014), https://ssrn.com/abstract=2524593 or http://dx.doi.org/10.2139/ssrn.2524593 (a partnership, set up as management company, provides management services and receives the management fees for each fund. Another

from companies held in the portfolio. Commentators have characterized as opaque and convoluted the breakdown and totality of that compensation. [168]

From limited partners, private equity managers collect annual management fees for outstanding funded capital commitments. General partners also receive a carried interest, which is profit sharing, based on the performance of the portfolio companies. Typically, the fee structure, referred to as two-twenty, means the two percent management fees and twenty percent carried interest.[169] Private equity managers receive annual management fees in advance, while the payment of carried interest occurs only if the fund produces a return, usually above a stated threshold, called the hurdle rate or preferred return (often eight percent).[170] In addition to limited partners, private equity managers receive other streams of income from the companies held in their portfolios. These include fees paid directly by the portfolio company to the private equity owner such as transaction fees, monitoring fees, and advisory fees.

Tax treatment of these various incomes (management fees, - that is, income from limited partners - and carried interest – that is, income from profits) differs. Management fees are taxed as ordinary income, while carried interest receives the preferential treatment of capital gains.[171] This means that two percent management fees receive a federal marginal tax rate, which ranged up to thirty five percent before the tax reform of 2017, whereas the twenty percent profits or carried

---

entity, set as general partner, manages each fund, usually established as limited partner. The general partner collects the carried interest.

[168] *See e.g.,* Kate Litvak *supra* note 149 at 161-218 (the author finds three sources of income). *But see* Phalippou *supra* note 77 (the author adds a fourth source of income).

[169] Fleischer *supra* note 166. *See also infra* Polsky, note 171 at 6-7

[170] *See* Victor Fleischer, *The Missing Preferred Return*, 31 IOWA J. CORP. L. 77, 87 (2005) (hurdle rates or preferred returns are found with private equity buyout funds and do not exist with venture capital. It means that contrary to buyouts, venture capitalists share the profits with their investors regardless of the fund performance).

[171] *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-08-885, PRIVATE EQUITY: RECENT GROWTH *in* LEVERAGE BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION (2008) - Appendix III: Overview of Tax Treatment of Private Equity Firms and Public Policy Options, at 72-73.

interest are taxed at a twenty percent rate (it was 15 percent before 2013). The tax treatment of private equity incomes allows managers to maximize revenue while reducing tax liability by converting ordinary income into capital gains to benefit of preferential rate (1) and the deferral (2) of taxation. In addition, the technique of offsetting management fees (paid by limited partners) through monitoring fees (paid by portfolio companies) is another controversial use of tax laws (3).

2.4.1.1 Fee conversions: ordinary income to preferential tax rates

Conversion means changing the character of an income to tax it at a preferential rate. The income recharacterization often discussed by scholars and observers pertains to the treatment of interest from profit– with the character of labor income, thus, ordinary income- converted into carried interest. Less argued, is the conversion of management fees – ordinary income - into carried interest.[172]

2.4.1.2 Performance-based income converted into carried interest

The issue whether carried interest should be taxed as ordinary income or as capital gains is a question of partnership tax principles and the treatment made when a partner receives a partnership interest in return for services. Under the current law, partnership equity has two components: capital interest and profit interest.[173] Profit interest gives rights to the partner in the partnership but does not have a current liquidation value, while capital interest provides not only a right in the partnership but also a current liquidation value.[174] Because capital interest has a determinable value, services rendered by the partner become immediately taxable income. Profits

---

[172] *See generally* Greg D. Polsky, *Private Equity Management Fee Conversions* (Fla. Sate Univ. College of Law, Law, Bus & Econ. Working Paper No. 08-18, 2008), https://ssrn.com/abstract=1295443.

[173] Fleischer *supra* note 166 at 10.

[174] *Id. See also* Fleischer, *supra* note 170 at 109.

interest, however, having no liquidation value readily determinable, is not taxable income.[175] Revenue Procedure 93-27 codifies the tax treatment of profits interest with a safe harbor for profits interest and "guidance on the treatment of the receipt of a partnership profits interest for services provided to or for the benefit of the partnership." Thus, profits interest is not a taxable event for the partner. [176]

Through the years, Congress has introduced several bills to change taxation on carried interest and align it, or at least part of its income, with ordinary income. None of these bills have become law.[177] Fairness dictates closing the loophole by taxing carried interest as ordinary

---

[175] *Id.*, at 11. *See also* Diamond v. Commissioner, 492 F.2d 286, 290-91 (7th Cir. 1974): A confusion occurred in 1974 as the court held "There must be wide variation in the degree to which a profit-share [profit interest] created in favor of a partner who has or will render service has determinable market value at the moment of creation", such as this case where the partner had already rendered the service and the prospect of income was not speculative. The Court concluded the receipt of profit interest "with determinable market value is income", thus immediately taxable.

[176] *See* REV. PROC. 93-27, 1993-2 C.B. 343. For more discussion on whether carried interest should be taxed as income from services rendered (i.e., ordinary income) or investment (i.e., capital gains), *See* U.S. Government Accountability Office, *supra* note 16 at 75 (There are four basic arguments in favor of taxing carried interest as ordinary income: first, private equity firms provide the same services as asset management firms do when they acquire, control and oversee companies; thus, they should be taxed the same as investment managers. Second, and similar to the first argument, since private equity firms compete for the same pool of talent and provide the same services as investment banks, they should receive the same tax treatment. Third, it is an inadequate tax because private equity owners contribute only a small portion of money to the buyout fund. Fourth, by paying a lower marginal rate than many lower-income workers subject to ordinary income tax, taxpayers subsidize private equity owners, who are wealthy individuals earning millions. Opponents of taxing carried interest as ordinary gains argue that carried interest represents assets held for long-term investment and involve risk-taking by private equity firms. As such, carried interest is taxed at a preferential lower rate since risk-taking is a goal of the preferential treatment of capital gains. Supporters also argue private equity creates new ventures that are not compensated for this service. In addition, there is no performance of services when the portfolio companies of private equity firms hold capital assets and pass the gains to private equity partnerships. Supporters also contend that carried interest, such as capital gain, grows through someone's effort. Finally, capital gain treatment mitigates the double taxation effect of private equity activities because portfolio companies are already subject to corporate taxes before passing any gains to the private equity partnership and partners. Thus, carried interest should remain taxed as a capital gain and not ordinary income).

[177] *See e.g.*, Victor Fleischer, *Taxing Blackstone*, IL. L. & ECON. RES. PAPERS SERIES, RES. Paper No. LE-036 (2007) (the Blackstone bill or "PTP" (publicly-traded partnership) bill was introduced in 2007 by senators Baucus and Grassley in reaction to the private equity giant Blackstone and its decision to go public in March 2007. Private equity going public was a trend in the 2007 years as several firms such as Fortress, or Apollo filled to become publicly traded companies. The Blackstone bill offered to tax publicly traded private equity firms with carried interest at the same rate of 35% as ordinary income. It did not affect other private equity firms remaining privately held. The bill viewed as a response to private equity gamesmanship did not prosper in Congress).

income.[178] Carried interest represents profit sharing or performance-based pay, which is a common compensation scheme in many industries, including in the steel industry. While employees in the steel industry receive performance pay taxed as ordinary income, millionaire owners of private equity receive the same type of profit sharing compensation taxed at a lower rate of capital gains.[179] This tax loophole benefits private equity owners to the detriment of the government and taxpayers.[180] The absence of public data prevents from knowing the revenue provided by carried interest or losses incurred by the government. However, some estimates tax-saving represented by the carried interest loophole to be as high as $180 billion over ten years.[181]

Besides converting performance-based income into long-term capital gains, private equity managers have used a portion of their management fees, which are normally ordinary income, to convert those fees into carried interest.

2.4.1.3 Management fee converted into carried interest (partnership interest)

Limited partners pay annual management fees to private equity managers – ad hoc management companies - to care for regular business matters of the partnership (employees, office space, etc.). Management fees, for which limited partners pay 2 percent of interested funds are taxed as ordinary income. However, this practice has showed that private equity firms convert part of their management fees (ordinary income) into capital gains by adding these fees to the carried

---

[178] Appelbaum & Batt *supra* note 164.
[179] *Id.* at 30.
[180] *Id.*
[181] Victor Fleischer, *How a Carried Interest Tax Could Raise $180 Billion*, N.Y. TIMES: DEALBOOK (June 5, 2015), https://www.nytimes.com/2015/06/06/business/dealbook/how-a-carried-interest-tax-could-raise-180-billion.html?_r=2 (A Congressional Joint Committee on Taxation provided much modest estimate of $15.6 billion over 10 years). *See also*, *A Tax Break that Wall Street Cannot Defend*, FIN.TIMES (Jan., 14 2016), https://www.ft.com/content/8b330a4a-babe-11e5-bf7e-8a339b6f2164 (additional critics have also concluded that carried interest is a "tax break that Wall Street cannot defend" because, as noted above, private equity owners take little risk with their own money while they "*are receiving payment for a service, namely to invest money on behalf of limited partners in the fund, while losses on investments fall on their clients alone)*."

interest pool. The goal of which aims at having preferential tax rate treatment applied (deferred capital gains and dividend income).[182]

To do this, private equity managers use "management fee waivers"[183] that waive future management fees in exchange for the general partner receiving additional compensation from profits realized by the fund. Thus, fees waived in one part offset additional rights on the profits. The economic structure between private equity managers and limited partners does not change, only the income divide.

This results in creating two categories of carried interests: the regular 20% of net gain of the fund and an additional carried interest or "priority allocation"[184] carried out from management fees.[185] Different from regular carried interest, which takes into account net gains realized by the fund, the priority allocation is accounted for as early as soon as the first dollar of net gains is realized by the fund in any fiscal year. The amount of the priority allocation equals the management fee waived. Thus, if the private equity manager waives one million dollars of management fees, he will receive an equivalent carried interest or priority allocation of one million dollars.[186] Strangely, this priority allocation does not depend on the profits realized by the fund as regular carried interest does; rather, priority allocations are based on accounting periods showing gains (without taking into account eventual losses that may occur during a fund's life).

Converting management fee waivers into additional carried interest raises an issue of character: should fee waivers account for "profits interest" under the safe harbor of rev. Proc. 93-

[182] *See* Polsky *supra* note 172.

[183] *See* Polsky *supra* note 167 at 5 (there are two types of fee waivers: upfront fees made since the inception of a fund and elective fees made during the life of a fund).

[184] *Id.* The author names the additional carried interest "priority allocation"

[185] *Id.* for detailed discussion on tax consequences on management fee conversions.

[186] *Id.* at 12.

27? The structure resembles a fee-for-services transaction "disguised as partnership transactions and bona fide transactions," which ordinary income legislators sought to prevent.[187] Thus, management fee waivers do not have the character of profits interest.

In addition to conversion, taxing carried interest as a capital gain provides the benefit of deferral of income tax.[188]

2.4.2 Deferral of income tax

Conversion means income from profits interest are taxed at long-term capital gains rather than higher ordinary income rates.[189] Tax deferral means payment of investments will occur at a future date instead of the time they occur. Under partnership law, the receipt of interest from profits is not a taxable event; thus, it is not taxed upon receipt, but a deferral occurs until profits are distributed.[190]

Deferral of income tax confers a timing advantage for private equity (and hedge fund) managers. With carried interest treated as capital gains, managers can choose to pay tax at a later date when the interest materializes. For private equity firms, this means portfolio companies, which represent illiquid securities interests difficult to value, are taxed at liquidation (usually during the exit phase of the private equity strategy). Deferred treatment of income benefits from the time value of money because the taxpayer holds securities in his portfolio longer and taxes paid in the future are cheaper than taxes paid in the present due to the potential earning capacity

---

[187] Polsky *supra* note 167 at 8.

[188] *See* Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profits Shares: What Is It? Why Is It Bad?* 75 U. CHI. L. REV., 1075 (2008).

[189] *Id.*

[190] *See* Fleischer, *supra* note 166 at 11.

of money and inflation.[191] Deferral of taxation provides to private equity firms an interest-free loan from the government[192] or a subsidy that private equity firms take advantage of.

The benefit of deferred compensation works for partnership compensation structured as profits interest and not capital interest.[193]

As noted, conversion and deferral provide a tax advantage for private equity managers. However, their investors receive more taxable ordinary income equivalent to the profits interest private equity mangers convert and defer.[194] The detriment to investors is often reduced as most are tax-exempted entities.[195]

Another controversial tax practice consists of disguising dividends from fees provided by portfolio companies to offset management fees limited partners pay.

2.4.3 Dividends disguised as Monitoring fees

Portfolio companies pay private equity managers various fees (monitoring fees, transaction fees, breakup fees). In the private equity industry, monitoring fees serve to offset management fees.[196] This does not modify the economic structure between private equity managers and limited

---

[191] *See generally* DONALD J. MARPLES, CONG. RES. SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 9 (2014).

[192] Polsky *supra* note 172 at 8 (an interest-free loan is provided because the realization of the income occurs after the services are performed).

[193] Fleischer *supra* note 166 at 13.

[194] *See* Sanchirico, *supra* note 188 at 1075-6.

[195] *See* PETER R. ORSZAG, CONG. BUDGET OFFICE, TAXATION OF CARRIED INTEREST 10 (2007), http://www.cbo.gov/ftpdocs/85xx/doc8599/09-06-CarriedInterest_Testimony.pdf (most limited partners are tax-exempt or foreign entities and are not subject to taxation).

[196] *See generally* Gregg D. Polsky, *The Untold story of Sun Capital: Disguised Dividends*, TAX NOTES 556 (Feb 3, 2014); *See e.g.*, Dan Primack, *Private Equity's New Tax Problem*, CNN MONEY (Feb. 3, 2014); William Alden, *Tax Expert Sees Abuse in a Stream of Private Equity Fees*, N.Y. TIMES DEALBOOK (Feb. 3, 2014).

partners. The structure poses an issue of tax avoidance when monitoring fees paid by portfolio companies appear disguised as dividends rather than as deductible compensation.[197]

A two-prong test establishes whether a payment is truly compensatory and thus deductible:[198] (1) the compensation is reasonable in amount and (2) a payment made for services or a compensatory purpose or intent.[199] In determining the nature of the payment, names or labels provided by the parties do not matter; the facts, circumstances and substance of the payment are determinative.[200] Here, the question exposes whether monitoring fees and the offset structure satisfy the compensatory intent for deductibility. As a commentator points out, monitoring fees paid by portfolio companies lack compensatory intent and therefore, no deduction should be allowed, even if the amount paid is considered reasonable.[201]

Private equity fund advisers take advantage of tax laws by aggressively managing their tax liabilities and the liabilities of their portfolio companies.[202] Tax planning is not specific to private equity firms. Private equity poses the issue to identify when tax planning becomes tax avoidance.[203] There are two specific tax issues with private equity: the use of debt versus equity to

---

[197] *Id.*

[198] 26 U.S.C.A. § 162(a)(1) states the following: "*(a) In general.-There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--(1) a reasonable allowance for salaries or other compensation for personal services actually rendered.*"

[199] *See e.g.* O.S.C. Associates Inc. v. Commissioner, 187 F.3d 1116 (9th Cir. 1999).

[200] Polsky *supra* note 196. *See e.g.* David E. Watson P.C. v. U.S., 668 F. 3d 1008 (8th Cir. 2012) (incentive compensation plan" deemed dividends in disguise, regardless of whether payments were reasonable.

[201] Polsky *supra* note 196 (the author has reviewed several monitoring agreements between portfolio companies and private equity firms to conclude that the vast majority of these arrangements could not satisfy the compensatory intent requirement because: 1) compensation are large periodic payment to private equity firms over a long period (usually 10 years) for exchange of future unspecified management consulting, advisory services; 2) the private equity firm determine the timing of execution and the scope of the service with no minimum number of hours; 3) the arrangement can be terminated at sole discretion of the private equity firm and still receive the entire amount of the contract even if it has been terminated.

[202] *See generally* Brad Badertscher, Sharon P. Katz, & Sonja Olhort Rego, *The Impact of Private Equity Ownership on Corporate Tax Avoidance* (HARV. BUS. SCH., Working Paper No. 10-004, 2009).

[203] *Id.*

lower tax liability, and the taxing of carried interest at a lower bracket when its income is categorized as long-term performance rather than ordinary income.

2.4.4 Tax treatment of debt

Most private equity firms finance the acquisition of companies by engaging in leveraged buyouts. Typically, the capital structure of a leveraged buyout acquisition uses a small portion of equity – mainly money raised from private equity investors, also known as limited partners – and a big portion of debt.[204] The use of debt, known as leverage, is central to the private equity model: [205] private equity firms acquire viable but undervalued companies with solid cash flow. The cash flow produced by the company will service the debt used to finance the acquisition. [206]

In the early eighties – considered the first wave of buyouts debt represented 85-to-90 percent of acquisitions' costs compared to 10-to-15 percent equity (4-1 or 7-1 leverage ratios).[207] In the 2000s, the debt portion of leveraged buyouts fell to 70 percent versus 30 percent equity (roughly 3-1 debt-to-equity leverage ratio).[208]

The excessive use of debt amplifies the return of private equity owners because they commit a very small portion of equity (1 to 2 percent) compared to limited partners (98 percent) but collect the benefit of any successful investment by sharing with limited partners 20 percent of the profits. In the meantime, the acquired company, burdened with debt may face financial strain

---

[204] *See generally* Kaplan & Stromberg *supra* note 13 at 121-46.

[205] APPELBAUM & BATT *supra* note 78 at 22 (the authors cite the company Houdaille a fortune 500 company that had "lots of cash on hand, little debt, and an undervalued stock price;" the private equity firm purchased Houdaille with 8 percent equity and 92 of debt).

[206] Kaplan & Stromberg *supra* note 13 at 139.

[207] *Id.*

[208] APPELBAUM & BATT, *supra* note 78 at 3 (a typical public company issues 30 percent debt and 70 percent equity).

and the prospect of bankruptcy. In sum, general partners commit little compared to other actors – that is, limited partners and the portfolio company- but with financial commitment to the venture, general partners will nevertheless reap an outsized benefit.

The use of leverage or debt allows private equity firms[209] to capitalize on more favorable treatment of debt in the tax code. Interest on debt is tax-deductible and reduces tax liabilities for private equity owners as the interest on debt may be subtracted from taxable income, while retained earnings or dividends are taxable as profits.[210]

The favorable treatment of debt means that debt in the form of interest benefits from the deductibility of taxable profits, whereas the equity - dividends distributed to shareholders or capital gains on shares- is not deductible.[211] Thus, private equity general partners have a greater tax advantage compared to other companies due to this use of leverage. Paying lower tax due to increased leverage increases a company's value, which represents a gain for private equity owners but does not correspond with increasing economic wealth for the company.[212]

---

[209] *Id.* at 76.

[210] *Id.* also at 32.

[211] *See generally* RUUD A. DE MOOIJ, TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS (2011).

[212] APPELBAUM & BATT, *supra* note 78 at 77.

3.0 Third Chapter: Governance of Private Equity Before the Dodd-Franck Act of 2010

The Dodd-Frank Act represents the first comprehensive legislation concerning private equity and managers of private funds.

Economics and finance scholars fueled the literature on private equity investments long before legal scholars took an interest on the subject. In the 1980s, concurrent with the rise of the law and economics movement, economics and finance scholars became interested in private equity investments. Corporate governance means the "*allocation of power or authority to allocate (...) the corporation's resources among its various constituencies (shareholders, directors, managers, and employees*."[213] It should come as no surprise that the discussions about private equity at this time focused on "vertical" corporate governance, which analyzes the relationships between owners and boards of directors.[214] Here, the owners are the private equity managers dealing with the boards of directors of the portfolio companies.

As stated above, the early literature on private equity focused on managers monitoring their investments in portfolio companies. That is, the relationship between the owner (private equity manager) with the manager of the portfolio company. Too little attention was given to investors, those who provided funds to the private equity firms.

After the financial crisis of 2008, literature questioning the soundness and truthfulness of private equity financial results took a front seat.[215] As a result, attention shifted to investors'

---

[213] Douglas M. Branson, *The Social Responsibility of Large Multinational Corporations*, 33 TRANSACTIONAL L. 121, 122 (2002).

[214] *Id.* at 121 (noting how legal and business educators depict vertical corporate governance as a pyramid wherein shareholders are located at the base and the handful of senior executives stand on top).

[215] *See e.g.*, Kaplan & Stromberg *supra* note 13, Litvak *supra* note at 149, Phalippou *supra* note at 77.

willingness to control managers and curb their abusive practices. It appeared obvious that heavily negotiated agreements and reputations alone had limited effect on an industry known for its lack of transparency. Many have also decried the lack of protection for so-called sophisticated investors unable to understand complex financial products. Suddenly, investor protection and investor sophistication did not seem contradictory.

The overall debate on corporate governance, especially how to reign in agency costs that resulted from the separation of ownership and control, mirrors the private equity debate. A brief history of corporate governance (I) explains how private equity literature fits in corporate governance: it has evolved from contractarian views, from first refusing any sort of government intervention between private parties and then moving to good governance, self-regulation (II), and to move towards social responsibility (III).

3.1 A Brief History of Corporate Governance

Corporate governance theories attempt to improve the management of companies. The literature has mainly focused on public corporations listed on a stock exchange. The 1932 theory of separation of ownership and control by Adolf Berle and Gardiner Means[216] describes the first major attempt to analyze corporate governance.[217] This theory states that the modern corporation faces an agency problem caused by the separation of ownership from control. Shareholders of public corporations are a widespread, a heterogenous group unable to monitor managers' behavior,

---

[216] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[217] *See generally* Douglas M. Branson, *Proposals for Corporate Governance Reform: Six Decades of Ineptitude and Counting*, 48 WAKE FOREST L. REV. 673 (2013).

that is, ones in control of the corporation. As a result, shareholders (owners of the corporation) cannot monitor managers who often may behave opportunistically and not in the best interest of owners.

Corporate governance scholars have ever since used the theory of separation of ownership from control as the premise to elaborate their own reform proposals.[218]

In the 1970s, the corporate social responsibility movement posited that corporations have a social responsibility to play in response to the void created by the separation of ownership from control.[219] According to this movement, government intervention should monitor and discipline corporate misbehavior. Corporations should account not only to their owners but also to the society as a whole.[220] Social responsibility advocates justified government intervention by pointing to the size of corporations, too big to be acting solely as private property.[221] Some of the proposals of social responsibility movement included public interest directors imposed on big corporations, working alongside directors but acting as advocates for the public interest.[222]

Another interesting proposal of the corporate social responsibility movement called for social accounting disclosures through the SEC, [223] which aimed at reporting social responsibility activities undergone by a company.

In the late 1970s, the law and economics movement moved to center stage. This movement has largely dominated the private equity literature ever since. Law and economics posit that market forces are better governance tools than government intervention or lawsuits.[224] Efficiency of the

---

[218] *Id.* at 608.
[219] *Id.* at 612-5.
[220] *Id.*
[221] *Id.*
[222] *Id.*
[223] *Id.* at 613
[224] *Id.* at 618.

market, and cost-benefit analysis of regulation became the main objective of corporate governance. Law and economics reached its pinnacle in corporate law, in which every corporate subject had to demonstrate some economics perspective on how a legislation could (or could not) improve corporate efficiency.

According to law and economics scholars, the separation of control from ownership did not pose an issue as previous theorists opined. To the contrary, it served the purpose of efficiency as it divided how to perform labor: shareholders of large corporation purposefully delegate the management of their companies to professional managers.[225] Market forces would regulate problems, if any, caused by the separation of ownership from control (such as embezzlement, self-interest of managers). In no case did government intervention, regulation, or public interest directors represent a solution.[226] Market forces, in a way, served as a deterrent against managers' bad behavior or counter performance because failure could cost a manager's the loss of her reputation or her position.

The law and economics movement refined its theory with contractarians, a subset. Contractarians posit a minimalist view of corporate law with "*no mandatory content at all*."[227] Based on Ronald Coase's *Nature of the Firm*,[228] a core tenet of contractarians lies in the existence of a contractual relationship between managers and shareholders of public companies.[229] Market forces invite corporations to detail best corporate contract when a company plans to go public.

---

[225] *Id.* at 619.
[226] *Id.*
[227] *Id.* at 620.
[228] Ronald Coase *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (economic theories explaining the nature of the firm through its transaction costs and their effects).
[229] *See generally* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006) (questioning the soundness and realism of contractarian theorists about corporate governance being a contract between managers and shareholders. Most corporate governance mechanisms are used without contractual relationship between shareholders and managers; such as incentive pay, board independence, committee structures, etc.).

Market forces reward those companies having contracts containing efficient corporate governance mechanisms.[230] In addition, corporate law should favor default rules rather than mandatory rules, with an option to opt out of any or all rules. Default rules enhance the value of the company.[231]

The law and economics movement has influenced private equity literature. One reason might be that the market of private equity started to develop in the late 1970s, growing significantly in the 1980s. Private equity growth parallels the development of law and economics jurisprudence.

The law and economics movement emphasized the freedom of contract and private ordering. Freedom of contract promotes economic *laissez-faire* by market participants and encourages government to keep "*its heavy hands off the economy*."[232] Private ordering means the sharing of regulatory authority with private actors.[233]

In the late 1980s, commentators promoted the idea of freedom of contract, with the objective of eliminating mandatory rules.[234] As a result, some scholars advocated for deregulation in securities law, emphasizing substance rather than form to define a security,[235] or eliminating of fiduciary duties.[236] They also insisted on eliminating mandatory rules in securities laws and

---

[230] *Id.*

[231] *Id.* at 783.

[232] LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 177 (2d ed. 1985) (laissez-faire is essentially a notion of the 19th century where government policy was meant at releasing the creative energies by helping the economy to grow, which limited government intervention).

[233] Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319 (2002).

[234] *See generally* Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (analyzing both sides of contractual freedom debate: with leading scholars represented by Frank Easterbrook and Daniel Fischel advocating for freedom of contract and opt out options in one part. While the other side of the aisles preferring mandatory rules is represented by scholars such as Melvin Eisenberg, Jeffrey Gordon, John Coffee or Robert Clark).

[235] *See e.g.* Larry E. Ribstein, *Form and Substance in the Definition of a Security: The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807, 810 (1994) (noting LLC interests such as partnership interests should not be securities based on "economic reality." This debate is currently obsolete as partnership interests are since been qualified as security interests).

[236] *See generally* Douglas M. Branson, *Assault on Another Citadel: Elimination of Fiduciary Standards Applicable to Corporate Officers and Directors*, 57 FORDHAM L. REV. 375, (1988).

allowing parties to selectively opt out of securities law under certain circumstances.[237] Private ordering advocates favored efficiency and cost-benefit over regulation.

In the meantime, by the early 1980s, the American Law Institute ("ALI") started a new movement by attempting to draft a restatement of corporate governance.[238] The ALI restatement ultimately failed but it managed to introduce several "good governance" principles.[239] That is, ideas such as independent directors (free of financial or other sort of dependence with senior managers).[240] The adopted and final ALI's version entitled *Principles of Corporate Governance: Analysis and Recommendations*[241] rejected law and economics principles, particularly that subset known as contractarians, and reaffirmed the importance of mandatory rules in corporate law.[242]

Early literature ignored horizontal corporate governance and mainly explored vertical corporate governance, that is the separation of ownership from control between private equity managers and the companies in their portfolio.

---

[237] Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 5 (1992) (challenging principle of mandatory rules both normatively and positively: affirming that the normative rationale of federal securities law should permit to opt out of securities laws in some circumstances. As a positive view, jurisprudence of Supreme court and other federal courts have encouraged opting out of securities laws by acknowledging the importance of private ordering).*See also* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989) (offering a theory on how courts and legislatures could set default rules for efficiency purposes). *Contra* Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 520-21 (1999) (critical of selective securities law deregulation as it raises fundamental questions of government role and the purposes served by regulation that aimed at protecting the society as a whole).

[238] PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (AM. LAW INST., Tentative Draft No. 1 1982).

[239] *See* Branson *supra* note 216, at 683 (early drafts offered notions such as independent directors, audit and compensation committees).

[240] *Id.*(Large companies will have a majority of independent directors while smaller companies will have a minimum of three independent directors).

[241] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (AM. LAW INST. 1994).

[242] Branson *supra* note 217 at 684-5 (principles of corporate law about structure and composition of boards, fair dealing and duty of loyalty, duty of care, business judgment rule, shareholders' actions such as derivative suits and appraisal).

Corporate governance in private equity barely discussed horizontal corporate governance,[243] with the possible exception of compensation arrangements between private equity and investors. However, agency costs exist between private equity managers and investors resulting from the separation of ownership from control. Agency costs exist when investors, or owners, provide money to private equity managers, or agents, to make an investment in various companies. Investors relinquish their power over acquired companies to private equity managers[244] The question then arises is how to eliminate or reduce these costs to manageable or equitable levels?[245]

Contrary to the assumption made that compensation arrangements align interest between investors and managers, a closer look at contracts reveals that interests among these groups appear divergent.

Commentators have observed that ways to reduce agency cost are through private ordering, contract, coregulation, or regulation.[246]

---

[243] *See* Branson *supra* note 217.

[244] Jarrod Shobe, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1435, 1440 (2016)

[245] *Id* at 1444-5.

[246] *Id*. at 1445 (advocating the change of private equity funds compensation to align the interests of managers and investors and suggesting means regulators could impose more transparency so that investors can better understand their compensation arrangements). *See also* Harris note *supra* note 51 at 263 (noting the divergent interests between managers and investors can be resolved by private enforcement or monitoring through contract design but that solution remains ineffective). *See also* DOUGLAS CUMMING, PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION 379-87 (2010).

3.2 Private Ordering and Opting out of Everything in Private Equity

As stated above, the private equity literature has emphasized governance between private equity managers as investors in portfolio companies.[247] The literature described the business model of creating a financially viable company from scratch (venture capital) or reorganization and cut a corporation (private equity). The business structure of venture capital or private equity provided testing ground for the corporate governance theory of separation of ownership from control.

To be sure, when referring to governance with those providing the monies to fund the venture, most literature acknowledges that investing in private equity requires a "leap of faith"[248] because of little to no protection afforded to them. Governance in this case largely consists on private ordering or enforcing contracts.[249]

Commentators assume that investors rely on "market forces" and "reputational constraints" to ensure managers make decisions that will maximize the return on investment.[250] The following statement summarizes this idea:

> *Consistent with the legal rules governing limited partnerships, the limited partners may not participate in the day-to-day management of the fund's business, including*

---

[247] For a sample of economics and finance literature: *see e.g.* Sahlman *supra* note 24 at 473 (the article opined about governance on the angle of venture capitalist investments in "equity-linked securities of private ventures at various stages on their development." A section analyses the relationship between external investors and venture capitalists. *Id.* at 493). *See generally* GOMPERS & LERNER *supra* note 7.

[248] *Id.* at 24

[249] *Id.* at 65-90 (private equity funds are governed by heavily negotiated partnership agreements. Absent governance mechanisms found in corporation -such as board of directors - investors' remedy remains the enforcement of covenants. Negative covenants are essentially used in partnership agreements and can touch on overall fund management, activities of the general partners, or investment restrictions). *See also* Rosenberg supra note 41 at 367: "*Given the amount of money at stake and the uncertainty involved in the investments, one would assume that limited partners in venture capital funds would avail themselves of substantial legal protections to ensure that those managing their investments act in the investors' best interests. Yet a close examination of the nature of venture capital limited partnerships reveals that few such protections exist: the managers of venture capital funds have virtually no general legal obligation to behave in the best interest of their investors.*"

[250] *Id.* at 367.

especially the approval of particular portfolio company investments. In this respect, the venture capital fund's [or private equity firm's] governance structure formalizes the standard Berle-Means problem of the separation of ownership and control. The general partner (GP) puts up only one percent of the capital, but receives essentially complete control over all of it. The particular terms of the fund's governance are set out in the limited partnership agreement. [251]

The *legal rules governing limited partnerships prevent investors from exercising control over the central elements of the venture capital fund's business. Most important, the investors are prohibited from insisting on an approval right of the GP's investment decisions. Thus, the venture capital fund's formal governance structure presents an extreme version of the Berle-Means problem of the separation of ownership and control: The GP receives control grossly disproportionate to either its one percent capital contribution or its twenty percent carried interest*.[252]

Thus, private ordering, described as effective, took central stage in private equity "regulation" at least until the financial crisis of 2007-2008. [253]

---

[251] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV.1067, 1071 (2003).

[252] *Id.* at 1088. *See also* Sahlman *supra* note 24 at 493 (representing venture capitalists as agents of limited partners who chose to invest in entrepreneurial businesses through intermediaries rather than directly. Conflict arising between the principal and agent must be addressed "*in the contracts and other mechanisms that govern their relationship.*" Agency problems are very high since limited partners cannot monitor each individual investment. *Id.*). *see also* Michael C. Jensen, *Eclipse of the Public Corporation,* HARV. BUS. R. (1989) available at https://hbr.org/1989/09/eclipse-of-the-public-corporation (predicting a decline of public corporations in favor of new and innovative forms of organizations that include takeovers, corporate breakups, divisional spin-offs, leveraged buyouts, and going-private transactions).

[253] *See* Gilson *supra* note 251 at 1093, stating: "The central lesson to be learned from the U.S. venture capital market is that it is overwhelmingly the product of private ordering-an extremely effective contracting structure that covers the entire venture capital cycle, from initial investment in the VC fund, to the VC fund's investment in a portfolio company, to the exit from the portfolio investment to allow the VC fund's cash and noncash investment to be recycled."

3.3 Self-Regulation and its Limits

Soft law constitutes a set of rules and principles that has no or little binding power. Large organizations usually issue rules and principles of best conduct to influence corporate behaviors.[254] Soft law can take the form of bilateral or multilateral treaties, codes of conduct, or statements of best practices used by professionals to self-regulate their industry.[255] However, soft law principles are optional. They lack enforceability because they are not law.

During the financial crisis of 2007-2008, some world leaders realized that surveillance of complex financial products and innovation required coordinated responses at international and national levels. To be sure, coordination on macro regulation, that is, regulation of the entire financial system, as well as micro oversight needed to occur.[256] World leaders met during the crisis to discuss financial policies (1), international organizations issued studies and reports (2), and trade groups multiplied self-regulation codes of conduct in an effort to prevent regulation imposed on them (3).

3.3.1 International Cooperation on Financial Regulation

U.S., European, and world leaders framed their policies on private funds during international gatherings from 2007 through 2010.[257] For instance, at the London Summit, the G/20

---

[254] *See generally* Douglas M. Branson, *Teaching Comparative Corporate Governance: The Significance of Soft Law and International Institutions*, 34 GA. L. REV. 669 (2000).

[255] *Id.* at 670.

[256] *See* Eilis Ferran & Kern Alexander, *Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board*, 4 (U. CAMBRIDGE FAC. L. LEGAL STUD. RES. PAPER SERIES, Working Paper No. 36/2011, 2011).

[257] *See* Eilis Ferran, *The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis* 10 (U. CAMBRIDGE & ECGI, Working Paper No. 10/2011 and 176/2011, 2011) (U.K.) (detailing international policy formation for alternative investment funds).

issued a communiqué which stated principles for "*strengthening transparency and accountability"* to enhance *"sound regulation"*, to promote *"integrity in financial markets and reinforcing international cooperation*."[258] Leaders also agreed to expand the role of the Financial Stability Board ("FSB"), previously known as Financial Stability Forum, and strengthen prudential regulation at the international level. Finally, countries had to widen the scope of regulation to "*systemically important financial institutions, markets, and instruments*."[259] That included power for regulators to gather information on large and complex financial institutions, particularly hedge funds. The summit recommended the regulation of hedge funds through registration, periodic information, and assessment of systemic risk. Leaders also touched upon managers' compensation, tax havens, accounting standards and the role of credit rating agencies. Other world summits reinforced the mantra of cooperation and financial stability.[260]

3.3.2 IOSCO Reports on Private Equity

The International Organization of Securities Commissions ("IOSCO") is an international body composed of world securities regulators. It "*develops, implements, and promotes adherence to internationally recognized standards for securities regulation*."[261] IOSCO partners with G20

[258] Declaration on Strengthening the Financial System, London Summit (on Apr. 2, 2009) available at http://www.fsb.org/wp-content/uploads/london_summit_declaration_on_str_financial_system.pdf

[259] *Id.* at 3.

[260] *See e.g*. Leaders' Statement – The Pittsburgh Summit (Sep. 24-25, 2009) (pledging for international cooperation and financial regulatory system that includes hedge funds).

[261] *See* INTER.'L ORG. OF SEC. COMMISSIONS https://www.iosco.org/about/?subsection=about_iosco (last visited Oct. 9, 2019).

and FSB for global regulatory reform and locally with national securities regulators such as the SEC.

IOSCO has issued several reports on private funds regulation. For private equity funds, IOSCO released reports and recommendations after conducting research on dealing with conflicts of interest.[262]

3.3.3 Industry Self-Regulation

In the years leading to the financial crisis, the private equity industry engaged in a flurry of self-regulation establishing guidelines and standards in order to demonstrate that private funds industry could self-regulate. At the international level, the International Private Equity and Venture Capital Valuation ("IPEV"), a trade group whose mission consists of providing best practices valuation guidelines for private equity and venture capital practitioners. IPEV represents private equity firms in the U.S., Europe, and South Asia, issues guidelines that trade associations could adopt. For example, local associations have endorsed the International Private Equity and Venture Capital Valuation Guidelines enterprises.[263]

At the European level, examples of guidelines and recommendations by trade groups abound. The European Private Equity and Venture Capital Association ("EVCA") has developed handbooks on professional standards.

---

[262] *See* INT'L ORG. SEC. COMMISSIONS, PRIVATE EQUITY CONFLICTS OF INTEREST (Nov. 2009), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf.

[263] The following, among other institutions, have endorsed the guidelines: American Investment Council, US National Venture Capital Association, British Private Equity and Venture Capital Association, Association Française des Investisseurs pour la Croissance, Institutional Limited Partners Association.

In the U.S., the Venture Capital Association, a trade group pioneer in its category, was created in 1973 to represent the interest of venture capitalists. It takes positions on policy issues such as taxes, immigration, or regulation. It has also developed accounting and auditing standards.

The American Investment Council, formerly known as Private Equity Growth Council, was launched in 2007 to advocate for the largest private equity firms in the United States. In 2009, it developed guidelines for "*responsible investing*" that cover a hodgepodge of subjects, including environment, labor, governance, or social issues.[264]

On the investors' side, in 2002, the Institutional Limited Partners Association ("ILPA"), began advocating for institutional investors investing in private equity. ILPA has formulated best practice guides and templates. For instance, it created a private equity principle in 2011, which aimed at providing guidance for alignment of interest, governance, and transparency.[265] This guideline addresses fee structures, governance, fiduciary duty, and transparency. ILPA has also drafted templates for reporting fees to reinforce transparency and alignment of interests.

3.4 Toward a New Social Responsibility with Private Equity?

After the financial crisis of 2007-2008, a literature on private equity has emerged. Managers that exhibited prowess in making huge sums of money for themselves seemed to have faltered. Attention has shifted to less flattering issues related to weak performance, managers' pay compared to performance, debt assumed by portfolio companies, and workers' lay-offs.

---

[264] *Guidelines for Responsible Investing*, AM. INV. COUNCIL, https://www.investmentcouncil.org/guidelines-for-responsible-investing/ (last visited Oct. 20, 2019).

[265] *Private Equity Principles*, INSTITUTIONAL LTD. PARTNERS ASS'N, (Jan. 2011), https://ilpa.org/wp-content/uploads/2018/02/ILPA-Private-Equity-Principles-version-2.pdf. (last visited Jul. 31, 2018).

The mere fact of regulating private equity funds, even if they did not cause risk to the financial system, appeared to be an important consideration that trumped concerns of individual interest groups. Here, social consideration included transparency, accountability to regulators, or fiduciary duties, so advocates for regulation claimed.

4.0 Fourth Chapter: The Regulation of Private Equity Funds by the Dodd-Frank Act

This chapter details of the Dodd-Frank Act's regulatory provisions. First, I look at arguments opposing regulation of private equity, and the rationale for private equity regulation. then I examine the Private Fund Investment Advisers Registration Act of 2010 and reporting requirements by private funds. Finally, actions the SEC has undertaken conclude this chapter.

4.1 Arguments opposing regulation of private equity

Dodd-Frank Act is not the first legislation attempting to regulate private funds. Starting in the 1980s, the SEC and legislators have introduced various propositions and bills aiming at regulating or curbing private equity activities.[266]

Opponents of private equity (and private funds) regulation have raised several arguments that private equity should continue to be exempt from regulation.[267] Opponents of regulation argue the following:[268] private funds are already subject to regulation and market discipline. Even if private funds do not register under the Advisers Act, they are nevertheless subject to its provisions

[266] *Venture Capital Improvements Acts of 1980: Hearing on H.R. 7554 and H.R. 7491 Before the Subcomm. on Consumer Prot. and Fin. of the H. Comm. on Interstate and Foreign Commerce*, 96th Cong. (1980) [hereinafter *Venture Capital Hearing*]. *See also* Kenneth Lehn, *A view from Washington on Leveraged Buyouts, in* THE HIGH YIELD DEBT MARKET: INVESTMENT PERFORMANCE AND ECONOMIC IMPACT 154 (Edward I. Altman ed., 1998) (In 1989, the fallout from the RJR Nabisco deal include many congressional hearings on LBOs related to tax, banking, securities and labor laws).

[267] *Regulating Hedge Funds and Other Private Investment Pools: Hearing Before the Subcomm. on Securities, Insurance., and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 111th. Cong. (2009) [hereinafter *Regulating Hedge Funds and Other Private Investment Hearing*].

[268] *Id.* at 82-87 (Commissioner Paredes did not endorse the position of Andrew J. Donohue, Director of the Division of Investment Management at the SEC and oppose registration of hedge funds and other private funds).

against fraud, insider trading, and manipulation. Market discipline also holds advisers of private equity funds accountable to their investors.[269]

Another argument points that exemptions of private funds serve important interests. The so-called “regulatory gap” has a negative meaning that infers a gap needs to be closed with more regulation.[270] It does not acknowledge the purpose of the gap, leaving flexibility to investors to privately organize their businesses.[271] Closing a gap affects investors and the economy as a regulatory gap affords freedom of entrepreneurship to expand, innovate, and create jobs for the overall economy. In addition, the SEC should not spend its limited resources on regulating exempted investors able to take care of themselves, rather, it should concentrate on other priorities.[272]

In addition, opponents of regulation warn of potential costs to the financial market and the economy when private funds are subject to additional regulatory scrutiny. Do the costs associated with the new regulation carefully balance the interests at stake?[273] The answer might differ depending on the type of fund. Adding more regulation could adversely affect the industry by reducing efficiency, liquidity to the securities markets, capital flow to innovations, or limiting the restructuring of companies.[274]

---

[269] *Id.* at 83
[270] *Id.*
[271] *Id.*
[272] *Id.* at 84.
[273] Id at 84.
[274] *Id.* at 85. *Compare* Venture Capital Hearing *supra* note 266: The venture capital industry advanced the same arguments back in the 1980s. at the time the National Venture Capital Association was composed of eighty capital firms with combined assets of more than $1.5 billion, *Id.* at 76. In the 1980s, many venture capital were licensed under the Small Business Administration (“SBA”) – entity of the Small Business Investment Company (“SBIC”) - to provide professionally managed investment funds to risky companies. The adoption of limited partnerships came in the late 1970s. Limited partnerships became the most popular business organizations because they allowed managers to receive stock options or other forms of performance-based compensation -unlike SBICs or publicly traded venture capital firms. Also, limited partnerships did not have SBICs’ investment restrictions (imposed by the Investment Company Act of 1940).

Finally, even if legislators authorize regulation of private funds, should this regulation occur through the Securities Act of 1933?[275] the Investment Company Act of 1940s[276] or the Investment Advisers Act of 1940? Another regulatory option can expand the rulemaking authority of Securities and Exchange Commission.[277]

4.2 Rationale for private equity regulation

In 2009, many congressional discussions aimed at regulating hedge funds and other private funds.[278] While capital markets became increasingly interwoven, private funds operated outside any regulatory framework. Reliable data on private funds prevented the government and regulators

---

[275] *Id.* at 77-78 (Amending the Securities Act of 1933 can make it easier and less expensive for businesses to raise capital from sophisticated investors by reducing long and costly disclosure requirements imposed on issuers. Accredited investors can fend for themselves, and that these investors neither need or want Government protection to insure sufficient disclosure is made to them. Furthermore, resales from one accredited investor to another accredited investor should not require registration and should benefit from exemption).

[276] *See supra* note 62 for the definition of investment company. Registration under the Investment Company Act is generally not favored because it restricts fund investments and trading activities. *See also* Venture Capital Hearing *supra* note 265 at 78-79 (The Investment Company Act contains many prohibitions that is not compatible with private funds model: to exempt venture capital companies from registering and allowing qualified venture capital companies to raise capital from the public. Although the public is a large source of capital, the Investment Company Act prevents the pubic from investing with risky investments like venture capital companies. Other Investment Company Act issues relate to the expensive provision of Section 17 (15 USCS § 80a-17) requiring an SEC exemptive order for transactions between a registered investment company and its investee "affiliates", and equity incentives for managers, which is a big issue for private fund, *Id.*

[277] *See* Regulating Hedge Funds and Other Private Investment Hearing *supra* note 267 at 38 (Andrew J. Donohue, Director of Division of Investment Management at the SEC explains how the Commission could condition the use of exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Thus, imposing certain requirements believed to be necessary to protect investors and enhance transparency, which would depend on the type of the fund. This approach would allow adaptability to changing markets and unnecessarily subjecting private funds to the Investment Company Act requirements). *But see Id.* at 86 (Commissioner Paredes did not endorse the decision by Donohue. Paredes believes that expanding the SEC rulemaking authority does not provide regulatory predictability and creates uncertainty in commercial dealings0.

[278] *E.g.*, Regulating Hedge Funds and Other Private Investment Hearing *supra* note 267. *See also*, Symposium, Beyond Crises-Driven Regulation – Initiatives for Sustainable Financial Regulation: Article: *A Return to Old-Time Religion? The Glass-Steagall Act, the Volker Rule, Limits on Proprietary Trading, and Sustainability*, 11 U. ST. THOMAS L.J. 359 (evaluating decades of financial institutions reforms, and specifically the Volker Rule that limits proprietary trading).

from evaluating the risk, if any, they presented to the entire economy. The public, lawmakers, and commentators viewed hedge funds and private equity businesses with suspicion. The financial crisis provided the opportunity to expand regulation to these entities.[279]

The Securities and Exchange Commission has long advocated for regulation of private funds.[280] The Commission supported registration of private fund advisers under the Investment Advisers Act. For the past two decades, hedge funds, private equity, and venture capital had played an increasingly essential role in capital markets, but in the SEC's view, the regulatory setting has not evolved to deal with the growth and market importance of these funds. The SEC had incomplete data about the advisers of these funds, representing a regulatory gap the Commission wished to close. The SEC attempted to close the gap by requiring all hedge fund advisers to register under the Investment Advisers Act, [281] but this initiative failed before an appellate court in 2006. [282] The plaintiff challenged the validity of the SEC rule requiring investors in a hedge fund be counted as clients of the fund's adviser for the purposes of the fewer-than-fifteen-clients exemption from registration under the Adviser Act. That is, the SEC contend for "see through" calculations.

A group of hedge fund managers challenged the SEC rule requesting hedge fund investors be counted as clients of the fund's adviser and register with the Commission if they advise fifteen or more "shareholders, limited partners, members, or beneficiaries."), 17 C.F.R §275.203(b)(3).

---

[279] *Compare* Venture Capital Hearing *supra* note 266 (a legislation to register venture capitals – and private equity- did not prosper because Congress believed registration through the Investment Company Act or Advisers Act was an unnecessary impediment to economic growth).

[280] *Id. See also* Regulating Hedge Funds and Other Private Investment Hearing *supra* note 267 at 34-38(statement before the Subcommittee to support the registration of private funds by Andrew Donohue, SEC's Director of Investment Management).

[281] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004)

[282] *See* Goldstein v. SEC, 461 F .3d 873 at 874(D.C. Cir.2006). *See also* Abrahamson v. Fleschner,568 F.2d 862 (2nd Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

The petitioners refuted the rule equating “client” with “investor.” The court agreed with the plaintiff’s interpretation as the plan registration appeared to conflict with the underlying statute.

Admitting the importance each fund plays in the efficiency of the capital market, the regulatory regime can tailor the particularity of each actor with their business model, risks to investors, and the markets.[283]

The option to regulate private funds through the Investment Adviser Act could have advantages for investors because it could allow them to obtain accurate, reliable, and complete information about the industry and assesses the risk private funds may pose. Regulators and Congress, for the first time, could see the size and importance of the private fund industry, and this would better protect investors and market integrity.[284]

Registration also would allow the Commission to enforce the fiduciary responsibilities of investment advisers. The antifraud provisions of the Advisers Act supplement fiduciary duties, avoidance of conflicts of interest (or disclosure). Registration provides SEC the authority it needs to enforce the Act with on-site compliance examinations and identify issues investors cannot

[283] *See* Regulating Hedge Funds and Other Private Investment Hearing *supra* note 267 at 37 (for instance, the Advisers Act is scalable to small advisers with little resources and the Commission can rely on existing rules and regulations to accommodate advisers both large and small (69 percent of registered advisers have 10 or fewer employees)

[284] *Id.* at 87 (Commissioner Casey departed from the testimony of the Director of Investment Management. Commissioner Casey believed that even if expanding investment adviser registration to managers of private funds seems the best option, Congress has to clearly identify its objective for doing so. Regulation of private pools is important to assess risk to the overall financial system, but it is also important to clearly differentiate funds to identify the standard to which they should be subject, what information to share with regulators, and how information is used. Regulators can make use of information about leverage or financial positions of multibillion-dollar hedge funds, while such information might not be necessary for a small venture capital or family office. Congress should limit the authority of the SEC to obtain information tailored to a set of standards and information based on the size and nature of the adviser. It is also important to acknowledge additional regulation, even if necessary, should not constitute a substitute by investors of their duty of care and diligence in choosing an investment adviser).

determine for themselves: [285] such as safekeeping, or performance representation. Registration could also work as a deterrent since registration can prevent market abuse and manipulation of trading activities, insider trading, or improper short-selling activities. Registration serves also the purpose of keeping unfit persons from using private funds to perpetrate fraud. Finally, investment advisers registered with the Commission must develop a comprehensive compliance program administered by a chief compliance officer.

4.3 The Private Fund Investment Advisers Registration Act of 2010

In securities law, investor protection means that an issuer of securities, here partnership interests, may be requested to register with the Securities and Exchange Commission and be subject to disclosure, reporting, recordkeeping compliance, and examination programs.

4.3.1 The Rule: Private Funds must register with the SEC

Title IV of Dodd-Frank contains the regulations applicable to of advisers to hedge funds and others.[286] The Private Fund Investment Advisers Registration Act (the "Private Fund Act") adds sections to the Investment Advisers Act of 1940. It requires advisers to "private funds" with assets under management over $150 million to register with the SEC and submit periodic reports.

---

[285] *See* Venture Capital Hearing *supra* note 266 at 187-196 (Based on enforcement activities against small business investment companies ("SBICs") registered under the Investment Company Act, a sample of SEC enforcement activities involved: (i) breach of fiduciary duty by officers and directors of a company who invested in other companies owned and controlled by the directors and officers, (ii) self-dealing by an investment company in numerous affiliated transactions not approved pursuant to the Investment Company Act, (iii) abuse of position by a president of an investment firm responsible for making loan decisions and requesting prospective borrowers to hire him as an attorney for loans made by the investment firm, (iv) overvaluation of portfolio companies, paying excessive interest rates on borrowings from affiliates and violation of the firm own investment policies).

[286] 15 U.S.C.§ 80b-20, LEXIS NOTES (2018).

The rule prescribes that investment advisers of a private funds must register with the Securities and Exchange Commission[287] or the State (less than 150 million under management), unless an exception applies. A private fund adviser means an issuer that is an investment company under the Investment Company Act of 1940, except in those case when one uses section 3(c)(1) or 3(c)(7) of that Act[288]. The Dodd-Frank Act eliminates the private adviser exemption under which adviser of a fund did not have to register if he did not hold himself out as an investment adviser and did not have more than 15 clients. The new provision requires all investment advisers to register.[289]

There are exemptions to the registration requirement, including three new exemptions the Dodd-Frank Act created: one for advisers of venture capital funds, two, for advisers of private funds with less than $150 million in assets under management, and, three for foreign private advisers.[290]

4.3.2 The exception: some private funds advisers are exempt from registration

The Advisers Act and Dodd-Frank contain several exemptions from registration. Dodd-Frank creates two new of exemptions: first, the "specifically exempted" advisers, not subject to reporting or record keeping requirements[291] (an example is foreign private advisers). Second,

---

[287] 15 U.S.C.§ 80b-3(a) (2018).

[288] *Id.*

[289] *Id.*

[290] *See Exemption for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. IA-3222 (Jul. 21, 2010), [hereinafter *Exemption for Advisers to Venture Capital Funds Release*]; codified at 17 CFR U.S.C. § 275 (2010).

[291] *Id.* § 80b-3(b) (registration does not apply to a foreign private adviser and Section 204(a) prescribing maintenance of records for examinations by the Commission will not apply).

another category of specifically "exempt reporting advisers,"[292] exempt from registration but NOT reporting. An instance is the adviser to venture capital funds and those who advise private funds with assets under management of less than $150 million. For this type of adviser, exemption means the advisers do not register with the Commission but must report their activity in a limited fashion.[293]

Exempt reporting advisers must complete and file reports on the Form ADV[294] consisting of electronically filing through the Investment Adviser Registration Depository (IARD).[295] Unless a temporary hardship[296] is requested, the initial Form ADV must be filed within 60 days of relying on the exemption.

Exempt reporting advisers do not have to register with the Commission. However, they still report, subject to lighter reporting requirements compared to non-exempt advisers. The reporting consists of the same Form ADV used by advisers to register with the SEC.[297] Exempt reporting advisers complete only Part 1A of the Form ADV. They must list basic information[298] (Identifying Information, Form of Organization, Control Persons), whether they are exempt reporting advisers and for which exemption they qualify (SEC Reporting by Exempt Reporting Advisers).[299] Other information aims at detecting potential conflicts of interest with advisers' other

---

[292] *See* 15 U.S.C. § 80b-3 (2010) (add Advisers Act sections 203(l) and (m)).

[293] *See* Investment Advisers Act §204(a) of the Advisers Act (mandates registered advisers to maintain records and authorizes examinations by the Commission unless the adviser is "specifically exempted from registration pursuant to section 203(b)" of the Investment Advisers Act. Section 203(l) and 203(m) are not "specifically exempted" because they still subject to reporting and recordkeeping with the Commission).

[294] 17 CFR § 275.204-4 (2018).

[295] SEC AND EXCH. COMM'N, FORM ADV 5-7 (2017) [hereinafter *FORM ADV*]. *See also* FORM ADV General Instructions 6, 7, and 9.

[296] 17 CFR § 275.204-4(e) (an adviser can apply for a temporary hardship exemption if unanticipated technical difficulties (such as computer malfunction or electrical outage) prevent from filing to IARD system).

[297] FORM ADV has a dual role: registration for investment advisers and report for exempt reporting advisers, information is collected for the Commission, which can seem confusing because even if not registered, an exempt adviser still faces SEC scrutiny.

[298] *See* FORM ADV *supra* note 295 at 1-4, 6, 16.

[299] *Id.* at 5-6.

businesses (Other Business Activities)[300] and affiliations (Financial Industry Affiliations and Private Fund Reporting),[301] along with the report on the disciplinary history of the adviser and its employees (Disclosure Information).[302] In addition to the items on Form ADV, exempt reporting advisers must complete all the relevant sections of schedules A, B, C and D of Form ADV.

Note that exempt reporting advisers must also provide the extensive information on private fund reporting found in item 7.B. (Financial Industry Affiliations and Private Fund Reporting) and Section 7.B. of Schedule D (Private Fund Reporting).[303]

4.3.3 The venture capital fund adviser exemption

The Private Fund Act exempts venture capital fund advisers from registration [304] and limits the reporting requirement.[305]

Venture capital indicates any private fund that [306] (1) pursues a venture capital strategy, [307] (2) holds no more than 20 percent of the fund's capital contributions in non-qualifying investments,

---

[300] *Id.* 11.
[301] *Id.* 11-12.
[302] *Id.* 16-19.
[303] *Id.* 12, and Section 7.B of Schedule D
[304] 15 U.S.C. § 80b-3 (2010) ("Exemption of and reporting by venture capital fund advisers"): The Act required the Commission to define the terms "venture capital" no later than a year after the enactment of the Act and issued a final rule on July 21, 2011.
[305] 17 C.F.R. § 275 (2011).
[306] 17 C.F.R. § 275.203(I)-1(a)(1) (2010) (A venture capital is a private fund as opposed to a publicly traded, one that represents to investors and potential investors that it pursues a venture capital strategy ("holding out").
[307] 17 C.F.R. § 275.203(I)-1(a)(1) (c)(2) (2010) ("Equity security has the same meaning as in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c (a)(11)) and § 240.3a11-1 of this chapter").

[308] (3) does not use leverage other than qualifying short term borrowing, [309] (4) does not offer redemption rights to its investors,[310] (5) has not registered under Section 8 of the Investment

[308] *See id.* at 23-30 (noting to qualify as an exempt reporting adviser, an adviser to a venture capital fund must be a private fund that invests in qualifying investments or short-term holdings. A qualifying investment is defined as an equity security issued by a qualifying portfolio company in three ways: (i) acquired directly by the private fund (ii) in exchange for an equity security issued by the qualifying portfolio company or (iii) an equity security issued by a company of which the qualifying portfolio company is a majority-owned subsidiary. This definition aims at differentiating venture capital from other funds such as hedge funds or private equity: Whereas venture capital invests directly in portfolio company to finance the company business or its expansion, as opposed to a buyout strategy. Eighty percent of the fund's capital must be invested in a qualifying investment with no more than 20 percent in non-qualifying investments. A qualifying investment excludes a secondary sale, as the equity security must be acquired "directly" by the private fund from the qualifying portfolio company.

In addition to a qualifying investment, a venture capital fund can hold short-term holdings, that is, cash and cash equivalents, U.S. Treasuries with remaining maturity of 60 days or less, and shares of open-end management investment company, *see* 17 C.F.R. § 275.203 (I)-1 (c)(4) (noting a qualifying investment is an equity security issued by a qualifying portfolio company. The qualifying portfolio company (i) is an investment by the private fund, at the time of the investment, not reporting or foreign traded (and does not control or is not controlled by another company that is reporting or foreign traded) (ii) does not borrow or issue debt in connection with an investment in a company and distribute the proceeds of the borrowing or issuance in exchange for the private fund investment (iii) and is not an investment company or a private fund), *see also.* 17 C.F.R. § 275.203 (I)-1 (c)(3) (noting reporting or foreign traded status is analyzed at the time of the acquisition. Investment does not disqualify the portfolio if the company becomes subsequently a reporting or foreign traded company, so long as the 20% threshold of non-qualifying investments is met. A venture capital fund may hold up to 20% of the fund's capital commitment that are not qualifying investments or short-term holdings. The 20% limit is calculated based on a basket of non-qualifying investments at the time a non-qualified investment is made).

[309] 17 C.F.R. § 275.203 (I)-1 (a)(3) (2018) (The absence or limited use of leverage was the motivation for allowing a venture capital exemption, compared to other funds, whose leverage was considered to create systemic risk. As defined, a venture capital fund "does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital" so long as the borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days. The limitation does not apply when the venture capital fund guarantees a qualifying portfolio company's obligation up to the amount of the value of the private fund's investment in the qualifying portfolio, *Id.* The use of debt and borrowing transactions is limited to the company's ordinary course of business (cash management, payroll, inventory and the like), so it delineates venture capital strategy from leverage transactions used by buy-out funds or hedge funds. A qualifying portfolio company excludes a company that borrows "in connection with" the private fund's investment and distributes to the private fund the proceeds of such borrowing "in exchange for" the private fund's investment. Thus, a venture capital fund could finance and provide loans to portfolio companies so long as the financing meets the definition of equity security or is within 20 per cent threshold for non-qualifying investments).

[310] 17 C.F.R. § 275.203 (I)-1(a)(4) (2018) (explaining another aspect of the definition of venture capital is the exclusion of redemption rights to investors, except in extraordinary circumstances (usually events beyond the control of the investor); but investors are entitled to receive distributions on a pro rata basis. This definition does not differentiate between hedge funds and private equity).

Company Act of 1940,[311] and is not a business development company pursuant to Section 54. [312] The rule also includes a grandfather provision for preexisting venture capital funds. [313]

The definition differentiates venture capital funds from other funds such as private equity funds, because the venture capital size is small compared to other funds and the investment strategy does not concentrate on the public market, limiting potential systemic risk.

4.3.4 The private fund adviser exemption

The Private Fund Act has created an exemption for private fund advisers requiring the Commission to exempt from registration any investment adviser acting solely as an adviser to private funds and having assets under management in the United States of less than $150 million[314]. As the Act directs, the Commission adopted rule 203(m)-1.[315]

The exemption applies to U.S. advisers acting solely as advisers to qualifying private funds, [316] if the assets under management[317] do not exceed $150 million.[318] A qualifying private fund

---

[311] 17 C.F.R. § 275.203 (I)-1 (c)(4)(iii) (2018) (explaining that to benefit from the registration exemption, a venture capital fund must be a private fund not registered under the Investment Company Act of 1940 or a business development company).

[312] *See generally* 17 CFR 275.203(l)-1 (2018).

[313] 17 C.F.R. § 275.203 (I)-1 (b) (2018) (describing how a private fund can also qualify as venture capital is (1) it represented to investors pursuing a venture capital strategy (2) has sold securities to investors that are not related persons to any investment adviser of the private fund before December 31, 2010 (3) and does not sell securities to any person after July 21, 2011).

[314] Dodd-Frank Act § 408 (2010).

[315] *See generally* 17 CFR 275.203(l)-1 (2018).

[316] Investment Adviser Act of 1940, § 202(29) (defining private fund "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act").

[317] 17 C.F.R. § 275.203(m)-1(a)(1)(2) (2018).

[318] 17 C.F.R. § 275.203 (m)-(d)(1) (2018) (describing how private fund assets, which are the assets under management of the qualifying private fund must not exceed $150 million. *See also* FORM ADV *supra* note 294 at Item 5.F defines regulatory assets under management to provide a uniform method of calculation).

means a private fund that has not registered under Section 8 of the Investment Company Act and does not qualify as a business development company.[319]

The exemption of Section 203(m) applies to investment advisers of private funds acting solely as advisers to private funds and having assets under management in the United States of less than $150 million.[320] The $150 million assets apply only to advisers whose principal office and place of business is in the United States; it does not apply to a non-United States adviser with principal place of business outside the United States. [321]

4.3.5 The foreign private adviser exemption

The Dodd-Frank Act eliminates the private adviser exemption, creating a foreign private adviser exemption instead.[322] The Act defines "foreign private adviser" to mean an investment adviser who (1) has no place of business in the United States, (2) has fewer than 15 clients and investors in the United States, (3) has aggregate assets under management of less than $25 million and, (4) does not hold itself out to the public in the United States as an investment adviser nor acts as one or a business development company pursuant to of the Investment Company Act of 1940, section 54.[323]

---

[319] 17 C.F.R. § 275.203 (m)-(d)(5) (2018).

[320] Investment Advisers Act of 1940, § 203(m).

[321] 17 C.F.R. § 275.203 (m)-1(d)(2) (2018) (referring to Section 275.222-1(a) which defines place of business: is an office "at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients: and " Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.").

[322] Dodd-Frank Act, §403 (2010).

[323] Dodd-Frank Act, § 402(30) (2010); *see also* Investment Act of 1940 § 203(a)(3); Investment Advisor Act of 1940, § 202(a)(30), 17 C.F.R. § 275.202(a)(30)–1 (2018) (defining terms of section 202(a)(30) of: "investor", "in the United States", "place of business" and "assets under management").

4.4 Private funds reporting requirements

The Dodd-Frank Act amends the Investment Advisers Act by adding a new section for private funds, The Private Fund Investment Advisers Registration Act.[324] It adds to existing reporting requirements new record keeping and reporting provisions.

In 2011, the Securities and Exchange Commission adopted amendments to existing rules to implement Title IV, the regulation of advisers to hedge funds.[325] The Act has considerably modified the original Form ADV.[326] Notably, the biggest change consists of the private funds category[327] to gather information about advisers and the funds they advise. In addition, data related to advisory business are expanded (such as the adviser' s employees, type of clients advised, compensation arrangements, and so on) as well as information about potential conflict of interests. Finally, Form ADV adds reporting on information about non-advisory activities and financial industry affiliations.[328]

---

[324] 15 U.S.C.§ 80b-2(a) (amending Section 202(a) of Investment Advisors Act of 1940 by adding (29) "private fund"; it means "an issuer that would be an investment company, as defined in section 2 of Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act").

[325] *See* SEC. & EXCH. COMM'N RELEASE NO. IA-3221, RULES IMPLEMENTING AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940 (2011) (the release follow the propositions of rules and amendments, Release No. 3110 Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010)) [hereinafter *Amendments to the Investment Advisers Act of 1940*].

[326] *See generally* FORM ADV (Paper Version) Uniform Application for Investment Adviser Registration and Report Form by Exempt Reporting Advisers. *See also* FORM ADV Instruction 2 (explaining the use of the Form, which is a uniform application used by investment advisers to register with the SEC, the states, amends the registration. It also allows to report as an exempt reporting adviser to the SEC or one or more state securities authorities, amend these reports and submit an exempt reporting adviser).

[327] *Id.* at Item 7.B and Section 7.B of Schedule D

[328] *Id.* (see Item 7 related to financial industry affiliations).

4.4.1 Private Fund reporting: Item 7.B and Section 7.B(1) of Schedule D

The private fund adviser Section of Form ADV represents a significant amendment as it requires investment advisers to identify if they advise private funds. Registered or exempt reporting advisers must answer the question whether they are an adviser to a private fund. If so, then, with exceptions, this triggers the reporting on Section 7.B(1) of Schedule D for each private fund advised, [329] regardless of the form of the private fund or if the fund is a related person[330] of the adviser.[331]

The form reduces financial information to a minimum, as it requires only the current "gross asset value" of the private fund. [332] In addition, the form does not include other sensitive information such as disclosure of the fund's net asset value, description of the fund assets and liabilities by class and categorization in fair value hierarchy as per the generally accepted accounting principles or the percentage of ownership in each fund by types of beneficial owners.[333]

---

[329] Prior to the adoption of SEC Release No. IA-3221, section 7.B of Schedule D required an adviser to private fund, a limited partnership or limited liability company, to only provide basic information such as name of the fund, of the general partner or manager, if solicitation of the clients advised.

[330] *See* SEC & EXCH. COMM'N, FORM ADV: INSTRUCTIONS FOR PART 1 A, GLOSSARY OF TERMS, RELATED PERSON 7 (2017) (defining "any advisory and any person that is under common control with" the advisory firm).

[331] Section 7.B(1) of Schedule D contains two parts: one part has information about the private fund while the other part has information on service providers, also known as 'gatekeepers."

Information about the private fund aims at expanding basic data reporting for a better understanding of private funds' organizations and operations; in that aspect, an adviser must provide information about the name of the fund, private fund identification number, names of general partners, directors, and whether the fund qualifies for exclusion from the definition of investment company under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. *See* FORM ADV *supra* note 295 at Item 7.B and Section 7.B of Schedule D, questions 1, 3, 4. and other information on whether the private fund is a "master fund" in a master-feeder arrangement; *Id.* at questions 6, 7. The adviser must also select what type of fund it advises based on a defined list: hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund, and other private fund; *Id.* at question 10. *See also Id.* at General Instruction 6(e)(2) (defines all private funds).

[332] *Id.* at question 10.

[333] Few argued the disclosure of detail financial information were too sensitive and carried competitiveness issues.

4.4.2 The Brochure rule for private funds

Under the Investment Advisers Act, an adviser is a fiduciary whose duty must serve the best interest of its clients. This means treating his clients and prospective clients fairly and disclosing all material information to them, including conflicts of interest. Disclosure allows clients and prospects to make informed decisions whether to engage in an advisory relationship.[334]

Since 1979, the SEC requires registered advisers to deliver a written disclosure document to clients.[335] Form ADV serves two purposes: it serves as a registration of advisers with the SEC or a state authority (Part 1 A or B) and it serves as a disclosure of the adviser's information, also known as "brochure" (Part 2). The brochure (Part 2A) and brochure supplement (Part 2B) contain among other things, information about the advisory business, personnel, fees and compensation, type of clients, conflicts of interest.[336]

Advisers must deliver a brochure and supplement to each client or prospect containing information on Part 2 of Form ADV.[337]

The SEC subsequently amended Part 1 of FORM ADV to fill certain data gaps and add information about investment advisers, private funds adviser entities operating a single advisory business ("umbrella registration).[338]

---

[334] *See generally* FORM ADV *supra* note 295 (Appendix C for General Instructions for Part 2 of FORM ADV and the Disclosure Obligations as a Fiduciary). *See also* 17 C.F.R. § 275.204–3 (Delivery of brochures and brochures supplements, 2016).

[335] *Id.* at 4.

[336] Information provided by the brochure and supplements are intended to communicate clearly with clients by using plain English. Plain English means taking into consideration clients' level of financial sophistication and drafting a brochure and supplements: using for instance (i) short sentences, (ii) definite, concrete and everyday language, (iii) active voice, (iv) avoiding jargons; *Id.* at Appendix C (General Instructions for Part 2 of FORM ADV provide a definition of "plain English").

[337] 17 C.F.R. § 275.204–3 (2016) at (a).

[338] *See generally* Form ADV and Investment Advisers Act Rules, Investment Advisers Release No. IA-4509 (August 25, 2016).

4.5 Private Equity disclosure for the assessment of systemic risk

Systemic risk has no statutory definition but "*usually taken to mean the risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions, typically banks, that occurs over a short period of time and typically caused by a single major event*."[339]

Since the 2008 financial crisis, systemic risk has become a concern of securities regulation. Traditionally, securities laws were concerned about boosting economic efficiency, which included maintaining competition, protecting investors against fraud and abuses, and correcting market failures.[340]

The collapse of hedge fund Long Term Capital Management ("LTCM") and the government rescue provided an indication at the disruption a highly leverage hedge funds could cause on the market as a whole.[341] LTCM was a hedge fund founded in 1994 using a variety of trading strategies such as convergence trades or dynamic hedging.[342] Most of its balance sheet positions had government bonds of the G-7 countries and in other various markets including North America, Europe, or Asia.[343] Unlike other hedge funds and financial institutions, LTCM had huge positions in markets and enormous leverage.[344] To compare, LTCM had total assets of $ 129 billion at the end of 1997 with a balance sheet leverage of 28-to-1.[345] At the same period, the five largest

---

[339] *See Hedge funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony of Andrew W. Lo Prepared for the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3-4 (2008) (written testimony of Andrew Lo, Harris & Harris Group Professor, MIT Sloan School of Management) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217

[340] *See* Steven L. Schwarcz, Systemic Risk, 97 GEO. L. J. 193, 205-6 (2008).

[341] *See generally* PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999) [hereinafter *PRESIDENT's WORKING GROUP*]

[342] *Id.* at 10

[343] *Id.* at 11.

[344] *Id.* at 12.

[345] *Id.* at 29.

commercial bank holding companies had total assets between $261 billion to $617.7 billion , with a leverage ratio of 14-to-1.[346] The five largest investment banks had a total assets between $154 billion to $318 billion, with an average we now know it was much higher than that, e.g., leverage ratio of 27-to-1.[347]

The LTCM principals also enjoyed stellar reputations in the financial market.[348] The policy issue with LTCM concerned the excessive leverage in the financial system combined with excessive risk taking. Leverage magnifies positive or negative effects. In case of LTCM, it magnified the series of negative events that occurred in the fall 1998 (Russia's devaluation of the rubble and debt moratorium on August 17, 1998).[349]

Since the LTCM episode, some scholars have argued that securities regulation should include consideration of systemic risk as a goal, in addition to market efficiency, confidence in the market, protection of investors against manipulation, fraud, and abuse.[350]

Some private funds, those registered with the SEC, must disclose additional information through the Form PF. On October 31, 2011, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission adopted Form PF final rules.[351] [352] Form

---

[346] *Id.*
[347] *Id.*
[348] *Id* at 15.
[349] *Id.* at 28.
[350] *See* Schwarcz *supra* note 340. *See also* Anita I. Anand, *Is Systemic Risk Relevant to Securities Regulation*, 60 U. TORONTO L.J. 941, 942 (2010) (arguing that the complexity of financial markets and products blur the lines between prudential regulation and securities regulation).
[351] SEC & EXCH. COMM'N, FORM PF: REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS, 1 (2014), https://www.sec.gov/about/forms/formpf.pdf [hereinafter *FORM PF*]
[352] COMMODITY FUTURES TRADING COMM'N, SEC & EXCH. COMM'N, RELEASE NO. IA-3308, REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND

PF collects information of private funds to assess systemic risk. The Dodd-Frank legislation mandates that Commission collect information to assess systemic risk private funds pose and to provide the information collected to the Financial Stability Oversight Council ("FSOC" or "Council"),[353] a newly created governmental body under the Department of Treasury.[354]

Thus, FORM PF is the main monitoring tool to collect systemic risk information. The Commission and the CFTC also use FORM PF for their other regulatory programs, examinations, investigations, and investor protection. Unlike FORM ADV, the public has not access to information collected on FORM PF; the SEC uses and shares the information on FORM PF with other agencies including the CFTC and the FSOC[355] on confidential basis. (*See* Appendix 1 for details about who must file FORM PF).

4.6 Costs associated with compliance

In conducting its rulemaking authority, the SEC has statutory obligations to consider economic consequences prior to issuing a new rule. Since the 1980s, the SEC has calculated a cost-benefit analysis for rules it intends to implement. Dodd-Frank and AIFMD have drastically

COMMODITY TRADING ADVISORS ON FORM PF (2011). FORM PF is adopted jointly by the SEC and CFTC for sections 1 and 2 while sections 3 and 4 are unique to the SEC.

[353] *See generally* Dodd-Frank Act § 404 (2018).

[354] Dodd-Frank Act § 111, 112 (2018) (explaining that the FSOC's mission is to assess systemic risk posed by private funds with the mission to (i)identify risks to the financial stability of the United States arising from financial distress or failure of large interconnected bank holding companies or nonbank financial companies or outside the financial services marketplace (ii) promote market discipline, by eliminating expectations of government bailout and, (iii) respond to emerging threats to the stability of the United States financial system).

[355] Advisers Act of 1940 § 204(b)(A)(B) (mandating the SEC to collect reports filed by private fund and make information available to the Financial Stability Oversight Council to assess systemic risk. The SEC and CFTC may use information collected for their regulatory programs, examinations, and investigations in relation to investor protection).

changed the way private funds conduct their business since they must report and disclose their activities to regulators. In the U.S., private fund advisers must register and report to State regulators if their asset under management does not exceed $150 million. When assets under management exceed $150 million, advisers to private funds must register with the SEC. Registration with SEC requires completing FORM PF (*See* Appendix 2 for AIFMD requirements on fund managers).

AIFMD imposes several requirements on fund managers. Managers must obtain an authorization from their local authority to establish their fund business and market it. Fund managers must hire a depositary for each fund they manage. In addition, managers must maintain a minimum capital requirement of euros 125,000 ($143,033 USD) or euros 300,000 ($343,279 USD) if the fund is internally managed. Moreover, AFM must submit to organization and governance requirements that include annual reports to investors, information to authorities, portfolio disclosures and asset-stripping information.

4.7 Limited Adverse Effects of Dodd-Frank Regulation on Private Equity in the U.S

Did additional regulation potentially limit capital formation? Will investors shun away from private funds due to increased regulation? In the U.S., regulation materializes mainly in FORM ADV and FORM PF for larger advisers.

The direct cost for completing and filing FORM PF might cause the reduction of capital available for investment. Costs may pass on to investors and, thus, reduce the amount of capital available to invest in new projects. The SEC has rebuked these arguments by stating that direct costs will "*only transfer capital from private fund advisers to other market participants, such as employees or service providers paid to complete the Form*."[356]

FORM PF became effective in late 2012. Most advisers had to file their first FORM PF as of December 31, 2012.[357] In practice, a constant increase in fundraising since 2012 contradicts arguments positing that regulation by Dodd-Frank reduces capital flow.

Despite critics of regulation and SEC assurances, evaluation of real costs of doing business with Dodd-Frank could only occur *ex post*. A survey realized in 2015 has evaluated the costs of FORM PF.[358] Three thousand six hundred sixty-nine (3,669) private fund advisers registered with the SEC responded to the survey. Most respondents paid less than $10,000 for their first initial filing of FORM PF with the SEC. In subsequent years, these costs dropped by more than half. However, larger private funds have substantially higher initial and subsequent compliance costs but remain underestimated. For smaller funds, costs are identical to SEC estimates.[359] These findings are more or less in line with SEC estimates. The overall survey shows that costs did not hamper the dynamic of private funds in the U.S.[360] (*See* Table 1 below).

---

[356] *See* FORM PF *supra* note 351 at 170.
[357] *Id.* at 118.
[358] *See generally* Wulf A. Kaal, *Private Fund Disclosures under the Dodd-Frank Act*, 9 BROOK. J. CORP. FIN. & COM. L. 428 (2015).
[359] *Id. See* FORM PF *supra* note 351.
[360] *See* Kaal *supra* note 358 at 443. In Figure 5, the survey addresses essentially hedge funds (56%), private equity (30%), since venture capital, securitized asset funds, liquidity funds, and real estate funds represent a small percentage overall. 30% of responded they did not correspond to any qualification.

The majority (59,18%) of respondents had a total filing cost for the first time estimated less than $10,00; minority (18,37%) declared a cost for the first time filing between $10,000 and $20,000; Others (8.15%) declared costs over $30,000 - Figure 10; *Id.* at 446-447

Comparing average costs between small and large funds to complete FORM PF, it shows that large funds spend an average of $155,286 quarterly for initial filing while small funds spend on average $9,520 annually. - Figure 11 – *Id.* at 447. Comparing the survey estimates with the SEC, it reveals SEC had overestimates costs for annual filling for small private fund and quarterly for large private funds - Figure 12 – *Id.* at 447-448.

Subsequent filings of FORM PF show an annual reduction of costs as 57.14% responded with decrease under $5,000; 16.32% had a cost between $5,000 and $10,000. However, a minority responded with costs ranging between $10,000 and $20,000 and others had costs over $20,000 - Figure 13 – *Id.* at 448.

4.7.1 Costs to Implement FORM PF

As FORM PF demonstrates,[361] analysis tends to find more benefits than costs and aims at striking "*an appropriate balance between the benefits of the information to be collected and the costs to advisers of providing it*."[362]

According to SEC estimates, FORM PF would most likely generate significant costs for the first year of the report due to necessary familiarization with the new reporting form. Costs include an important implication of senior managers, and for large funds the automatization of compliance systems.[363] Costs also include human capital implication. After the initial report, the SEC estimated filing reports would drastically decrease costs to advisers thanks to improved efficiency, better system configuration, and automation.[364] Other costs may include hardware and computer

---

Quarterly, small private advisers spent an average of $5,262 quarterly for subsequent FORM PF filing. Large private fund advisers paid an average of $72,143 annually for subsequent FORM PF filings - Figure 14 – *Id.* at 449.

Comparing with SEC estimates of subsequent filing, the survey suggests SEC may have slightly underestimated costs of filing for smaller advisers. Conversely, it appears the SEC had overestimated the costs of subsequent filings- Figure 15 – *Id.* at 450. The terms of persons used to prepare FORM PF, 67.35% of respondents declared the use of one to three persons, 10.20% declared minimum seven persons. – Figure 16 – *Id.* at 450.

For the number of hours, 69.39% stated they spent between 0 to 49 hours to fill FORM PF, 14.29% spent more than 50 hours, and 8.16 declared a number over 150 hours – Figure 17 – *Id.* at 451. Larger fund advisers spent more time than smaller advisers to fill out FORM PF. – Figure 18 – *Id.* at 451-452.

[361] *See generally* FORM PF *supra* note 351.

[362] *Id.* at 145.

[363] *Id.* at 159.

[364] *Id.* at 161. The estimate costs of periodic filing under FORM PF include: For a small private fund adviser: 40 hours costing $13,600 initial annual report and 15hours costing $4,200 for subsequent annual reports. For a large private equity fund adviser: 100 hours costing $31,000 for initial annual report and 50 hours costing $ 13,900 for subsequent annual reports. For large a hedge fund adviser: 300 hours costing $93,100 for initial quarterly report; and 140 hours costing $38,800 for subsequent quarterly report. For a large liquidity fund adviser: 140 hours costing $43,500 initial quarterly report and 65 hours costing $18,000 for subsequent quarterly report. *Id.* at 162-164. The SEC estimates the overall cost for all private funds totals $107,000,000 for the first year of reporting and $59,800,000 annually for each subsequent year. These number assume the are 3,070 small private advisers, 250 large hedge fund advisers, 80 large liquidity fund advisers, and 170 large private equity fund advisers. *Id.* at 164-165.

supplies.[365] In addition to direct costs associated with reporting data on FORM PF, private funds advisers would most likely incur indirect costs, which are impossible to quantify.

Data on FORM PF is not made public but increases transparency. According to the SEC, increased transparency has a positive effect on advisers because it increases their ability to assess risks related to an investment. Thus, advisers could allocate funds for higher value projects for the whole economy.[366] However, critics have pointed to the negative effect of increased transparency on capital formation.[367] Transparency might deter advisers from risky projects that benefit the whole economy.

Newly created private funds usually incur no cost associated with FORM PF because they rarely reach the minimum reporting threshold of $150 million of assets under management.[368] As for existing funds, experience gained with FORM PF will enrich existing funds when they consider forming new ones.[369] In both cases, costs associated with FORM PF would not deter advisers from investing in a new fund.

4.8 Limited Adverse Effects of Regulation on Venture Capital in the US

During the 1980s, the main argument opposing venture capital regulation relied on the cost of regulation and how regulation would adversely affect investment and the economy.[370]

---

[365] *Id.* at 167-168 (SEC estimates an aggregate annual cost of $108,000,000 for the first year and $60,000,000 for subsequent years. For hardware the estimate ranges from $0 and $25,000,000 the first year).
[366] *Id.* at 169-170.
[367] *Id.* at 170.
[368] *Id.* at 172.
[369] *Id.*
[370] *See* Venture Capital Hearing *supra* note 266.

Regulation, argued the venture capital industry, would reduce capital flows to small and innovative businesses. Economic freedom served the public interest. Regulation limiting economic freedom could only have an adverse effect on public interest.[371] Economic and public interests largely did outweigh benefits to the public than "potential conjectural benefits that may be ascribed to additional securities regulations."[372]

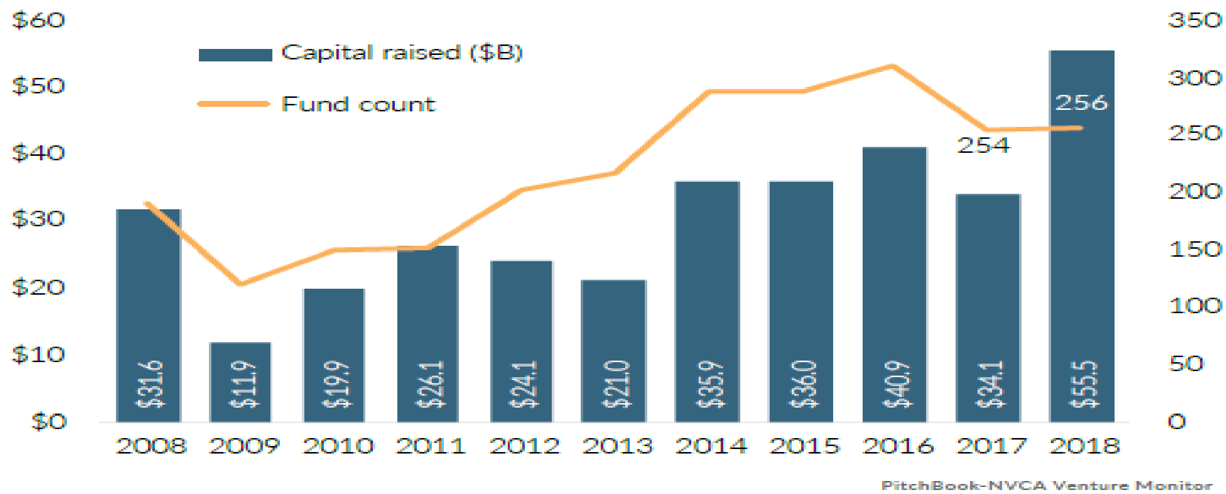
The venture capital industry used the same arguments during the Dodd-Frank debate in 2009.[373] This resulted in an exemption for venture capital funds which do not register but submit to periodic reporting requirements.[374]

Regardless of how fierce the venture capital industry opposed any idea of regulation, monies constantly flowing within the industry appeased the initial resistance. In 2018, the venture capital industry had its best year ever, raising over $55.5 billion spread among 256 vehicles.[375] The industry invested more than $130.9 billion with 8,948 U.S. deals, eclipsing for the first time the annual capital invested of $100 billion from dot-com era of the 2000s.[376]

---

[371] *Id.* at 88.
[372] *Id.*
[373] *See e.g.*, Regulating Hedge Funds and Other Private Investment Hearing *supra* note 267.
[374] *See* Exemption for Advisers to Venture Capital Funds Release *supra* note 290.
[375] *See generally Venture Monitor 4Q 2018*, PITCHBOOK & NAT'L VENTURE CAP. ASS'N (Jan. 9, 2019), https://files.pitchbook.com/website/files/pdf/4Q_2018_PitchBook_NVCA_Venture_Monitor.pdf
[376] *Id.* at 3.

Table 1 U.S. VC fundraising Activity



In 2018, venture capital fundraising reaches new high with over $55 billion commitment and 256 vehicles.

4.9 The Costs of Regulation Seem to Outweigh the Benefits of AIFMD

Based on an industry survey realized in 2017, Alternative Investment Fund Managers Directive has provided little benefits compared to costs it has subjected the private equity industry.[377] A trade association, Invest Europe, sponsored the survey. Formerly known as European Private Equity and Venture Capital Association, Invest Europe represents Europe private equity, venture capital, and infrastructure. GPs warry about high operating costs of AIFMD. Drivers of these costs include the authorization process, marketing rules, depositary compliance and minimum capital requirements.[378]

---

[377] *Evaluation of the Alternative Investment Fund Managers Directive*, EUR. ECON. (Dec. 2017), https://www.investeurope.eu/media/698210/Europe-Economics-Final-Report-On-AIFMD-Dec-2017.pdf.

[378] *Id.* at 3.

LPs do not seem to dislike AIFMD as much as GPs.[379] In most of the case, LPs have not seen increased costs passed on to them. In the contrary, they recognize improvement with transparency and investor protection: they do appreciate the additional information provided to them.[380] *See* Table 2 below.

---

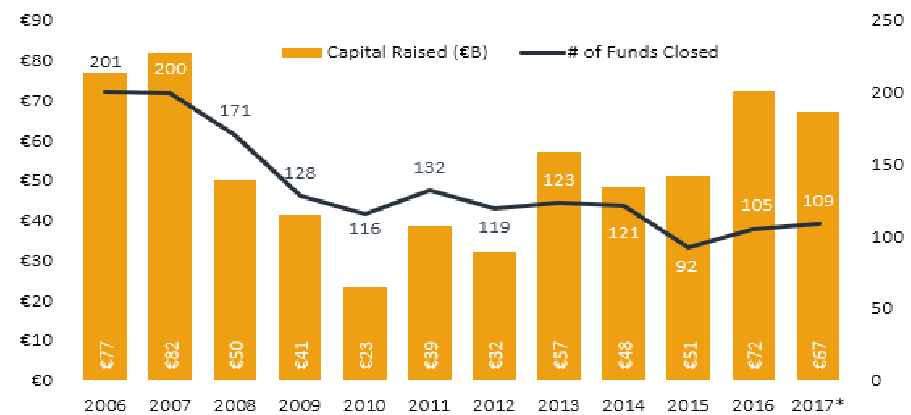
[379] *Id.*
[380] *Id.* at 3-4.

Table 2 EU Fundraising 2006 - 2017

European PE fundraising by Year

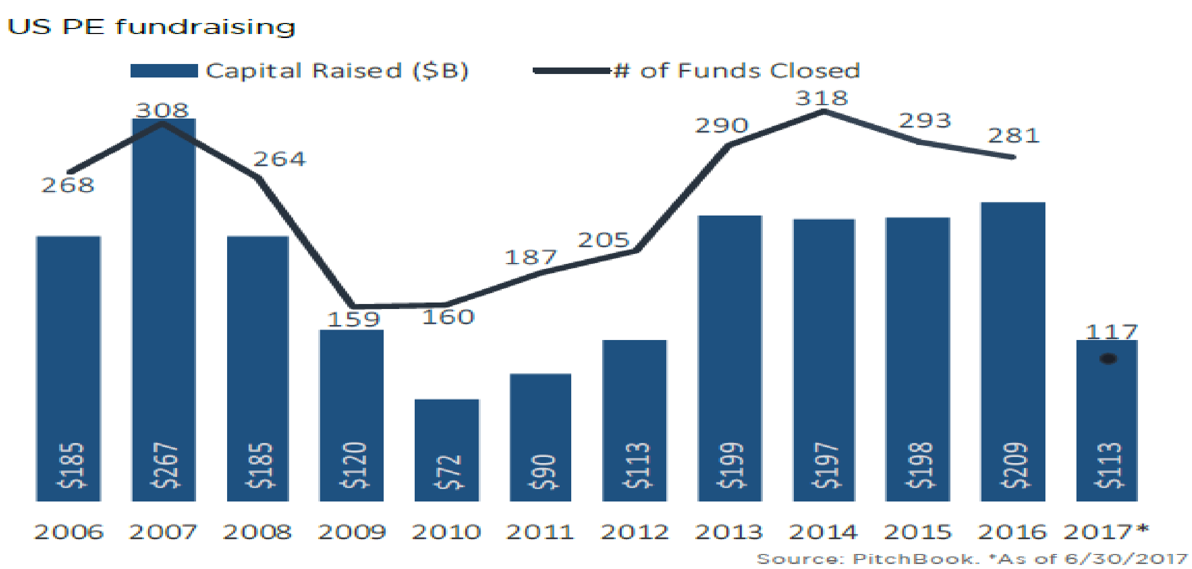
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017*
Capital Raised (€B)	€ 76.90	€ 81.74	€ 49.96	€ 41.49	€ 23.49	€ 38.54	€ 32.18	€ 56.97	€ 48.33	€ 51.28	€ 72.40	€ 67.28
# of Funds Closed	201	200	171	128	116	132	119	123	121	92	105	109

*As of 12/31/2017



From 2006 to 2017, fundraising in Europe has dropped. 2007 was the pick year and the biggest drop occurred in 2010. The market improved by 2013 to fall the next two years. 2016 shows a big improvement but follows by a drop in 2017.

Table 3 U.S. Private Equity Fundraising 2006 - 2017



In the U.S., the golden era of private equity fundraising is 2007. The market dropped the next year, then significantly in the years 2010, 2011, and 2012. Successive years show a big improvement with a pick in 2016. However, fundraising decreases in 2017.

Table 4 U.S. Funraising 2012 - 2018

Year-on-year fundraising		
	Capital raised ($bn)	Number
2012	259.08	741
2013	364.11	758
2014	386.49	809
2015	357.00	736
2016	391.06	802
2017	473.21	757
2018	358.25	508

$425bn	Total amount raised between 2012 and 2018 by the 10 largest managers
63%	Of the total amount raised between 2012 and 2018 was raised by US-headquartered firms

Year-on-year by strategy							
	Buyout	Growth Equity	Venture Capital	Secondaries	Fund of Funds	stressed / Turnaroun	Co-Investment
2012	124.16	53.11	28.52	22.84	17.17	4.36	8.82
2013	206.90	39.10	30.88	23.59	28.43	13.33	21.87
2014	225.55	55.40	36.65	28.89	19.75	9.40	10.85
2015	196.20	53.72	44.48	23.66	14.20	8.66	16.09
2016	216.98	61.92	47.57	33.02	19.02	3.64	8.93
2017	296.65	62.62	35.88	43.70	20.73	3.22	10.41
2018	224.87	40.90	44.25	22.73	15.41	7.28	2.82

Fundraising from 2012 to 2018 highlight yearly increases with buyout and venture capital strategies. Growth equity, funds of funds, distressed or co-investment strategies have uneven fundraising.

Table 5 U.S. Fundraising by strategy 2012 – 2018

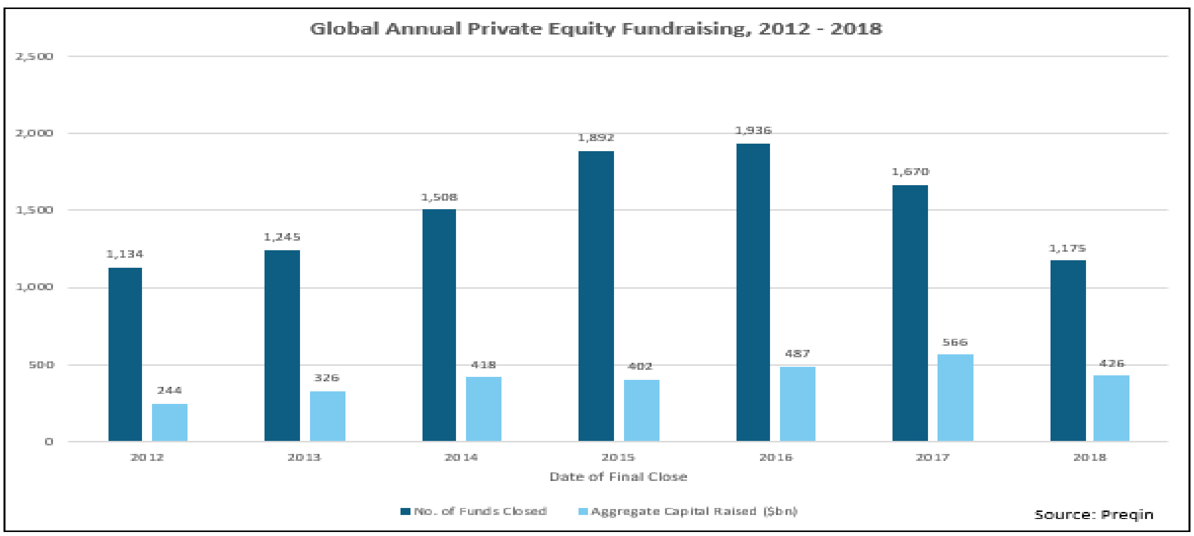
2018 fundraising strategy breakdown		
	2018 capital raised	2018 funds closed
Buyout / Corporate Private Equity	63%	28%
Venture Capital	12%	38%
Growth Equity	11%	17%
Secondaries	6%	6%
Fund of Funds	4%	7%
Distressed / Turnaround	2%	1%
Co-Investment	1%	3%
Total	$358.25bn	508

Largest fund closes, 2018		
Fund name	Capital raised ($bn)	Month close
Carlyle Partners VII	18.50	July
Hellman & Friedman Capital Partners IX	16.00	October
EQT VIII	12.30	February
Hillhouse Fund IV	10.60	September
BC European Capital X	8.01	January
American Securities Partners VIII	7.00	February
Landmark Equity Partners XVI	7.00	September
Carlyle Asia Partners V	6.55	June
Bridgepoint Europe VI	6.52	May
Insight Venture Partners X	6.30	July

Data compile by a service Provider alleging information of more than 6,800 GPs and 5,900 LPs and tracking over 22,100 funds. It shows. *Source: Private Equity International*

Table 6 Global Annual Private Equity Fundraising 2012 - 2018

Year	No. of Funds Closed	Aggregate Capital Raised ($bn)
2012	1,134	244
2013	1,245	326
2014	1,508	418
2015	1,892	402
2016	1,936	487
2017	1,670	566
2018	1,175	426



Global annual private equity has steadily risen from 2012 to 2018. However, the number drops from 2017 to 2018.

Source: Preqin

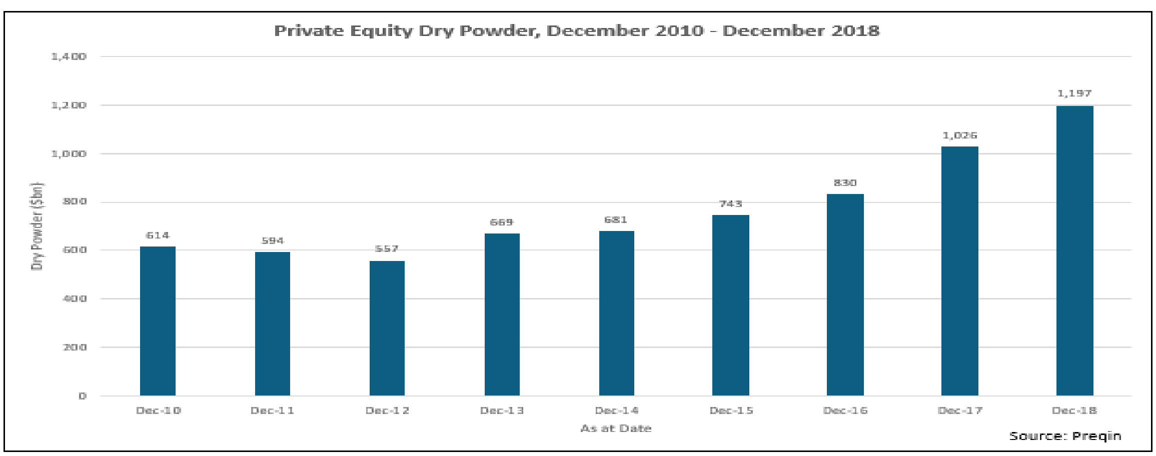
Table 7 Private Fundraising by Fund Type and Geographic Focus 2018

Fund Type	North America		Europe		Asia		Rest of World		Global	
	No. of Funds Closed	Aggregate Capital Raised ($bn)	No. of Funds Closed	Aggregate Capital Raised ($bn)	No. of Funds Closed	Aggregate Capital Raised ($bn)	No. of Funds Closed	Aggregate Capital Raised ($bn)	No. of Funds Closed	Aggregate Capital Raised ($bn)
Buyout	112	123.2	61	61.3	29	37.3	12	7.2	214	229.0
Growth	66	35.6	28	8.4	47	12.4	14	2.7	155	59.1
Turnaround	2	1.8	1	0.1	4	0.4		0.0	7	2.3
Venture Capital	342	41.5	65	10.0	150	23.8	48	3.5	605	78.9
PE Fund of Funds	38	8.4	22	5.4	6	2.2	12	2.4	78	18.4
PE Secondaries	19	17.6	8	2.7	2	0.3	1	0.0	30	20.7
Other Private Equity	60	12.2	11	1.7	12	3.5	3	0.2	86	17.6

Fundraising activities in North America, Europe, Asia and the rest of the world in 2018, with U.S. outpacing competition. *Source: Preqin*

Table 8 Private Equity Dry Powder 2010 - 2018

As at Date	Dry Powder ($bn)
Dec-10	614
Dec-11	594
Dec-12	557
Dec-13	669
Dec-14	681
Dec-15	743
Dec-16	830
Dec-17	1,026
Dec-18	1,197



As of December 2018, dry powder (capital available to invest) represents $1,197 billion.

Source: Preqin

Table 9 Largest Private Equity Funds Closed in 2018

Fund	Firm	Fund Size (mn)	Fund Type	Geographic Focus	Firm Headquarters
Carlyle Partners VII	Carlyle Group	18,500 USD	Buyout	North America	US
Hellman & Friedman Capital Partners IX	Hellman & Friedman	16,000 USD	Buyout	Asia, Europe, North A	US
EQT VIII	EQT	10,750 EUR	Buyout	Austria, Germany, No	Sweden
Hillhouse Fund IV	Hillhouse Capital Management	10,600 USD	Buyout	China, Global	China
BC European Cap X	BC Partners	7,000 EUR	Buyout	Europe, North Ameri	UK
Sequoia Capital Global Growth Fund III	Sequoia Capital	8,000 USD	Growth	Global	US
West Street Capital Partners VII	Goldman Sachs Merchant Banking Division	7,240 USD	Buyout	Global	US
American Securities Partners VIII	American Securities	7,000 USD	Buyout	North America	US
Landmark Equity Partners XVI	Landmark Partners	7,000 USD	te Equity Second	Europe, North Ameri	US
Carlyle Asia Partners V	Carlyle Group	6,550 USD	Buyout	Asia	US

In 2018, US firms overwhelmingly dominate the top largest private equity funds closed.

Source: Preqin

Table 10 Top 10 Largest Private Equity Funds in 2019

Fund	Firm	Target Size (mn)	Status	Fund Type	Geographic Focus	Firm Headquarters
SoftBank Vision Fund	SB Investment Advisers	100,000 USD	Second Close	Hybrid	Global	UK
China Structural Reform Fund	CCT Fund Management	350,000 CNY	First Close	Growth	China	China
China Integrated Circuit Industry Investment Fund II	SINO-IC Capital	200,000 CNY	Raising	Growth	China	China
Blackstone Capital Partners VIII	Blackstone Group	20,000 USD	Raising	Buyout	Global	US
Vista Equity Partners Fund VII	Vista Equity Partners	16,000 USD	First Close	Buyout	North America	US
Advent Global Private Equity IX	Advent International	15,000 USD	Raising	Buyout	Europe, North America	US
Asian Institutional Investor Joint Overseas Investment Fund	China Minsheng Investment Group	15,000 USD	Raising	Buyout	ASEAN, Asia, Central Asia, Chir	China
Shanghai Changsanjiao Xietong Fund	Shanghai Guofang Fund Management	100,000 CNY	Raising	Venture (General)	China	China
Sino-Singapore (Chongqing) Connectivity Private Equity Fund	UOB Venture Management	100,000 CNY	Raising	Growth	China, Singapore	Singapore
TPG Partners VIII	TPG	14,000 USD	First Close	Buyout	Asia, Europe, Global, North Am	US

As at 3rd January 2019, China and U.S. firms dominate the top 10 Largest Private Equity Funds and U.K tops the list.

Source: Preqin

Table 11 Fundraising 2007 vs. 2017

2007		2017 pace*
308	Funds closed	234
$267B	Capital raised	$226B
54%	Capital from $5B+ funds	50%
14	Avg. time to close (mos.)	12
$217M	Median fund size	$275M
69%	Hitting target	93%
70	First-time funds	20

*figures are projections extrapolated from 1H data; does not include Apollo Global Management's pending $23.5B fund

PitchBook

In second quarter of 2017, "US private equity firms are on pace to challenge (or even exceed) the prodigious fundraising figures recorded 10 years ago", that is the year 2007, considered the heady of private equity.[381]

4.10 The SEC Presence Exam Initiative Program and Enforcement Activities

The fiduciary obligation is the general legal duty of fairness that the law of partnership imposes on its members. When dealing with partnership activities, members of a partnership must treat each other fairly and disclose material activities to the partnership.[382] The laws of partnership mirror the agency relationships existing between an agent and its principal, where the agent owes the principal fiduciary duties. [383]

---

381 *See* Kevin Dowd, *2007 vs. 2-17: A US PE Fundraising Throwdown*, PITCHBOOK: NEWS & ANALYSIS (Jul. 19, 2017), https://pitchbook.com/news/articles/2007-vs-2017-a-us-pe-fundraising-throwdown

382 *See generally* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 221-83 (4th ed. 2013).

383 *See Meinhard*, 164 N.E. 545 at 546 (1928) (duty of loyalty is met when the partner offers opportunity, full and fair chance to allow its fellow partners to capitalize on the opportunity).

With private equity limited partnership agreements, violation of the duty of loyalty by general partners is often at issue. The SEC has raised this concern since the 1980s[384] and others, such as the International Organization of Securities Commissions ("IOSCO") released a report to that effect in 2009. [385] The Private Equity Conflicts of Interest report addresses regulatory concerns and notes that conflicts of interest happen at four different stages: fund raising, investment, management, and exit. Disclosure to limited partners usually seems the proper action to mitigate this specific risk. Since Dodd-Frank, private equity and other private funds must register with the Commission.[386] Under the Investment Advisers Act, conflicts of interest that violate fiduciary duties violate securities laws.

In 2012, the Commission[387] started the Presence Exam Initiative program. [388] The program aimed at engaging with the private equity industry by gathering information, identifying issues, and assessing risk. By 2014, the Commission made more than 150 examinations of newly registered private equity advisers, with the goal of examining 25% of newly registered funds. [389]

---

[384] *See* Venture Capital Hearing *supra* note 266.

[385] *See* COMM. OF THE INT'L. ORG. OF SEC. COMMISSIONS, PRIVATE EQUITY CONFLICTS OF INTEREST (2009), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf.

[386] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010).

[387] Within the SEC, the Office of Compliance Inspections and Examinations ("OCIE"), is responsible for conducting examination of registrants. OCIE has created the Private Funds Unit ("PFU"), composed with veterans of private equity industry, and specialized in examinations of advisers to private funds. PFU conducts risk-based examinations to identify situations or behaviors posing significant risk to investors, or which may violate federal securities laws and regulations.

[388] SEC. & EXCH. COMM'N. LETTER TO INDUSTRY REGARDING PRESENCE EXAMS (2012), https://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf

[389] *See* Andrew J. Bowden *supra* note 54. *See also* Marc Wyatt, Acting Dir., SEC Off. of Compliance Inspections and Examinations: Private Equity: *A Look Back and a Glimpse Ahead*, Speech at Private Equity International, SEC. & EXCH. COMM'N (May 13, 2015), at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

The examinations revealed that half of the advisors violated their fiduciary duties to their funds and their limited partners, [390] even though mechanisms to avoid conflicts existed in most cases.

Organizational documents of partnerships usually provide for an Advisory Board and Limited Partnership Agreements ("LPAs"). LPAs contain mechanisms by which the adviser can disclose potential conflicts of interest for review and approval by the Advisory Board. The Advisory Board can waive or approve a course of action as to any conflict, allowing the adviser to proceed with its actions without exposure to any potential liability to the fund. Often, advisers bypass procedures set in place, usually when they come to fee sharing, fee shifting, and the use of consultants.

4.10.1 Non-sharing monitoring fees

Limited partnership agreements ("LPAs") often indicate that the adviser may receive fees from its portfolio companies for services provided by the adviser (fees for break-ups, origination, commitment, and monitoring). Some LPAs include accelerated monitoring fees and "evergreen" fees (which are renewed automatically after an initial term of ten years even if the company is no longer in the portfolio). Transaction fees from portfolio companies are in addition to management fees limited partners pay (ranging from 0.75% to 1.5%). Fees received by portfolio companies usually go to offset management fees by limited partnerships. LPAs can contain the following language: "*The management Fee shall be reduced in any given quarter by an amount equal to fifty percent 50% of any break-up, origination, commitment, broken deal, topped bid, cancellation,*

[390] *Id.*

monitoring, closing, financial advisory, investment banking, director or other transaction fees received by the General Partner or any Affiliate thereof during the prior quarter from Portfolio Investments [defined in LPA as "assets of the Partnership" invested in securities of companies." However, the adviser needs to inform the fund and limited partners when it receives monitoring fees, accelerated fees, or other fees, so that it shares them with the funds and limited partners.[391]

For instance, Blackstone, a private equity fund adviser has entered into advisory agreements with several private equity funds it controls. Each fund has a limited partnership agreement ("LPA") that governs relationships with the adviser. This includes payment of fees and expenses to Blackstone pursuant to a separate management agreement. In addition, to the fund's LPA, each fund has established a process to deal with any potential conflicts of interest through a Limited Partnership Advisory Committee ("LPAC") for issues related to any transactions or relationship among parties.

Blackstone advises multiple funds that own multiple portfolio companies. Blackstone also contracts monitoring agreements with each portfolio company whose goal consists of advisory services in exchange for fees. In addition, portfolio companies pay Blackstone a monitoring fee, which usually serves to offset a portion of the annual management fee paid by LPs.

Blackstone only disclosed the monitoring fees to the funds and limited partners prior to their commitment to the fund but omitted to mention the practice of accelerated monitoring fees.[392]

---

[391] *See e.g.*, Blackstone Management Partners L.L.C., Investment Advisers Act Release No. 4219 (Oct. 7, 2015).

[392] *Id.* (fees were subsequently disclosed via distribution notices, quarterly management fee reports, or SEC filings after the advisor had already taken accelerated fees. The SEC blamed the adviser, Blackstone, for inadequately disclosing to limited partners and LPAC monitoring and other fees, such as accelerated monitoring payments, disregarding fund documents, such as LPAs. Blackstone settled with the SEC).

Also, if the allocation methodology is not disclosed, this can result in the adviser apportioning fees for its advantage at the expense of the fund and limited partners.[393]

For example: a private equity firm, WL Ross, advises several private equity funds, including WLR Funds.

Each WLR Fund contains an Advisory Board in which some limited partners participate. The Advisory Board deals with conflicts of interest and investment issues. An LPA governs each WLR fund, setting forth obligations to pay fees and expenses to the adviser WL Ross.

LPAs provided that transaction fees received by the adviser would offset quarterly management fees payable by the Funds to the adviser by 50%. But, between 2001 and 2011, the adviser adopted a different methodology to allocate transaction fees, which resulted in the advisor retaining a significant amount of those fees for itself rather than distributing them to the funds: here the allocation to the funds were based upon their relative ownership percentages of the portfolio company. Consequently, the adviser received around $10.4 million more in management fees than anticipated.[394]

4.10.2 Shifting expenses

An adviser shifts expenses in various ways by transferring expenses between several funds when it manages or allocates portfolio company expenses between different funds, or when it misallocates expenses between the adviser and the fund.[395]

---

[393] *See e.g.*, WL Ross & Co. LLC, Investment Advisers Act Release No. 4494 (Aug. 24, 2016).

[394] *Id.* (SEC blaming the adviser for failing to disclose its fee allocation practices to some private equity Funds it advised, resulting in the Funds paying higher management fees ($10.4 million between 2001 and 2011). WL Ross settled with the SEC).

[395] *See e.g.*, JH Partners, LLC, Advisers Act Release No. 4276 (Nov. 23, 2015).

The structure of this matter follows the same path private equity firms use. JHP illustrates the purpose. JHP, a private equity firm, advises several funds. Each fund had an Advisory Board to resolve potential conflicts of interest and investment matters. In addition, an LPA imposes on the adviser, principals or affiliates the duty to have the consent of the Advisory Board for any investment in the portfolio companies or any transfer of securities or assets to the funds.

However, for six years, the adviser and some principals provided $62 million in direct loans to the Funds' portfolio companies (interim financing for working capital and other matters) without disclosing it to the Funds and its limited partners. The advisor and principals' securities interest were senior to equity held by the Funds. The adviser failed to disclose the conflicts of interest, the loans or the seniority of the loans to the advisory board, nor did the adviser obtain the advisory board's consent).[396]

4.10.3 The use of consultants to avoid sharing fees

This practice occurs when an adviser terminates a portfolio company's advisory fees, replacing them with an agreement between an adviser's affiliate and the portfolio company. In this case, fees paid directly to the affiliate, instead of the adviser, are no longer shared with limited partners, and no longer offset management fees.[397]

---

396 *Id.* (SEC calling loan operations "negligent breaches of fiduciary duty" and respondents settling the case with the SEC).

397 *See e.g.*, Fenway Partners, LLC, Peer Lamm et. at., Investment Advisers Act Release No. 4253 (Nov. 3, 2015) (the adviser did not disclose to the Funds and limited partners that the portfolio companies terminated their payment obligations under the Management Services Agreements and replaced them with consulting agreements with an affiliate. Thus, the limited partners were deprived from the advisory fee offset afforded by portfolio companies' payments).

From 2014 to 2016, the SEC brought six enforcement actions against private equity advisers. The cases all reached settlement. It is not clear if the Commission will step up its enforcement activities as suggested by some commentators, [398] or if it will consider a new course of action.

[398] APPELBAUM & BATT *supra* note 164.

5.0 Fifth Chapter: Comparative Analysis with the European Alternative Investment Fund Managers

The Dodd-Frank Act and Alternative Investment Fund Managers Directive (AIMFD) offer different visions of regulation. Commentators have described U.S. regulation as rules-based while describing European regulation as principles-based. In practice, regulations contain a mix of both rules and principles, the number of each depending on the main goal legislators are seeking to accomplish. In addition, each country must implement multiple European layers of regulation in addition to its own legislation. (*see infra* Chapter on France and UK).

Rules-based regulation gives specific directions and takes the form of "dos and don't."[399] Traffic laws are usually cited to illustrate a rule-based regulation. A traffic rule takes the form of "Yield", "Do not pass" "No turn on red" "Speed limit 55", "Stop", "Slow" and so forth.[400] Rules leave no room for interpretation, also providing legal security since provisions are known ex ante. But rules have the inconvenience of rigidity, tending to over or under include.[401] Rules also encourage "loophole behavior" and sophisticated players can game the system as in the Enron debacle.[402]

Unlike rules-based regulations, principles-based regulations use broad and general language to regulate. In complex industries, regulation with too many details can lead to confusion

---

[399] John Pearson Allen, *Rules- or Principles-Based Regulation - Factors for Choosing the Best Language Strategy*, 56 CAN. BUS. L.J. 375 (2015).
[400] *Id.*
[401] *Id.* at 263.
[402] *Id.*

and legal uncertainty.[403] Principles-based regulation favors plain language, general principles that regulators can interpret with industry representatives.[404] Staying with traffic laws, principle-based regulation can incorporate the following prohibitions as Montana and Nevada traffic laws once did: driving no faster than "reasonable and prudent in all circumstances."[405] The generality of terms in principle- based regulation becomes a problem if it leaves too much room for interpretation, and can lead to inconsistency. To use the Montana traffic laws, one can wonder who is to determine what constitutes "reasonable" and "prudent," and which criteria to use? Would the road conditions, age, and driver experience suffice?[406]

Main critics of principles-based regulation claim that, because of the enormous power provided to regulators to interpret the regulation, principles-based regulations tend to become arbitrary regulation.[407]

In securities regulation, commentators usually distinguish European regulation from American regulation, the first described as principles-based and the latter as rules-based.[408]

---

[403] *Id.* at 377 (Noting that clear rules added together can lead to confusion).

[404] *Id.* at 380.

[405] Cristie Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L. J. 257, 264 (2010) (Montana traffic law allowing drivers to determine what traffic conditions constitute "reasonableness" and "prudence").

[406] *Id.*

[407] *Id.* at 263-4. *See also* Allen *supra* note 399 at 381.

[408] *See e.g.*, Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953 (1995) (distinguishing rules, standards and principles. Stating that rules could justify political or moral principles. *Id.* at 966. Standards differ from principles as standards do not serve as a justification for rules but need specifications for their use in solving individual cases. *Id.* at 967. COLIN S. DIVER, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983) (Identifying four principal subcategories of costs and benefits of rules: i) rate of compliance, the more a rule is precise the more compliance to it can increase; ii) transparency of a rule limits over-and under-inclusiveness; iii) lack of a rule transparency can increase the cost of rulemaking (analysis of a rule social impact, plus cost of securing agreements among stakeholders); and iv) possible increase of cost to regulate and enforce the rule if opaque or inaccessible. *Id.* at 72-74. James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007) (Analyzing conflicting views of regulatory systems construed on rules and principles. Questioning if regulators should punish arguable misconducts by enforcing the broader principle through what the author calls a "principles-based enforcement action" (as opposed to "rules-based enforcement action). *Id.* at 630. Or should regulators, as critiques pretend, use rulemaking rather than "regulation by enforcement" because the latter establishes norm ex post through

The line between principles-based and rules-based regulations can appear difficult to draw. The reality of that distinction seems at times elusive.[409] Regulatory systems contain a blend of principles and rules in which *ex ante* general provisions combine with *ex post* dispositions.[410] Complex systems, such as corporate law, require mixing principles and rules to take into account the entire system as a whole and not in isolation.[411] Thus, doctrinal notions such as fiduciary duty derive from general principles in which rules-based statutes intertwine for a coherent application of the principle.[412]

Likewise, in securities regulation, the U.S. has the reputation of using rules for its provisions. It enacts a vast architecture of rules for registration with prospectus, timing, exemptions, and disclosure.[413] Securities regulation detailed rules exist side-by-side with principles such as safe harbor and fiduciary duty.

Disclosure provisions are another example of the blurring line between both principles and rules, as disclosures exhibit both attributes. For instance, advisers must advertise using "plain English" language, which is a general principle coupled with specific rules, for example

enforcement actions instead of es ante rulemaking. "Regulation by Enforcement" could create economic disruption. *Id.* at 631-2. William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003) (Debating the rules-based accounting failures with the Enron debacle and the proposition to move towards principles-based accounting. The adoption of Sarbanes-Oxley Act after the financial market crash of 2002 results among other things from the failure of auditors. Here, the legislation delegate to a newly created agency, Public Oversight Board ("POB") the task to issue new accounting rules; the agency is supervised by the SEC Ultimately, enforcement of rules and principles are more important; *Id.* at 1037. The Enron debacle was not caused by the rules as opposed to principles but by failure to apply the accounting rules; plus, Enron's fraud and their auditors' incentive; *Id.* at 1044 GAAP is more governed by rules because lawyers and clients prefer "clear instructions" and reduce risk for lawyers and clients alike. *Id.* at 1051.for an economic perspective. *See also* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (discussing the cost of rules and standards.

409 *See generally* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of Principles-Based Systems in Corporate Law; Securities Regulation, and Accounting*, 60 VAND. L. REV. 1409 (2007).

410 *Id.*

411 *Id.* at 1413.

412 *Id.* at 1413.

413 *Id.* at 1447.

prohibiting "multiple negative."[414] Another example of securities regulation using both principles and rules concerns the concept of "market manipulation" with the rule 10(b).

5.1 Private equity regulation with the Dodd-Frank Act: a mix of rules and standards

The Private Fund Investment Advisers Registration Act of 2010 implements Section 403 of Dodd-Frank Act. That section, which relates to private funds, modifies the Investment Advisers Act of 1940. It eliminates the private adviser exemption for private equity, hedge funds, and other private funds, which now must register with the SEC, with a few exceptions.[415]

Section 403 of Dodd-Frank prescribes a rule that incorporates in section 203(b) of the Investment Advisers Act.[416] The rule is straightforward. However, other provisions of the Private Fund Act resemble principles-based regulation. Other sections of the Act afford the SEC a great rulemaking authority to interpret or adjusting the law according to its own criteria. For instance, in Section 404, which is related to the collection of systemic risk data, reports, examinations and

---

[414] *Id.* at 1450.

[415] 15 U.S.C.§ 80b-3(a) (2018). Thus, the new Section 203(b) of the Investment Advisers Act reads as following:

"Section 203(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(b) is amended-

In paragraph (1), by inserting", other than an investment adviser who acts as an investment adviser to private fund," before "all of whose";

By striking paragraph (3) and inserting the following:

"(3) any investment adviser that is a foreign private adviser," and"

The revised Section 203(b) provides the following:

"(b) The provisions of subsection (a) shall not apply to-

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"

any investment adviser whose clients are insurance companies;

any investment adviser that is a foreign private adviser;"

[416] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010).

disclosure, the SEC "*may require any investment adviser registered under this title*" to maintain records and file of private funds "*as necessary and appropriate in the public interest and for the protection of investors, or the assessment of systemic risk by the Financial Stability Oversight Council.*"[417]

Based on the Dodd-Frank legislative mandate, the SEC has issued several implementation rules. The SEC issued first "*Rules Implementing Amendments to the Investment Advisers Act of 1940.*"[418] These rules had three main objectives: i) increase the registration threshold by investment advisers, ii) impose registration to hedge funds, private equity and other funds, and iii) impose reporting exempt advisers.[419]

5.1.1 Principles and Rules to Increase the registration threshold to register with the Commission

Dodd-Frank Section 410 commanded the SEC to regulate newly created mid-size advisers by amending Section 203A(a) of the Advisers Act of 1940. As a result, mid-size advisers now register with the SEC based on the threshold established by it.[420]

[417] *Id*.
[418]*See generally* Amendments to the Investment Advisers Act of 1940 *supra* note 325.
[419] *Id.*
[420] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (amending Investment Advisers of 1940 15 U.S.C.§ 80b-3a(a) by inserting a new paragraph for mid-sized investment advisers). Dodd-Frank states at Sec. 410:
"(ii) has assets under management between –
"(I) the amount specified under subparagraph (A) of paragraph (1), as such amount may have been adjusted by the Commission pursuant to that subparagraph; and
"(II) $100,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title."

The legislative body directed the Commission to act starting with a command of "*$100,000,000*" and in the same time allowing the rule making authority "*or such higher amount as the Commission may, by rule, deem appropriate*." The legislature mixed principles-based and rules-based regulations. In the end, the SEC raised the $100 million buffer to $110 million. This means that mid-sized advisers are those managing $110 million of assets, and they must register with the SEC. If assets under management fall below that threshold and reach $90 million, advisers switch registration to have their states.

5.1.2 Principles and Rules to impose registration of hedge funds, private equity and other funds

To require private equity advisers to register, Dodd-Frank amends Section 203(b)[421] of the Investment Advisers Act of 1940. Section 203(b) provides exemptions from registration which include the private fund adviser[422] and the foreign private adviser.[423] The legislation commands the modification of the Investment Advisers Act with little place for interpretation. Thus, it is a rule-based decision. As for the SEC, it uses essentially new rules to implement Section 203(b) by amending FORM ADV. FORM ADV tends to standardize information provided by advisers.[424]

---

[421] Prior Dodd-Frank, Sec. 203 (b) read as following:
"*The provisions of subsections (a) of this section shall not apply to –*
any investment adviser 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;"

[422] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (Sec. 403 amending Sec. 203(b) §1 of Advisers Act and inserting "other than an investment adviser who acts as an investment adviser to any private fund").

[423] *Id.* (striking Sec. 203(b) §3 of Advisers Act and inserting "(3) any investment adviser that is a foreign private adviser").

[424] *See generally* Form ADV *supra* note 295.

The Dodd-Frank Act also restructures Section 204 of the Advisers Act to insert a new subsection for records and reports for private funds.[425] The law mostly relies on the SEC rulemaking authority to draft records and reports "*as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk*."[426] This gives the Commission the power to define, in the context of private funds, what could constitute the public interest, the protection of investors, or how to assess systemic risk. That determination took almost a year after the Commission issued the final rule in June 2011. The rule amends FORM ADV and adds a new section to it: Item 7.B. for private fund reporting.[427]

5.1.3 Rules-based Regulation for Reporting by Exempted Advisers

Exempted advisers are those not required to register with the SEC but who, nevertheless, must comply with reporting. They include venture capital and private fund advisers.[428] With both venture capital and private fund advisers, the Dodd-Frank Act amended the Advisers Act and added new sections.

In the case of venture capital, Dodd-Frank prescribes that the Commission issues a rule defining "*venture capital fund*" subject to reporting requirement "*necessary or appropriate in the public interest or for the protection of investors.*"[429] The law provides principles and directs the

---

[425] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (§ 404(1)(2).
[426] *Id.* (the phrase is inserted four times in that Section 404(2).
[427] *See* FORM ADV *supra* note 295.
[428] Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (§ 407 and 408).
[429] *Id.* at § 407.

Commission to enact the rule. The Commission issued several rules accordingly.[430] The Dodd-Frank Act used the same method with private fund advisers.[431]

5.2 Private Equity Regulation with the AIFMD: Principles-based regulation

The European legislation to regulate private equity and private funds consists of principles-based regulation. That is, AIFMD provides general principles to newly created financial regulation in Europe.[432]

AIFMD consists of multi-level regulations spread among Member States, the European Commission ("EC"), and the European Parliament. AIFMD Level 1 consists of the Directive itself as adopted in June 2011 imposing upon Member States a requirement to implement the Directive in their home countries by July 2013. AIFMD contains vague principles, delegating legislative authority to the European Commission ("EC"). Pursuant to its delegated acts,[433] it must adopt measures specifying the content of designated articles.[434]

Level 1 tasks the newly created European Securities Markets Authority ('ESMA") with drafting Level 2 accompanying legislations and technical guidelines.

---

[430] *See* Exemption for Advisers to Venture Capital Funds Release *supra* note 290.

[431] *Id. See also* Dodd Frank Act, Pub. L. No. 111-203, 124 Stat.1376 (2010) (pursuant to Sec. 408, the Commission adopted rule 203(m)-1 codified at 17 CFR 275.203(l)-1).

[432] *See generally* AIFMD *infra* note 446 (for instance Recital §2 states the Directive "aims at establishing common requirements governing the authorization and supervision of AIFMs in order to provide a coherent approach"; see also "This Directive aims to provide for an internal market for AIFMs and a harmonized and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs", *Id.* at §4.

[433] *See* AIFMD *infra* note 446 at Art. 56.

[434] *Id.* Art 56 refers to articles 3, 4, 9, 12, 14-25, 34-37, 40, 42, 53, 67, and 68.

Level 2 Regulation designates the European Commission as the main body for AIFMD implementation acts.[435]

5.2.1 Comparing Regulation in the Context of Common Law and Civil Law Countries

Legal origin and quality of enforcement can explain how the laws of a country protect investors. *Law and Finance* literature has explored the laws protecting investors in several countries and their degree of enforcement.[436] A major difference in investor protection exists between the two big families of law: common law and civil law. According to this literature, common law protects investors and creditors better than civil law. In addition, common law countries provide better enforcement.[437]

Comparing the differences between Dodd-Frank and AIFMD might not involve the issue of common law and civil law principles. The AIFMD confronts two visions of regulations: one, pro- regulation states, such as France, Germany, and Italy, and two, light touch regulation led by the United Kingdom.[438] Pro-regulation belongs to the legal origins of civil law, while light touch regulation belongs to common law. The global financial crisis of 2008 has marginalized the "Anglo-American" capitalism embodied by deregulation.[439] Unlike the UK, France had already implemented regulation for private equity and hedge funds. In France, legislative authority and not

---

[435] AIFMD *infra* note 446 at Art.59. implementation regulation pursuant Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012 that supplements Directive 2011/61/EU of the European Parliament and of the Council regarding exemptions, general operating conditions, depositaries, leverage, transparency and supervision, available at https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:en:PDF.

[436] See *generally* La Porta et al. *infra* note 540.

[437] *Id.* at 1116.

[438] Eilis Ferran, *Crisis-Driven EU Financial Regulatory Reform*, U. CAMBRIDGE FAC. L. LEGAL STUD. RES. PAPER SERIES, Working Paper No. 6/2012, (2012) (UK) at 9.

[439] *Id* at 14.

contracts regulate private funds.[440] The end results of AIFMD show that civil law countries imposed a heavy hand on regulation. The directive regulates every aspect of investor protection mentioned in law and finance literature. As such, while Dodd-Frank limits its actions to disclosing to investors through the SEC, AIFMD also regulates managers by imposing on them depositaries, minimum capital and transparency requirements.

Ultimately, the quality of its enforcement, rather than its legal origin, might differentiate countries.[441] Professor Coffee analyzes the thesis which posits that strong enforcement and overregulation would injure the U.S.'s competitiveness, and offers a sharply opposite interpretation. That is, "higher enforcement intensity" offers advantages to the U.S. economy: a lower cost of capital and higher valuations of securities. Some are attracted by higher intensity while others are deterred by it.[442] U.S. markets seem to offer a valuation premium that other markets, such as the London Stock Exchange, do not.[443] According to Professor Coffee, the difference between the U.S. and other markets is its higher intensity enforcement.[444] Enforcement data show the following: (i) regulatory intensity differs greatly among common law and civil law, and common law countries spend greater resources on enforcement than civil law countries; and (ii) U.S. stands out as the actual enforcement and sanctions levied (financial) outnumber those of any other country. [445]

---

[440] *See* Transposition of AIFMD in United Kingdom and France *infra* Chapter 6 (describing the transposition of the Directive).

[441] *See generally* John C. Jr. Coffee, Law and the Market: The Impact of Enforcement, 156 U. PA. L. REV. 229 (2007).

[442] *Id.* at 230.

[443] *Id.* at 237.

[444] *Id.* at 244.

[445] *Id.* at 245.

The European Union has enacted its version of the Dodd-Frank Act, the Alternative Investment Fund Managers Directive,[446] which aims at providing a European regulatory framework for alternative investment funds ("AIF" or "AIFs")[447] The Directive regulates alternative investment funds managers ("AIFM" or "AIFMs"), defined as legal persons who regularly manage one or more Alternative Investment Funds.

The Directive provides a sweeping regulatory framework for AIFs and investor protection. The Directive creates a common European financial law for alternative investment funds for which various levels of regulation existed prior to its enactment: some countries already had statutory provisions (France, Germany) while others had no regulation (United Kingdom).

The Directive adopted in 2011 became European law on July 21, 2011. Member states had to implement the directive into their respective jurisdiction on July 22, 2013.[448] Generally, with some exceptions, AIFMD prescribes managers of AIFs exceeding 100 million euros (equivalent to $114 USD) to register and periodically to report to competent national authorities.

Like the Dodd-Frank Act, the AIFMD appears as crisis-driven legislation resulting from the financial crisis of 2007-2008. The legislation provides the first European regulatory standard for private fund managers and attempts to solve prudential regulatory deficiencies that occurred during the financial crisis.[449]

---

[446] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 16**,** available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN [hereinafter "*AIFMD*" or the "*Directive*"].

[447] *Id.* art. 4(1)(a) defines AIFs as collective investment undertakings, including raising capital from a various investors and those that do not require authorization pursuant to undertakings for collective investment in transferable securities ("UCITS") directive. See also Recital (4) ("an internal market for AIFMs and a harmonized and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs).

[448] *Id.* art 66(1).

[449] *See generally* Ferran *supra* note 257.

At the international level, consultations about alternative investments among world leaders took place at the G7 and G20 summits, and a flurry of international institutions published reports on that effects.[450]

At the European level, the European Parliament in 2008 requested the EU Commission to draft legislation to regulate hedge funds and private equity.[451] The Commission reluctantly complied, after surrendering to public pressure.[452]

AIFMD is a comprehensive legislation on alternative investment fund managers (1). The directive parallels Dodd-Frank to address investor protection and (2), to regulate use of leverage

---

[450] *Id.* at 11-12 (between 2007 and 2010 world leaders' meetings made declarations, communique, statements on systemic risk posed by hedge funds, stability of financial markets, stressed the need of financial regulation that would include hedge funds, increase transparency on hedge funds).

[451] *See* Report of the Committee on Legal Affairs with Recommendations to the Commission on Transparency of Institutional Investors, (July 9, 2008), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0296+0+DOC+PDF+V0//EN.(Requesting the Commission to draft a legislative proposal (in the form of a directive) on transparency of hedge funds and private equity. On private equity the report calls on the Commission to explore ways to stop "asset stripping" of portfolio companies and guarantee capital maintenance of these companies. *Id.* at 11. The report also invites the Commission to explore how to sanction banks which lend money to borrowers irresponsible of their ability to pay back, *Id.*). see also Report of the Committee on Economic and Monetary Affairs with Recommendations to the Commission on Hedge Funds and Private Equity, at 1-8 (Sep. 11, 2008) [hereinafter Rasmussen Report], http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0338+0+DOC+PDF+V0//EN. (Reiterates demands to the Commission to submit a legislation proposal dealing with all financial market participants, including hedge funds and private equity. The Report requires the Commission to focus on excessive leverage, valuation and illiquid securities, risks posed by hedge funds and private equity, failure by financial institutions to cooperate at global level. Finally, the Rasmussen Report recommends actions at European level based on the following seven principles: 1) closing any regulatory gaps nationally or internationally, 2) mandatory capital requirement for all financial institutions according to risk profile, 3) better alignment of interests between originators of securitized products and their investors by e.g., forcing originators to maintain stake in their loans, 4) improving accounting techniques for valuation 5) improving credit rating methodologies, 6) transparency for derivative trading, and 7) rewarding long-term profits. Id at 8-9. In addition, the Rasmussen Report recommended better transparency with prime brokers firms, *Id.* at 10 harmonization of European legislations on venture capital and private equity, protection and information of employees in case of ownership change with hedge funds or private equity. *Id.* at 11.

[452] *See* Ferran *supra* note 438 at 16 (Noting that the Commission released a consultation paper on hedge funds omitting private equity). *See* Commission Consultation Paper on Hedge Funds, (Dec. 2008), http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf. (stressing the importance to clearly identify market failures and actors before engaging in a comprehensive regulatory overhaul. While the Parliament requested to address hedge funds and private equity, the Commission report identifies only Hedge funds "where the need for further work – starting with an analysis of self-regulatory actions- will be needed"; *Id.* at 2. *See also* Opening Speech No. 09/80 of EC Conference on Private Equity & Hedge Funds, at 2 (Feb. 26, 2009), http://europa.eu/rapid/press-release_SPEECH-09-80_en.htm (Speech delivered by Charlie McCreevy stating that hedge funds and private equity serve as scapegoats to blame even if they did not play a major role in fostering the financial crisis).

and valuation. However, AIFMD contains far more overreaching aspects than Dodd-Frank, AIFMD introduces measures against asset stripping and protection of stakeholders, including portfolio companies. Some aspects of AIFMD reject the American style corporate governance "global" convergence theory advocates.

5.3 Descriptive overview of the AIFMD

The Directive provides a European regulation for managers of hedge funds, private equity, venture capital, and other funds not covered by the Undertakings for Collective Investments in Transferable Securities Directive ("UCITS") in 2009.[453] It provides a standard for EU member states without necessarily imposing a method to achieve goals set in its lengthy ninety-five recitals, sixty-nine articles, and four annexes. Thus, the Directive is broader in scope and outreach than the Dodd-Frank Act.

Despite regulating hedge funds and private equity managers, the Directive does not define these entities, referring to them by name only four times, mainly in recitals.[454]

In general, the directive provides guidance to member states on authorizations, operations and transparency for managers of alternative investment funds within the European Union.[455] The directive applies to European alternative investment managers who manage alternative investment funds, non-European funds which manage European funds, and non-European funds which market

[453] The Undertakings for Collective Investments in Transferable Securities ("UCITS"), Directive 2009/65/EC of the European Parliament and of the Council of July 13, 2009 that covers funds such as common funds, unit trusts.

[454] Wording of "hedge funds" appears only in the recital see AIFMD *supra* note 446 at 43, 89. Wording of "private equity" are seen in the recital section at §§ 8, 34, 78, and at art. 69(i).

[455] AIFMD *supra* note 446 at Art. 1.

funds in the European Union.[456] Member states must ensure a single alternative investment fund manager manages an alternative investment fund, which can be externally managed (by a third person appointed by the AIF) or internally managed (managed directly by the AIF).[457]

AIFMs (fund managers) must receive authorization to establish their activities by the competent authority in their AIFM home state.[458] AIFMs must provide information on managers, shareholders, or members controlling the AIFM, the organizational structure, and how it plans to comply with obligations under the directive (authorization, operating conditions, transparency, and marketing).[459] In addition, the application for authorization must include information on remuneration policies and procedures as indicated in the Directive.[460] Lastly, the investment strategy, policy with leverage and risks AIFMs use are mandatory information.[461]

A member state must grant AFMs authorization if general conditions are met and if the AIFM satisfies financial requirements. [462] Fund requirements include euros 300,000 ($343,279 USD) for an internally managed AIF and euros 125,000 ($143,033 USD), for AIFs utilizing and external managers. AIFMs managing portfolios value exceeding euro 250,000,000 ($286,662 USD) must provide additional proof of own funds, according to a percentage of the portfolio value.[463] However, like the Dodd-Frank Act, small funds are exempt from this regulatory regime if they do not use of leverage and their assets under management do not exceed euro 100 million

---

[456] *Id.* at art. 2
[457] *Id.* at art. 5§1 (a)(b).
[458] *Id.* at art 7.
[459] *Id.* at art 7§ 2(c).
[460] *Id.* at art 7§2(d).
[461] *Id.* at art 7§3(a).
[462] *Id.* at art. 8(b) & 9.
[463] *Id.* at art. 9 §§§1,2,3.

euros ($110,426 USD).[464] If a fund does not use leverage, assets under the management threshold must not exceed 500 million euros ($572,132,500 USD) and must not offer redemption rights to investors during the first five years of the initial investment in each fund.[465]

5.4 Cooperation for systemic risk

AIFMs using leverage have the obligation to report information to competent authorities.[466] The competent authority uses the provided information, in the aggregate, to monitor systemic risk.[467] The European Systemic Risk Board ("ESRB") and European Securities and Market Authority ("ESMA") are supervisory authorities and cooperation bodies for member states.[468] Similarly of course, Dodd-Frank has also created the Financial Stability Oversight Council ("FSCOC") to collect and assess information on systemic risk.[469]

5.5 Convergence of Dodd-Frank and AIFMD: Comparing their Investor Protection

Both Dodd-Frank Act and AIFMD are crisis-driven financial regulations enacted following the 2007-2008 debacle.[470] These laws embodies a concerted effort to transpose agreed upon soft

---

[464] *Id.* at art 3 §2(a)
[465] *Id.* at art 3 §2(b).
[466] AIFMD *supra* note 446 at Art. 24§ 4.
[467] *Id.* at art. 25
[468] *Id.* at art. 50 (set out cooperation conditions for member states).
[469] *See* Chapter 4 *supra* at 4.5.
[470] *See* Branson *supra* note 278. *See also* Ferran *supra* note 438.

law principles into enforceable acts, coordinate their actions, and collaborate.[471] Countries with active financial markets realize that complex financial instruments cause systemic risk that can spread outside the border of their territory.

Dodd-Frank and AIFMD converge since both attempt to rein in the perceived power (and threat) of alternative investments, especially hedge funds and private equity entities. Does this mean Dodd-Frank and AIFMD vindicate the "global convergence" movement of the late 1990s?[472] Global convergence scholars have opined that the world will emulate American style corporate governance used in large corporations. In other words, "global" corporate laws will mirror one another by transplanting the American experience.[473] The European AIFMD, enacted a year after the Dodd-Frank, bears resemblance to the American scheme.

5.5.1 Who are AIFMD's investors?

Investors are at the center of the alternative investment funds directive. As an investor focused directive, it imposes obligations on managers from the onset of the business relation. Unlike Dodd-Frank, though, which deals with sophisticated investors only, AIFMD applies to both professional and rank-and-file investors.

---

[471] *See* Chapter 3 *supra* discussing soft law, self-regulation and limits of declarations that are not enforceable in the court of law because of lack of authority.

[472] *See e.g.*, John C. Jr. Coffee, *Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1998-1999). Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001); Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Mary E. Kissane, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 621 (1997).

[473] *See* Gilson *supra* note 251 (describing how the American venture capital success can be replicated abroad).

5.5.1.1 Professional investors

A professional investor means an investor with experience, knowledge, and expertise. That investor can make her own investment decisions and assess investment risks.[474] The EU directive breaks-down professional investors in two categories: clients considered professionals and clients who, upon request, may be treated as professionals. The first category includes institutional investors (for example, credit institutions, investment firms, insurance companies, national or regional governments)[475] and large institutions with minimum size amount requirement.[476] For higher investor protection, professional investors have the option to request investment firms treat them as non-professional investors.[477]

The second category of professional investors consist of those requesting to be treated as such,[478] provided they satisfy a financial fitness test based on net worth and professional expertise.[479] The investment firm has the duty to confirm that investors possess knowledge and experience identical to those considered to be professionals.

---

[474] *Id.* at art. 4§2(ag) defines professional investor by reference to Annex II of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [hereinafter the *FINANCIAL INSTRUMENT DIRECTIVE*], available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004L0039&from=EN.

[475] *Id.* FINANCIAL INSTRUMENT DIRECTIVE *supra* at Annex II §I. (1)(3)(4).

[476] *Id.* at Annex II §I. (2): institutions must meet two of the size requirements with (i) a balance sheet total of euro 20,000,000 (ii) a net turnover of euro 40,000,000 (iii) own funds of euro 2,000,000.

[477] *Id.* at §4.

[478] *Id.* at Annex II §II.

[479] *Id.* at Annex II §II.1. (two of the three criteria must be met: (i) a client who has carried out significant transactions with average of 10 per quarter over the last four quarters, (ii) size of client portfolio exceedsneuro500,000, and (iii) a professional of the financial sector for a least one year.

5.5.1.2 Retail investors

Unlike the Dodd-Frank Act that focuses on sophisticated investors, AIFMD expressly enables non-professionals to invest in alternative investment funds.[480] Investors that do not fall within the professional investor group are *de facto* retail investors.[481] As an exception to the Directive, member states can allow funds to market to retail investors in their territory.[482] Depending on local habits, some countries authorize retail investors to invest in private equity (France, Ireland, Luxembourg, Italy) while others impose strict conditions (Germany, Netherlands), and some outright prohibit it (UK and Sweden).[483]

Recently, the U.S. has indicated it will allow retail investors to invest in private equity and other alternative funds.[484] In doing so, U.S. corporate governance seems to converge with that of other countries such as France.[485]

---

[480] *See e.g.* Jennifer Payne, *Private Equity and its Regulation in Europe* (U. OXFORD, Working Paper No. 40/2011, 2011) (describing the rise of European private equity market in which funds raised euro 69 billion and LBO transactions reached euro 140 billion in 2007 transforming private equity market to rival public market in terms of financing alternatives); Barbara Crutchfield George & Lynn Vivian Dymally, *The End of an Era of Limited Oversight: The Restructured Regulatory Landscape of Private Investment Funds through the U.S. Dodd-Frank Act and the E.U. Alternative Investment Fund Managers Directive*, 25 FLA. J. INT'L L. 207 (2013) (comparative regulatory analysis of Dodd-Frank and AIFMD provisions). *See also* Julia Khort, *Protection of private equity fund investors in the EU* (UPPSALA U., Working paper No. 2014:6, 2014) (to my knowledge, the first paper that discusses investor protection with private equity).

[481] AIFMD *supra* note 446 at art 4§(aj).

[482] *Id.* at art.43.

[483] Khort *supra* note 479 at 7.

[484] *See e.g.*, Dave Michaels, *SEC Chaiman Wants to Let More Main Street Investors In on Private Deals*, WALL ST. J: MKT.I FIN. REG. (Aug. 30, 2018, 4:54 PM), https://dealbook.nytimes.com/2014/04/25/private-equity-takes-steps-toward-wooing-smaller-investors/ (SEC considering an overhaul to allow mom and pop to invest in "private deals", specially venture capital. Investment can take form by lowering the accredited investor threshold, facilitating capital raising process. The SEC will issue a white paper in the coming months "concept release" seeking public comments). *See also* William Alden, *Private Equity Takes Steps Toward Wooing Smaller Investors*, N.Y.TIMES: DEALBOOK(Apr. 25, 2014, 4:42 PM), https://dealbook.nytimes.com/2014/04/25/private-equity-takes-steps-toward-wooing-smaller-investors/.(early plans to collect money from smaller investors).

[485] *See* Chapter 6 *infra* at 6.1.2.

5.5.2 Transparency and disclosure

The AIFMD prescribes managers of each European fund managed and marketed in the European Union to provide an annual financial report to investors upon request.[486] The annual report must contain minimum information regarding the funds (balance sheets, description of material changes, remuneration of AIFMs).[487] AIFMs may use accounting standards of the home state of the fund or a third party located where the fund has its office.[488]

Transparency is necessary also on disclosure requirements to investors and, reporting obligations to regulators. These obligations mirror those found in Dodd-Frank and its regulations.

5.5.3 Management of conflicts of interest

General operating conditions include the fiduciary duty of AIFMs whom must act at all time with honesty, skill, care, and diligence in conducting their businesses.[489] AIFMs must act in the "*best interests of AIFs or the investors of the AIFs they manage and the integrity of the market*."[490] The Directive puts a special emphasis on conflicts of interest to which references are found in scattered sections of the Directive.[491] In particular, managers must take steps to identify conflicts of interest that may arise from managing AIFs[492] This includes managing potential conflicts between AIFs, its managers, employees, funds and investors. Managing conflicts of

---

[486] *Id.* at art. 22§1.
[487] *Id.* at art 22§2.
[488] *Id.* at art 22§3.
[489] *Id.* at art. 12§1(a)
[490] *Id.* at (b)
[491] The AIFMD mentions "conflicts of interest" in four recital sections (§§ 22, 29, 43, 80, 81), in eight article sections (art. 11, 14, 15, 19, 20, 21, 23), and once in Annex II (1§b).
[492] *Id.* at art. 14§1

interest means dealing with any conflict that might "*adversely [affect] the interests of the AIFs and their investors*."[493] AIFMs must identify potential conflicts and describe them for investors.[494] However, if best efforts to prevent conflicts of interest are not sufficient, and "*risks of damage to investors' interests*" exist, managers are invited to "*clearly disclose*" the nature of the conflicts to investors.[495]

The Dodd-Frank Act deals with conflicts of interest by reference to the fiduciary duty of the Advisors Act.[496]

5.5.4 Disclosure to investors

Like Dodd-Frank, AIFMD mandates AIFMs to make available to their investors information about the funds they manage.[497] The Directive enumerates a comprehensive set of obligations managers owe investors. Requirements encompass a description of investment strategy and the objectives of the fund,[498] as well as procedures by which the fund may change its investment strategy and policies.[499] Investors may also obtain the identity of the AIFM and AIF's depositary, auditor, and any other service providers.[500]

---

[493] *Id.*
[494] *Id.*
[495] *Id.* at art 14§2.
[496] *E.g.*, Chapter 4 *supra* at 4.10.
[497] AIFMD *supra* note 446 at art 23.
[498] *Id.* at art 23§1(a).
[499] *Id.* at art 23§1(b).
[500] *Id.* at art 23§1(d).

5.5.5 Reporting to competent authorities

Basic annual reporting obligations are due to competent authorities for each European AIF. Reporting includes information on management of illiquid assets (percentage in portfolio, special arrangements),[501] risk profile, and results of stress tests.[502] AIFMs are also required, upon request by the competent authorities, to provide an annual report of each European fund managed and marketed within the European Union,[503] and a detailed list of all funds managed at the end of each quarter.[504]

AIFMs, such as private equity managers, using leverage on a substantial basis, shall make available additional information on the overall level of leverage each fund uses. Reports have to break down leverage from cash, securities, or derivative instruments, and how funds' assets are used in case of additional leverage.[505] Investors can obtain the procedure and methodology for valuation and pricing of the assets.[506] In the same vein, managers must provide a description "*of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors*."[507]

Finally, AIFMs must report to the competent authority information on leverage that can contribute to systemic risk in the financial sector.[508] Systemic risk authorities in member states, namely ESMA and the ESRB, share the information provided.[509]

---

[501] *Id.* at art 24§2(a)(b)(c)
[502] *Id.* at (e)
[503] *Id.* at art. 24§3(a)
[504] *Id.* at art. 24§3(b).
[505] *Id.* at art. 24§4.
[506] *Id.* at art 23§1(g)
[507] *Id.* at art 23§1(i).
[508] *Id.* at art 25§1.
[509] *Id.* at art 25§2

5.5.6 Valuation

AIFMD provides guidance for the valuation of funds.[510] The directive calls for an independent valuation of assets by using the net asset value per unit or share of the fund.[511] This calculation must occur at least once a year.[512] To perform its valuation, a fund may choose between an external valuer, or have the fund manager perform the task itself.[513]. Valuation done by the fund manager must demonstrate independence from portfolio management; management must also show independence with the remuneration policy, mitigate conflicts of interest, and from "*undue influence upon the employees*."[514]

5.5.7 Remuneration policy

AIFMD tries to address remuneration issues with private funds.[515] Fund managers are invited to establish "*total remuneration policies*" that includes salaries and discretionary pension benefits to senior management and risk takers. The policy must also include a clawback provision in case negative financial performance have been discovered after managers have earned their remuneration.[516]

---

[510] AIFMD *supra* note 446 at art. 19.
[511] *Id.*
[512] *Id.* at art. 19§3 (if a fund is open-ended, valuation can occur when appropriate; for a closed-ended fund, valuation can occur when capital of the fund increases or decreases).
[513] *Id.* at art. 19§4.
[514] *Id.* at art. 19§4 (b).
[515] *Id.* at Annex II.
[516] *Id.* at Annex II§1(o).

5.6 The Very Uncertain Prospect of Convergence in Corporate Governance: Major Differences between Dodd-Frank and AIFMD

The strongest rebuttal of the global convergence movement came from Professor Branson in his seminal article of 2001, in which he expresses doubt about a global convergence of American corporate governance.[517] Global convergence in corporate governance, an idea developed in elite U.S. academia, posits that American corporate governance practiced in large U.S. corporations will take over the entire world. However, other corporate law systems, such as the laws of United Kingdom, export better to foreign countries. U.K. corporate laws have proven more adaptable than American law.[518] Corporate governance scholars also put forward the unprecedented economic success of American capitalism as proof that other countries will replicate and emulate American way of corporate governance.[519] Yet, and as Professor Branson rightly pointed out, this analysis ignores other aspects of the American way of life that many countries strongly decry: not many countries comprehend the lack of social cohesion, high divorce rate, incarceration rate, and exorbitant corporate executive compensation packages in the United States.[520]

The central tenet of global convergence lies on modernization and westernization trumpeted by American values. These are rejected by less influential countries because of their

---

[517] *See generally* Douglas M. Branson, *The Very Uncertain Prospect of Global Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321 (2001).

[518] *Id.* at 336-7 (United Kingdom corporate law can adapt in less developed and newly industrializing countries because UK corporate law offers high regulation, protection of minorities and other features that allow adaptability. U.S. corporate law has not demonstrated it could export easily).

[519] *Id.* at 348. In that idea, *see* Gilson *supra* note 251 (on emulating abroad American venture capital success).

[520] Branson *supra* note 517 at 348-9. *See also* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 17 J. APPLIED CORP. FIN. 8, (2005) (refuting the assumption of financial economists that executive compensation result from arm's-length contracting between executives and board of directors. Managers exert big influence on executive compensation at the detriment of shareholders and long-term interest of the company, *Id.* at 8. Directors are conflicted to support executives because directors want to be re-elected, directors benefit from CEO's power, friendship and loyalty, *Id.* at 11; Market forces do little to influence directors to produce efficient compensation arrangements, *Id.* at 12).

absence of moral rectitude and poor values.[521] To be sure, a backlash against American values and globalization contradicts the idea that American style corporate governance will take over and replace the ones of other countries.[522] Note also the limited geographical outreach of the "global" convergence as discussion of the financial crisis occurred only within the selected club of G7/G20, that is, countries with most wealth and resources.

Finally, AIFMD struck a blow to the American style corporate governance. The Directive clearly rebuts the "*laissez-faire*" hand-off regulation the Anglo-Saxon system promotes; this shows that pro-regulation countries led by France and Germany imposed their pro-regulation views against countries with fewer regulations, such as U.K., a symbol of the American style corporate governance in Europe.[523]

5.6.1 EU Special Disclosure for Private Equity

In addition to general provisions applied to all alternative investment managers, the Directive contains special provisions for private equity managers. They must notify competent authorities in case of acquisition of companies (1), refrain from stripping assets of portfolio companies (2) and notify employees of portfolio companies or their representative in case of certain layoffs (3).

[521] *Id.* at 350

[522] *Id.* (noting the existence of two main opposition to any "global" convergence of corporate governance, particularly dominated by the U.S.: a direct backlash for a general influence and domination by U.S. and the second backlash against the concept of globalization perceived as an American led concept of domination). *See generally* JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (1st ed. 2002) (critics of international institutions such as the International Monetary Funds or World Bank, and devastating economic policies applied against poor nations).

[523] *See* Ferran *supra* note 438 at 14-15 (noting that the global financial crisis has discredited the "Anglo-American' capitalism and the other model of interventionist and tighter regulation led by France and Germany prevailed).

5.6.1.1 Notification on acquisitions of non-listed companies

The AIFMD requires AIFMs to notify competent authorities within a state, when their funds acquire a non-listed company.[524] The notification must contain the percentage of voting rights of the acquired non-listed company any time it reaches or falls below the thresholds of 10%, 20%, 30%, 50%, and 75%.[525] If the AIF acquires control of more than 50% of a company, managers must make additional disclosures.[526] Private equity managers must notify the acquired company, its shareholders, and competent national authorities.[527] When notifying the acquired company, the board of directors of the company must inform employees or their representatives.[528] Disclosure contains also the identity of the private equity managers and policies to prevent conflicts of interest.[529] Finally, the acquisition of control of a company forces fund managers to disclose their "*intentions with regards to the future business*" of the acquired company and the "*likely repercussions on employment*."[530]

Unlike Dodd-Frank, which focuses mainly on investor protection and systemic risk, AIFMD includes protection to stakeholders with mention of shareholders and employees. The problem of lack of accountability of private equity owners poses problems when equity owners do not assume responsibility for bankrupt companies. In that respect, union workers or laid-off employees would rather have the private equity firm held accountable instead of the company, the direct employer. The reason might be that by the time a plaintiff's action reaches the court system, the company already has filed for bankruptcy proceedings or ceased operations. Thus, the AIFMD

---

[524] AIFMD *supra* note 446 at art. 27.
[525] *Id.* at 27§ 1.
[526] *Id.* at 28.
[527] *Id.* at 28§ 1(a)(b)(c).
[528] *Id.* at 28§ 3.
[529] *Id.* at 28§ 2.
[530] *Id.* at 28§ 4.

imposes to the view that makes sense such as disgruntled employees may try to reach deep pocket private equity firms instead of bankrupt front-line enterprises.

Recently, in the U.S., workers have successfully used private causes of actions afforded by federal labor laws such as the Worker Adjustment and Retraining Notification Act of 1988 ("WARN Act").[531] Under the WARN Act, an employer whose plant is closing or undergoing a major layoff must give of 60 days' notice to employees' representatives and to the state.[532] A private equity firm can be held accountable to its portfolio company, and potentially to employees, if plaintiffs prove that the private equity firm and its portfolio company are in fact the same entity.[533] Courts adopt the Department of Labor ("DOL") fact sensitive regulation scheme to apply WARN Act. To determine WARN Act liability on a parent corporation, courts may consider the following five factors: 1) common ownership, 2) common directors and/or officers, 3) de facto exercises control, 4) personnel policies are from the common source, and 5) the dependency of operations. [534]

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*,[535] the issue discussed whether a private equity fund is involved in a "trade or business" for the purpose of ERISA when dealing with its portfolio company, or if it is a mere passive investor without liability for portfolio companies' withdrawal liability for underfunded pension plans?

---

[531] 29 U.S.C. §§2101 et seq.

[532] *Id.* at §2102.

[533] *See* Austen v. Catterton Partners V, LP, 709 F. Supp. 2d 168, 173, 30 I.E.R. Cas. (BNA) 1068, 159 Lab. Cas. (CCH) P 10197 (D. Conn. 2010): class action filed by former employees of Archway & Mother's Cookies, Inc., a bankrupt manufacturer owned by private equity firm Catterton Partners V LP.

[534] 20 C.F.R. § 639.3(a)(2). See also *Id.* at 173.

[535] Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Circ. 2013).

Two private equity funds, Sun Funds, held in their portfolio SBI, a struggling company. SBI filed for bankruptcy and stopped making payment to the New England Teamsters and Trucking Industry Pension Fund (TPF) as Teamsters Pension Fund. After failing to make payment, TPF requested that both SBI and Sun Funds pay withdrawal pension liability to SBI, employees' retirement fund.

Sun Funds claimed no liability for withdrawal, because the funds were not part of a joint venture or partnership and, thus, did not meet the common control requirement. In addition, the funds were not a "trade or business." On the other side, Teamsters Pension Fund claimed that Sun Funds and SBI were jointly and severally liable for SBI's withdrawal.

The First Circuit found that the private equity fund was in a "trade or business" for ERISA purposes. This could make private equity funds liable for unfunded pension obligations of their insolvent portfolio companies. Here, the court found that the funds were a trade or business because their active involvement in management provided them a direct economic benefit that an ordinary and passive investor would not obtain. The court pointed to the benefit provided by the private equity structure involving management fees as offsetting monitoring fees.

The court looked at multiple factors without finding any one dispositive. These facts included Sun Funds' activity in the management and operation of the portfolio companies as well as the general partners' decisions on hiring, terminating or compensating agents and employees of portfolio companies. Moreover, the term "employer" extends beyond a formal business entity with the effect of piercing the corporate veil.

In addition to the WARN Act, plaintiffs can litigate corporate veil piercing actions. One can pierce a corporate veil "and the individual or corporate shareholder exposed to personal or corporate liability, when a court determines that the debt in question *is not really a debt of the corporation*, but ought, in fairness, *to be viewed as a debt of the individual or corporate shareholder or shareholders."*[536]

In Delaware, the state in which most private equity firms are incorporated, plaintiffs must show the corporation through its subsidiary's alter ego intended to defraud investors and creditors.[537] As with WARN Act, veil piercing cases involve fact findings. Delaware courts use tests such as sufficient capitalization by the company, solvency, respect of corporate formalities, and if the controlling shareholder misappropriated funds.[538]

Given the low chance of success of veil piercing litigation in Delaware compared to other states, plaintiffs are often left with state law few remedies.[539]

AIFMD addresses ownership issues, so funds do not disclaim responsibility.

5.6.1.2 Protection Against Asset stripping

The provision aims at fending off negative perceptions that private equity funds unjustly dispossess of acquired companies of assets for funds gains irrespective of any harm this might cause portfolio companies. The provision against asset stripping prevents private equity funds controlling a non-listed company to dispose of their assets by mean of distribution, capital

---

[536] STEPHEN B. PRESSER, PIERCING THE COPORATE VEIL § 1:1 (2018)

[537] Manuel F. Cahan et al., *Viel Piercing/Alter Ego Determinations – How Fund Managers Can Protect Themselves*, PROSKAUER: PROSKAUER ON PRIVATE EQUITY LITIGATION (Sep. 20, 2017), https://www.privateequitylitigation.com/2017/09/veil-piercingalter-ego-determinations-how-fund-managers-can-protect-themselves/ (last visited August 6, 2018)

[538] *Id.*

[539] *See generally* Peter B. Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, (2010) (Delaware success averages 34.29% of veil piercing actions of which 21.43% success for corporate parents and 40.91% success for individual shareholders. *Id.* at 116)

reduction or during a period of 24 months.[540] Private funds must also make their best efforts to prevent such distribution.

The asset stripping provision starkly differs from Dodd-Frank which does not prescribe how funds should run most aspects of their businesses.

---

540 AIFMD *supra* note 446 at 30.

6.0 Sixth Chapter: Transposition of AIFMD in United Kingdom and France

The Alternative Investment Fund Managers Directive ("AIFMD") placed the deadline of July 22, 2013 on member states to harmonize their domestic laws with the Directive. AIFMD became effective on July 16, 2013 in the United Kingdom ("UK") and on July 27, 2013, in France.

Before AIFMD, the European private equity market had various level of regulations: some countries had regulatory frameworks in place while others did not.

Law and finance scholars remind us that legal traditions and investor protection spur financial and economic growth.[541] In commercial law, legal families are divided between two main categories: common law of English origin, and civil law of Roman origin.[542] A central tenet of law and finance claims that common law countries provide better investor protection than civil law countries. Common law countries have also better creditor rights and stronger enforcement. When a legal system protects investors, creditors and rights are enforced, this means better financial and economic development for that country, all of which common law legal tradition countries do better.

The question then arises: what does good investor protection means? Does it mean more regulation? Smarter regulation? But how much smart and why? Does it mean more disclosure, or transparency? And how is it measured?

Since AIFMD purports to unify European financial law, issues advanced by law and finance scholars appear moot. Another issue, however, arises concerning the American capitalist

[541] *See generally* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON., 1113 (1998) (Civil law breaks down further with traditions from French, German and Scandinavian laws).
[542] *Id.* at 1115.

system transplanted into Europe. In other words, the "Americanization" of the European financial system.

Venture capital and private equity are American creations other countries have copied. Countries have attempted to emulate the financial success of venture capital and private equity. As noted in previous chapters, venture capital and private equity did not have a regulatory framework before the Dodd-Frank Act of 2010. To be sure, European have engineered a financial product that blossomed under little or no regulation.

France and UK are good examples of the Americanization of European law and how the American way of finance was transplanted in Europe. American financial products do not necessarily have the American corporate style corporate governance championed by "global" convergence scholars. France, for instance, embraced private equity but chose to regulate it, while United Kingdom followed almost verbatim the American playbook.

It is fair to say that no evidence can decisively prove that common law affords better investor protection than civil law.[543] Evidence, however, suggests that investors are treated differently across legal systems, as illustrated by France and the United Kingdom.

---

[543] *See* Michael Graff, *Law and Finance: Common Law and Civil Law Countries Compared: An Empirical Critique*, 75 ECONOMICA 60 (2008) (UK).

6.1 Transposition of AIFMD in France

A legislative framework regulates private equity investments in France. Unlike United States, private equity funds and firms have evolved under French regulatory supervision and French authorities did not permit monitoring by covenants.

The *Autorité des Marchés Financiers* ("AMF") regulates financial products in France. Created in 1967 and inspired by the Securities and Exchange Commission ("SEC"), AMF is another symbol of the Americanization of French law.[544] AMF operates as the SEC operates, and its power includes rulemaking authority that legislators mandate.

6.1.1 Overview of Private Equity Regulation in France

In 2015, the private equity market invested 10.7 billion euros ($11 billion USD) 9.5 billion ($10.8 billion USD) of which were raised from investors.[545] Unlike U.S., in France, private equity has always evolved within the regulatory framework codified in the French Monetary and Financial Code and rulemaking of AMF.[546] France rejected the notion of regulation by contracts the Anglo-Saxon model favors. France authorizes two kind of private equity investors: non-professionals investors and professional investors.[547]

---

544 PIERRE-HENRI CONAC, LA RÉGULATION DES MARCHÉS BOURSIERS PAR LA COMMISSION DES OPÉRATIONS DE BOURSES (COB) ET LA *SECURITIES AND EXCHANGE COMMISSION* (SEC) [REGULATION OF STOCK EXCHANGES BY COB {AMF was formerly known as COB} AND THE SEC], 24-25 (LGDJ ed.2002) (Fr.) (French law makers came to adopt investor protection through information and disclosure, the same way adopted by American law makers).

545 *Les 10 Chiffres clés du Capital-Investissement* , FR. INV. (2018), available at http://www.franceinvest.eu/fr/Le-capital-investissement/Les-10-chiffres-cles-du-capital-investissement.html

546 French Monetary and Financial Code Art. 214-2 et seq. [hereinafter *FMFC*].

547 Christopher Clerc, *The AIFMD's Transposition in France*, *in* THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE, 837-45 (2d ed. 2015). [hereinafter *AIFMD BOOK*]

6.1.2 Private Equity for Retail Investors

Three categories of private equity funds are available to retail investors.[548] These are the retail private investment funds (*Fonds communs de placement à risques* or "FCPR")[549], retail venture capital funds (*Fonds communs de placement dans l'innovation* or "FCPI")[550], and retail local investment funds (*Fonds d'investissement de proximité* or "FIP").[551]

Fifty percent of securities in FCPRs are not listed in any stock exchange. Seventy percent of FCPIs are another type of retail investment fund, are invested in a European member state or countries with cooperation agreements with France. Finally, seventy percent of FIPs are equity invested in local small and medium size enterprise ("SMEs") located in areas that are geographically close.

6.1.3 Investor Protection for Retail Investors

French AMF must authorize retail private equity funds based on extensive information called Key Investor Information Document ("KIID").[552] In other words, a retail private equity fund cannot operate until it receives prior AMF authorization. Since France has long authorized retail

[548] *See* FMFC *supra* note 546 at Art. L. 214-27 and seq.
[549] *Id.* at Art. L. 214-28 to L214-29.
[550] *Id.* at Art. L. 214-30 to L214-30-1.
[551] *Id.* at Art. L. 214-31 to L214-32-1.
[552] AUTORITÉ DES MARCHÉS FINANCIERS ("AMF»), AMF INSTRUCTION DOC-2011-22, AUTORISATION PROCEDURES, PREPARATION OF KIID AND RULES, AND REPORTING FOR PRIVATE EQUITY FUNDS (2017) (Fr.) [Hereinafter "KIID"] (this AMF instruction applies to all three retail investors fund types: FCPR, FCPI, and FIP).

investors in that field, other countries can market private equity products pursuant to AIFMD,[553] so long as the private equity funds receive regulators' authorization.

The Key Investor Information Document contains detailed provisions for reporting to the regulator. KIID also requires private equity to provide information to their investors, the scope of which will help investors to make informed decisions. Each fund must prepare a KIID, using standard templates.[554] Information provided to investors must be short and use plain and simple language.

6.1.4 Private Equity for Professional Investors

As in the U.S. ("accredited investors"), the French regulator has provided criteria to determine which investors qualify as professional. AMF regulation defines professional Investors are those who meet certain wealth and knowledge criteria.[555] They resemble their American counterpart except for the financial threshold that appears more lenient. A professional investor is one who qualifies for French limited partnership[556] or commit 100,000 euros ($114,394 USD) or has an initial investment of euro 30,000 euros ($34,318 USD) and financial knowledge or is represented by an investment advisor.[557]

---

[553] *See* AIFMD *supra* note 446 art 43 (if retail private equity is allowed in a member state, other member state can market to the country at the same conditions than nationals. However, a member state cannot impose stricter requirements to other members).

[554] KIID *supra* note 552 at art. 25 (KIID has four parts: i) investment objectives and policy of the retail fund, ii) risk and reward profile, iii) charges presented in a standardized table, and iv) practical information).

[555] Art. 423-49 of the AMF General Regulation.

[556] French limited partnership or *sociétés de libre partenariat* was created by the Macron Act of August 6, 2015 to provide greater flexibility to manager but also legal certainty to investors.

[557] *Id.*

Professional private equity uses three type of vehicles: specialized professional funds ("*fonds professionnels spécialisés*"),[558] the professional private equity funds ("*fonds professionnels de capital investissement*"),[559] and the French limited partnership ("*sociétés de libre partenariat*").[560]

Professional private equity funds differ from retail private equity because they do not require AMF authorization; they only require a declaration in the month following their creation.[561] Professional investors have streamlined investment obligations and have fewer regulatory requirements.[562]

6.2 Transposition of AIFMD in United Kingdom

UK made extensive consultations to effectuate the Directive. Scattered regulatory manuals of the Financial Conduct Authority ("FCA") contain AIFMD regulations: the old Collective Investment Schemes Sourcebook ("COLL") and the new Investment Funds Sourcebook ("FUND"). [563] In addition, sections of the Perimeter Guidance Manual ("PERG") [564] provide interpretation guidance. [565] the UK does not have a specific regulation for private equity vehicles.

---

[558] *See* FMFC *supra* note 546 at Art. L. 214-154 to L.214-158.

[559] *Id*. at art. L. 214-159 to L.214-162.

[560] *Id*. at art. L. 214-162-1 to L.214-162-12.

[561] *See generally* AUTORITÉ DES MARCHÉS FINANCIERS ("AMF»), AMF INSTRUCTION DOC-2012-06, PROCEDURES FOR MAKING DISCLOSURES AND INTRODUCING CHANGES, PREPARATION OF A PROSPECTUS AND REPORTING FOR SPECIALISED PROFESSIONAL FUNDS AND PROFESSIONAL PRIVATE EQUITY FUNDS (2017) (Fr.).

[562] *Id.*

[563] INV. FUND SOURCEBOOK [hereinafter "FUND"] (2018)

[564] The Perimeter Guidance Manual [hereinafter *PERG*] available at https://www.handbook.fca.org.uk/handbook/PERG.pdf.

[565] *See* John R. Siena & David Eckner *The AIFMD's Transposition in the United Kingdom*, *in* AIFMD BOOK *supra* at 547.

The type of fund determines which regulation to follow. For private equity, PERG chapter 16 ("PERG 16") provides guidance on AIF definition,[566] legal forms,[567] type of funds,[568] and important factors to consider.[569] PERG also follows guidance from the European Securities and Markets Authority ("ESMA") for the implementation of the Directive.[570]

6.2.1 Overview of Private Equity Regulation in UK

In UK., private equity firms are formed using Partnership laws, similar to partnership laws in U.S. The Limited Partnerships Act 1907 governs the relationship between limited partners and general partners.[571] As its U.S. counterpart, Limited partnerships are unincorporated entities managed by a General Partner with one or more Limited Partners. Terms agreed upon by parties under the limited partnership agreement govern their relationships.

---

[566] PERG *supra* note 564 at 16.2.1 (rephrasing the definition of AIFs from art. 4.1(a) of AIFMD. The key elements of an AIF must show: (i) a collective investment undertaking (CIU), (ii) with a defined investment policy, (iii) raising capital with a goal of investing that capital for the benefit of those investors (iv) and is not an undertaking pursuant to article 5 of UCITS Directive. A, AIF must satisfy all the elements of the definition to be considered as such).

[567] *Id.* at 16.2.2 (AIFs do not have to take any particular legal form: it can be an open-ended or closed-ended, may be listed or not, can be set up under contract, trust or statute, it can be a limited partnership, a limited liability partnership, a limited liability company, an ordinary partnership, unit trust, etc.)

[568] *Id.* at 16.2.28 (providing the most common types of AIFs and listing hedge funds, commodity funds, infrastructure funds, real estate funds, private equity funds. The break-down of private equity funds include large buy-out funds, mid-cap investment funds and venture capital funds).

[569] *Id.* at 16.2.20 (pointing at the importance of a defined policy that clearly defines a AIF; particularly if there is a fixed investment policy known in advance by investors, how detailed the investment policy appears, whether investors can take legal action against managers of the AIF or the investment vehicle in case of breach of the policy, if investors consent is needed for a change to the investment policy or if investors can redeem their holdings in case of policy changes).

[570] For instance PERG 16.2.27 refers to the European Securities and Markets Authority Report on Guidelines on Key Concepts of the AIFMD [hereinafter *ESMA AIFMD key concepts guidelines*], Final ESMA/2013/600 (May 24, 2013), *https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-600_final_report_on_guidelines_on_key_concepts_of_the_aifmd_0.pdf* (reminding that ESMA AIFMD key concepts guidelines points that an undertaking must have all the definitions of an AIF summarized in PERG 16.2.1 to be considered as such).

[571] *See generally* Limited Partnerships Act 1907, available at http://www.legislation.gov.uk/ukpga/Edw7/7/24/2013-07-22

The FCA sourcebook FUND has codified European and UK laws. UK recognizes a few types of fund managers within the scope of European laws. In UK, the regulatory regime recognizes undertakings such as AIFs.[572] AIFMs are either a full-scope UK AIFM or a small AIFM, that is, to mirror Directive dispositions.

6.2.2 Full-scope UK AIFM

A full-scope UK AIFM is a fund authorized under AIFMD, and thus entirely subject to its requirements.[573] The fund can be an external AIFM or an internally managed AIF.[574] As mentioned above, PERG 16 provides further guidance on AIFMD interpretations.

6.2.3 Small AIFM

AIFMD authorizes member states to exempt funds from the full extent of the Directive provided the AIFM has assets undermanagement below a threshold of 100 million euros ($110 million USD) or euro 500 million euros (571 million USD) for AIF not using leverage.[575] A small AIFM with a registered office in the UK can either be a small authorized UK AIFM or a small registered UK AIFM.[576] The difference between the two depends on the regulatory regime applied to them and whether they can upgrade to full-scope UK AIFM.[577]

---

[572] *See* FUND *supra* note 563 at 1.3.1G.
[573] *Id.* at 1.3.4G (1).
[574] *Id*. at 1.3.4G(2)(a)(b).
[575] *See* AIFMD *supra* note 446 at art. 3.2(a)(b).
[576] FUND *supra* note 563 at 1.3.5G.
[577] A small authorized UK AIFM carries on regulated activities of managing an AIF and FCA rules can govern its activities; if the AIFM manages an authorized AIF, then COLL governs; if the AIF is unauthorized, then COLL will not rule. *See* FUND 1.3.6G. a small authorized UK AIFM has the option to become a full-scope UK AIFM. *Id.*

6.3 Investor Protection

UK transposes the entire transparency requirements of AIFMD containing annual report AIFs must provide investors and pre-investment disclosures and monitoring.[578] Thus, FUND transposes the mandatory annual report AIFs must make available to investors and regulators upon request each financial year.[579] Pre-disclosures to investors imposed by AIFMD are also transposed: for instance, obligation to provide certain information to investors before they invest and updates in case of any material changes, information related to the depositary. [580] For post-investment monitoring, FUND also transposes AIFMD dispositions related to periodic disclosures to investors, and leverage used.[581]

A small registered UK AIFM does not carry regulated activities as an AIFM for an AIF. See FUND 1.3.7G.
[578] *See* AIFMD *supra* note 446 at art. 22 and 23. *See also* Siena & Eckner *supra* note 564 at 815-16
[579] *See* FUND *supra* note 563 at 3.3.2R, 3.3.3R, 3.3.4R (transposing AIFMD article 22).
[580] *Id.* at 3.2.2R, 3.2.3R, and 3.2 (transposing AIFMD articles 23(1) through (3).
[581] *Id.* at 3.2.5R and 3.2.6R (transposing AIFMD articles 23(4)(5).

Conclusion

This dissertation has discussed investor protection in the context of private equity investment. While investor protection and private equity investment at first seem antinomic with securities laws, as investor protection regulates mainly those unable to fend for themselves, reportedly the weakest in society, securities regulation has expanded to concern the sophisticated investor.

In chapter I, the discussion centers on definitions and distinctions between private equity firms and private equity funds, then private equity funds and other common private funds. Investment managers usually structured in partnerships manage private equity funds through management companies. Private equity differs from venture capital in that private equity funds use mainly debt to acquire controlling interests in established companies. Venture capital funds take minority stakes in startup companies with growth potential. Private equity funds differ also from hedge funds. Hedge funds are unregulated mutual funds investing in public markets. Unlike private equity, hedge funds are open-ended investments, accepting new investors regularly.

Most private equity firms choose to structure their entity in the state of Delaware because that state offers flexible fiduciary duty for alternative entities.

Federal security laws regulate security interests of private equity funds. Thus, security interests of private equity funds register with the Securities and Exchange Commission and abide by the Security Act of 1933, Securities Exchange Act of 1934, Investment Act Company, and Investment Act of 1940. However, before the enactment of Dodd-Frank, private equity and private funds avoided registration with the SEC if they could find exemptions (accredited investors or private adviser exemptions).

Chapter II expresses the views that 1980s critics formulated against private equity economics. The main critique touches upon the use of debt to finance private equity deals. According to scholars and practitioners, the agency theory justifies the use of enormous debt to finance a deal. The agency theory posits that the separation of ownership and control prevents shareholders from efficiently monitoring managers in charge of day-to-day business. Loading the corporation with debt forces discipline on managers and constrains an efficient use of resources. However, during the financial crisis of 2007-2008, private equity firms used financial engineering techniques unrelated to managers' discipline; these included dividend recapitalizations, buying its own debt at a discount, or going bankrupt for a profit. I also discussed the negative perception of private equity often accused of killing jobs and communities

Many have also questioned investment returns of private equity funds since they exhibit a lower investment return than the S&P 500. A big question remains about taxing private equity return: the compensation package of private equity managers includes the 2-20 fee scheme consisting of 2% of management fees and 20% of carried interest. Management fees are ordinary income limited partners provide to general partners; these fees are taxed as ordinary income. Unlike management fees, carried interest (profit sharing between partners) is taxed as long-term capital gains rather than ordinary income. The new *Tax Cuts and Jobs Act* of 2017 law has not ended the carried interest loophole; it might, however, produce some adverse effects regarding the treatment of debt.

In chapter III, I focused on the governance of private equity prior Dodd-Frank's enactment. The rise of private equity literature parallels the rise of literature of corporate governance movement. Private equity literature centers on the relationship between private equity manager and the management of their portfolio companies. No-to-little attention was given to private equity limited partners as investors until the financial crisis of 2007-2008.

Chapter IV touches upon the regulation of private funds and debates surrounding the Dodd-Frank Act. The Private Fund Investment Advisers Registration Act of 2010 requires private funds advisers to private funds with assets under management over $150 million to register with the SEC and submit periodic reports. Exceptions to the registration requirement concern advisers of venture capital funds, advisers of private funds with less than $150 million in assets under management, as well as foreign private advisers. Reporting requirements consist of filing FORM ADV, which includes Item 7. B of Schedule D for private funds. In addition, private funds registered with the SEC must file the FORM PF that collects information to assess systemic risk.

The initial fear of costs associated with compliance did not materialize in the US, as costs did not hamper the dynamic of fundraising for private funds. In Europe, however, the Alternative Investment Fund Managers has created multiple layers of regulation that seem to outweigh its benefits. Even though no additional cost has passed to limited partners, investment managers complain about costs associated with the authorization process, marketing rules, depositary compliance, and minimum capital requirement.

Finally, in 2014, the SEC Presence Exam Initiative Program started to enforce registration and report activities concerning conflicts of interest by private equity managers. From 2014 to 2016, the SEC brought six enforcement actions against private equity managers.

In chapter V, I compare the Dodd-Frank regulation to its European counterpart the Alternative Investment Fund Managers. Dodd-Frank uses a mix of rules-based and principles-based regulations while principles regulate AIFMD. Like Dodd-Frank, AIFMD requires Alternative Investment Fund (AIF) exceeding 100 million euro ($114 million) to register and periodically report to competent authorities. AIFMD also regulates on leverage and valuation.

Unlike Dodd-Frank, civil law countries' heavy hand on regulation dominated AIFMD. While Dodd-Frank limits regulation to disclosure with the SEC, AIFMD regulates every aspect of investor protection. That is, AIFMD imposes depositaries on private equity managers, minimum capital and transparency requirements. In addition, AIFMD has inserted provisions in favor of protection of stakeholders (portfolio companies) and against asset stripping

Finally, Chapter VI illustrates how France and United Kingdom have harmonized AIFMD for private equity in their respective markets.

When I started this dissertation 2016, the Trump administration replaced the Obama administration. Questions lingered about possibly repealing Dodd-Frank to return to pre-2010 status when no regulation existed for private funds. Three years later, the discussion about repealing or replacing regulation on private funds has waned. On the contrary, it seems as if regulation of private funds holds a strong grip on the securities regulation landscape. We have seen that regulation has not affected fundraising activities in the US or in Europe. That regulation, which opposed the notion of freedom of contact, does not hold true for private funds. The government (and taxpayers) intervened with a massive bailout when the economy collapsed due to irresponsible businesspersons. Conversely, it is in the government's (and taxpayers') interest to prevent a major crisis from wreaking havoc on the economy. In these circumstances, regulation can help as long as it does not act as an impediment to the economy.

However, questions remain about what consequences US Tax law may have on the profitability of private equity managers. At the same time, in Europe, ripple effects caused by Brexit uncertainty make uncertain what effect the exit of the leader of the private equity market in Europe may have on the whole business of private equity in Europe. Also, whether the SEC will step up enforcement activities on private equity conducted in violation of fiduciary duty remains to be seen.

Appendix A Who Must File FORM PF

An investment adviser must complete and file FORM PF if it: [582] (i) is registered or required to register with the SEC; or with the CFTC as a commodity pool operator ("CPO") or with a commodity trading advisor ("CTA"), (ii) manages one or more private funds, and (iii) had at least $150 million in private fund assets under management in the latest fiscal year.[583] Thus, FORM PF excludes State-only registered advisers, those with less than $150 million in assets under management, and venture capital advisers.

In practice, most private fund advisers filing FORM PF must complete only Section 1. Only a large private fund manager – defined as any hedge fund adviser, large liquidity adviser or large private equity adviser[584]- must complete other sections of the FORM PF. These private fund advisers required to complete and file beyond Section 1 of FORM PF are:

- Large hedge fund advisers with at least $1.5 billion of assets under management, [585]
- Large liquidity fund advisers having at least $1 billion in combined money market and liquidity fund assets under management, [586] and

---

[582] *See* FORM PF *supra* note 351 at 2 (FORM PF is organized in diverse sections to tailor the risk profile of a private fund. As such, the FORM PF contains five sections: Section 1 must be filed by all private funds to this form, Section 2 is filed by large hedge fund advisers, Section 3 is filed by large liquidity fund advisers, Section 4 by large private equity advisers and Section 5 is filed by advisers who request a temporary hardship exemption).

[583] *See* at 1.

[584] *See* at 59.

[585] *See* at 2; *see also id.* at 59 (providing the definition of Large hedge fund adviser and referring to Instruction 3).

[586] *Id.* at 55, 59 (the last day of any month in the fiscal quarter immediately preceding the most recently completed fiscal quarter. Large liquidity fund adviser is defined by reference to filing Section 3 of FORM PF and refers to Instruction 3. Combined money market and liquidity fund assets under management is defined as "with respect to any adviser, the sum of (i)such adviser's *liquidity fund assets under management*; and (ii) such adviser's *regulatory assets under management* that are attributable to *money market funds* that it advises.")

- Large private equity advisers, those with at least $2 billion in private equity fund assets under management. [587]

Regulators have determined that large private funds (hedge funds, liquidity funds, and private equity funds) were the entities posing systemic risk due to the amount of assets they managed. Contrary to hedge funds and liquidity funds, for a private equity, the amount of assets under management that could represent a threat to the system was raised to 2 billion (as opposed to $1.5 and $1 billion for hedge funds and liquidity funds respectively). In other words, private equity funds appear the least risky of the riskiest assets.

As we have seen above, A central tenet of those opposing regulation of private funds posits that the cost of regulating private funds outweighs the benefit. Implementing a regulation could decrease the benefit of doing business for stakeholders (investors, advisers, and the whole economy). In other words, the direct cost of compliance could pass to investors and reduce the pool of capital available to invest. Another argument posits that investors are "big boys" and too sophisticated to need government protection.

[587] *Id.* at 59 (defining large private equity adviser by reference to filing Section 4 of FORM PF and refers to Instruction 3).

Appendix B AIFMD Requirement on Fund Managers

AIFMD imposes several requirements on fund managers. Managers must obtain an authorization from their local authority to establish their fund business and market it. Fund managers must hire a depositary for each fund they manage. In addition, managers must maintain a minimum capital requirement of euros 125,000 ($143,033 USD) or euros 300,000 ($343,279 USD) if the fund is internally managed. Moreover, AFM must submit to organization and governance requirements that include annual reports to investors, information to authorities, portfolio disclosures and asset-stripping information.

Bibliography

UNITED STATES STATUTES AND LEGISLATION

CAL GOV CODE § 7514.7 (2018) (West 2018)

Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat.1376 (2010)

Delaware Alternative Entity Acts comprise Delaware Revised Uniform Limited Partnership Act, 6 *Del. C.* §§ 17-101, et seq. (DRULPA)

Delaware Limited Liability Company Act, 6 *Del. C.* §§ 18-101, et seq. (DLLCA)

Revised Uniform Partnership Act (RUPA) § 404(b)(2) (1997)

Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat 2054 (2017)

UNITED STATES MATERIAL, HEARINGS AND PRESS RELEASE

Hedge funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony of Andrew W. Lo Prepared for the H. Comm. on Oversight and Gov't Reform, 110th Cong. 3-4 (2008)

Leaders'Statement – The Pittsburgh Summit (Sep. 24-25, 2009)

MARPLES DONALD J., CONG. RES. SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 9 (2014)

ORSZAG PETER R., CONG. BUDGET OFFICE, TAXATION OF CARRIED INTEREST 10 (2007)

Press Release, U.S. Dep't. of the Treasury, Secretary Timothy F. Geithner Written Testimony, House Financial Services Committee, Financial Regulatory Reform (Sept. 23, 2009)

PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999)

Regulating Hedge Funds and Other Private Investment Pools: Hearing Before the Subcommittee *on Securities, Insurance., and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate*, 111th. Cong. (2009)

Venture Capital Improvements Acts of 1980: Hearing on H.R. 7554 and H.R. 7491 Before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 96th Cong. (1980)

U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM -- A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009)

U.S. GOV'T ACCOUNTABILITY OFF., GAO-08-885, PRIVATE EQUITY: RECENT GROWTH *in* LEVERAGE BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION (2008)

UNITED STATES CODE (Title § Sec.)

15 §§ 681- 688

15 §§ 77a et seq.

15 § 77b (1)

15 §§ 78a et seq.

15 §§ 80a-1 et seq.

15 §§ 80b-1 et seq.

15 §§ 80b-2(a)

15 §§ 80b-3(a) (2018)

15 §§ 80b-3(b)

15 §§ 80b-3(b)(3)

15 §§ 80b-4

15 §§ 80b-4(3)

15 §§ 80b-6 (2012)

15 §§ 80b-20

26 §§ 162(a)(1) – U.S.C.A.

29 §§ 2101 et seq.

CODE OF FEDERAL REGULATION (Title § Sec.), REVENUE PROCEDURE

17 § 230.215

17 § 275.202(a)(30)–1

17 § 275.203(l)-1

17 § 275.203(l)-1(c)

17 § 275.203(m)-1

17 § 275.204–3

17 § 275.204-4

17 §275.204-4(e)

20 § 639.3(a)(2)

26 § 701 (2018)

REV. PROC. 93-27, 1993-2 C.B. 343

SECURITIES AND EXCHANGE COMMISSION RELEASES, LETTERS, AND SPEECHES

Blackstone Management Partners L.L.C. et at., Investment Advisers Act Release No. 4219 (Oct. 7, 2015)

Bowden, Andrew J., SEC & EXCH. COMM'N: OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, Spreading Sunshine in Private Equity at Private Equity International (PEI) Private Fund Compliance Forum 2014 (May 6, 2014)

COMMODITY FUTURES TRADING COMM'N, SEC & EXCH. COMM'N, RELEASE NO. IA-3308,

REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS ON FORM PF (2011)

Exemption for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. IA-3222 (Jul. 21, 2010)

Fenway Partners, LLC, Peer Lamm et. At., Investment Advisers Act Release No. 4253 (Nov. 3, 2015)

Form ADV and Investment Advisers Act Rules, Investment Advisers Release No. IA-4509 (August 25, 2016)

SEC. & EXCH. COMM'N, THIRD AMENDED AND RESTATED LIMTED LIABILITY COMPANY AGREEMENT OF FORTRESS INVESTMENT GROUP LLC (2008)

SEC. & EXCH. COMM'N, SECOND AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT OF OCH-ZIFF CAPITAL MANAGEMENT GROUP LLC (2007)

SEC. & EXCH. COMM'N, FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933: THE BLACKSTONE GROUP L.P. (2007)

JH Partners, LLC, Advisers Act Release No. 4276 (Nov. 23, 2015)

SEC AND EXCH. COMM'N, FORM ADV (2017)

SEC. & EXCH. COMM'N. LETTER TO INDUSTRY REGARDING PRESENCE EXAMS (Oct. 9, 2012)

SEC & EXCH. COMM'N, FORM PF: REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS (2014)

Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act

Release No. IA-2333 (Dec. 2, 2004)

SEC. & EXCH. COMM'N RELEASE NO. IA-3221, RULES IMPLEMENTING AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940 (2011)

Fast Answers: Hedge Funds, SEC. & EXCH. COMM'N (Dec. 4, 2012), http://www.sec.gov/answers/hedge.htm

SEC. & EXCH. COMM'N: OFFICE OF INV'R EDC. AND ADVOCACY, SEC PUB. NO. 139, INV'R BULLETIN: HEDGE FUNDS, https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf

WL Ross & Co. LLC, Investment Advisers Act Release No. 4494 (Aug. 24, 2016)

Wyatt Marc, SEC. & EXCH. COMM'N, A Look Back and a Glimpse Ahead, Speech at Private Equity International (PEI) (May 13, 2015)

CASES

Abrahamson v. Fleschner,568 F.2d 862 (2nd Cir. 1977), *cert. denied*, 436 U.S. 913 (1978)

Austen v. Catterton Partners V, LP, 709 F. Supp. 2d 168, 173, 30 I.E.R. Cas. (BNA) 1068, 159 Lab. Cas. (CCH) P 10197 (D. Conn. 2010)

David E. Watson, P.C. v. U.S., 668 F. 3d 1008 (8th Cir. 2012)

Diamond v. Commissioner, 492 F.2d 286, 290-91 (7th Cir. 1974)

Goldstein v. SEC, 451 F .3d 873 (D.C. Cir.2006)

Litwin v. Blackstone Group, L.P., 634 F.3d 706, 2011 U.S. App. LEXIS 2641, Fed. Sec. L. Rep. (CCH) P96,033 (2d Cir. N.Y. February 10, 2011) *cert. denied*, Blackstone Group, L.P. v. Litwin, 132 S. Ct. 242, 181 L. Ed. 2d 138, 2011 U.S. LEXIS 5436 (U.S., 2011)

Meinhard v. Salmon, 164 N.E. 545, 546 (1928)

O.S.C. Associates Inc. v. Commissioner, 187 F.3d 1116 (9th Cir. 1999)

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

Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1th Circ. 2013)

RESTATEMENT, PRINCIPLES, STAFF DISCUSSION

PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (AM. LAW INST., Tentative Draft No. 1 1982)

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (AM. LAW INST., 1994)

RUUD A. DE MOOIJ, TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS (2011)

EUROPEAN UNION LEGISLATION

Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012

Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174)

Directive 2009/65/EC of the European Parliament and of the Council of July 13, 2009

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

Limited Partnerships Act 1907 (UK)

The European Securities and Markets Authority Report on Guidelines on Key Concepts of the AIFMD, Final ESMA/2013/600 (May 24, 2013)

The Undertakings for Collective Investments in Transferable Securities (“UCITS”), Directive

2009/65/EC of the European Parliament and of the Council of July 13, 2009

EUROPEAN UNION REPORTS & SPEECH

Opening Speech No. 09/80 of EC Conference on Private Equity & Hedge Funds (Feb. 26, 2009)

Commission Consultation Paper on Hedge Funds, (Dec. 2008)

Report of the Committee on Economic and Monetary Affairs with Recommendations to Commission on Hedge Funds and Private Equity, at 1-8 (Sep. 11, 2008)

Report of the Committee on Legal Affairs with Recommendations to the Commission on Transparency of Institutional Investors, (July 9, 2008)

Declaration on Strengthening the Financial System, London Summit (on Apr. 2, 2009)

EUROPEAN COUNTRIES CODE OF REGULATION

Autorité Des Marchés Financiers (AMF) General Regulation, Art. 423-49

AMF, AMF Instruction Doc-2011-22, Autorisation Procedures, Preparation of KIID And Rules, And Reporting for Private Equity Funds, (2017) (Fr.)

AMF, AMF Instruction Doc-2012-06, Procedures for Making Disclosures And Introducing Changes, Preparation Of a Prospectus And Reporting For Specialised Professional Funds And Professional Private Equity Funds (2017) (Fr.)

Investment Fund Sourcebook (2018) (UK)

The Perimeter Guidance Manual [hereinafter "PERG"] (UK) (2019)

Code Monétaire et Financier [French Monetary and Financial Code "FMFC") (Fr.)

Limited Partnerships Act 1907 (UK)

BOOKS

APPELBAUM EILEEN & BATT ROSEMARY, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET. (2014)

BERLE ADOLF A. & MEANS GARDINER C., THE MODERN CORPORATION AND PRIVATE PROPERTY (1932)

BURROUGH BRYAN & HELYAR JOHN, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (20th ed. 2009)

CENDROWSKI, HARRY ET AL., PRIVATE EQUITY, HISTORY, GOVERNANCE, AND OPERATION (2d ed. 2012)

CONAC, PIERRE-HENRI, LA REGULATION DES MARCHES BOURSIERS PAR LA COMMISSION DES OPERATIONS DE BOURSES ("COB") ET LA SECURITIES AND EXCHANGE COMMISSION (SEC) (2002)

CUMMING DOUGLAS, PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION (2010)

DEMARIA CYRIL, INTRODUCTION TO PRIVATE EQUITY (1st ed. 2010)

FRIEDMAN LAWRENCE M., A HISTORY OF AMERICAN LAW (2d ed. 1985)

GOMPERS PAUL & LERNER JOSH, THE VENTURE CAPITAL CYCLE (2d ed. 1999)

KOSMAN JOSH, THE BUYOUT OF AMERICA: HOW PRIVATE EQUITY WILL CAUSE THE NEXT GREAT CRISIS (Portfolio ed. 2009)

Lehn Kenneth, *A View from Washington on Leveraged Buyouts, in* THE HIGH YIELD DEBT MARKET: INVESTMENT PERFORMANCE AND ECONOMIC IMPACT (Edward I. Altman ed. 1998)

PINTO ARTHUR R. & BRANSON DOUGLAS M., UNDERSTANDING CORPORATE LAW (4th ed. 2013)

PLUMMER JAMES L., QED REPORT ON VENTURE CAPITAL FINANCIAL ANALYSIS 11-13 (1987)

PRESSER STEPHEN B., PIERCING THE CORPORATE VEIL (2018)

STIGLITZ JOSEPH E., GLOBALIZATION AND ITS DISCONTENTS (1st ed. 2002)

ZETZSCHE, DIRK A. ED., THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (2d ed 2015)

REVUES, REPORTS, AND JOURNALS

AKERLOF, GEORGE A. & ROMER PAUL M., LOOTING: THE ECONOMIC UNDERWORLD OF BANKRUPTCY FOR PROFIT 1-74 (1993)

Allen John Pearson, *Rules- or Principles-Based Regulation - Factors for Choosing the Best Language Strategy*, 56 CAN. BUS. L.J. 375 (2015)

Anand Anita I., *Is Systemic Risk Relevant to Securities Regulation*, 60 U. TORONTO L.J. 941, 942 (2010)

APPELBAUM EILEEN & BATT ROSEMARY, FEES FEES, AND MORE FEES: HOW PRIVATE EQUITY ABUSES ITS LIMITED PARTNERS AND U.S. TAXPAYERS (2016)

Ayres Ian & Gertner Robert, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989)

Bebchuk Lucian Arye, Foreword: *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989)

Bebchuk Lucian A. & Fried Jesse M., *Pay Without Performance: Overview of the Issues*, 17 J. APPLIED CORP. FIN. 8 (2005)

Branson Douglas M.

Assault on Another Citadel: Elimination of Fiduciary Standards Applicable to Corporate Officers and Directors, 57 FORDHAM L. REV.375, (1988).

Teaching Comparative Corporate Governance: The Significance of Soft Law and International Institutions, 34 GA. L. REV. 669 (2000)

The Social Responsibility of Large Multinational Corporations, 33 TRANSACTIONAL LAW. 122, 21(2002)

Proposals for Corporate Governance Reform: Six Decades of Ineptitude and Counting, 48 WAKE FOREST L. REV. 673 (2013)

The Very Uncertain Prospect of Global Convergence in Corporate Governance, 34 CORNELL INT'L L.J. 321 (2001)

The Glass-Steagall Act, the Volker Rule, Limits on Proprietary Trading, and Sustainability Beyond Crises-Driven Regulation – in Initiatives for Sustainable Financial Regulation: Article: A Return to Old-Time Religion? 11 U. ST. THOMAS L.J. 359

Badertscher Brad & at., *The Impact of Private Equity Ownership on Corporate Tax Avoidance* (HARV. BUS. SCH., Working Paper No. 10-004, 2009)

Bratton William W., Enron, *Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003)

Bevilacqua Jonathan, Comments, *Convergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity*, 54 BUFF. L. REV. (2006)

Birdthistle William A. & Henderson M. Todd, *One Hat Too Many - Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. (2009)

Black Kenneth J., *Private Equity & Private Suits: Using 10B-5 Antifraud Suits to Discipline a Transforming Industry*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 271 (2013)

Boucly Quentin et al., *Growth LBOs*, 102 J. FIN. ECON., 432 (2011)

Cary William L., *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974)

Coase Ronald, *The Nature of the Firm*, 4 ECONOMICA 386 (1937)

Coffee John C. Jr.,

Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 NW. U. L. REV. 641 (1998-1999)

Law and the Market: The Impact of Enforcement, 156 U. PA. L. REV. 229 (2007)

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

Cunningham Lawrence A., *A Prescription to Retire the Rhetoric of Principles-Based Systems in Corporate Law; Securities Regulation, and Accounting*, 60 VAND. L. REV. 1409 (2007)

Davis et al., *Private Equity and Employment* (Nat'l Bureau of Econ. Research, Working Paper No. 17399, 2011).

DE MOOIJ RUUD A., TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, SOLUTIONS (2011)

Diver Colin S., *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983)

FENN, GEORGE W. ET AL., THE ECONOMICS OF THE PRIVATE EQUITY MARKET, FED. RES. BULL. 28 (Dec. 1995)

Ferran Eilis & Alexander Kern, *Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board*, 4 (U. CAMBRIDGE FAC. L. LEGAL STUD. RES. PAPER SERIES, Working Paper No. 36/2011, 2011) (UK)

Ferran Elis

Crisis-Driven EU Financial Regulatory Reform, U. CAMBRIDGE FAC. L. LEGAL STUD. RES. PAPER SERIES, Working Paper No. 6/2012, (2012) (UK)

The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of The EU's Regulatory Response to the Financial Crisis (U. CAMBRIDGE & ECGI, Working Paper No. 10/2011 and 176/2011, 2011) (U.K.)

Fleischer Victor

Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y. L. REV. 1-59 (2008)

The Missing Preferred Return, 31 J. CORP. L. 77, 87 (2005)

Taxing Blackstone, Illinois Law and Economics Research Papers Series, Research Paper No. LE-036 (2007)

Fletcher C. Edward, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1083 (1988)

Ford Cristie, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L. J. 257, 264 (2010)

Gilson Ronald J.

Engineering a Venture Capital Market: Lessons from the American Experience, 55 STAN. L. REV.1067, 1071 (2003).

Globalizing Corporate Governance: Convergence of Form or Function, 49 AM. J. COMP. L. 329 (2001)

Graff, Michael, *Law and Finance: Common Law and Civil Law Countries Compared: An Empirical Critique*, 75 ECONOMICA 60 (2008) (UK)

Hansmann Henry & Kraakman Reinier, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001)

Harris Lee, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259 (2010)

Jensen Michael

Agency and Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 AM. ECON. REV. 323-329 (1986)

Eclipse of the Public Corporation, HARV. BUS. R. (1989)

Jensen Michael C. & Meckling William H., *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON., 305, 305-360 (1976)

Wulf A. Kaal, *Private Fund Disclosures under the Dodd-Frank Act*, 9 BROOK. J. CORP. FIN. & COM. L. 428 (2015)

Kaplan Steven N. & Stromberg Per, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP., 121, 121-46 (2009)

Kaplan Steve & Schoar Antoinette, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FIN., 1791, 1791-1823 (2005)

Karmel Roberta S., *The Challenge of Fiduciary Regulation: The Investment Advisers Act after Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405 (2016)

Khort Julia, *Protection of private equity fund investors in the EU* (UPPSALA U., Working paper No. 2014:6, 2014)

Kissane Mary E., *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'l & COMP. L. 621 (1997)

Klausner Michael, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006)

La Porta, Rafael et al., *Law and Finance*, 106 J. POL. ECON., 1113 (1998)

Lehn Kenneth et al., *The Economics of Leveraged Takeovers*, 65 U. L. Q. 163 (1987)

Lerner Josh, Schoar Antoinette, & Wong Wan, *Smart Institutions, Foolish Choices?: The Limited*

Partner Performance Puzzle, 62 J. FIN., 731-764 (2007)

Litvak Kate, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 218 (2009)

Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992)

Manesh Mohsen, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 469 (2009)

Martin Cary, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST**.** JOHN'S L. REV. 87, 95 (2012)

Metrick Andrew & Yasuda Ayako, *The Economics of Private Equity Funds*, 23 REV. FIN.STUD., 2303, 2303-2341, (2010**)**

Oguss Greg, Notes and Comments, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW U.L REV. 285 (2012)

Oh Peter B., *Veil-Piercing*, 89 TEX. L. REV. 81, (2010)

Ordower Henry, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 312-3 (2010)

Park James J., *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007)

Payne Jennifer, *Private Equity and its Regulation in Europe* (U. OXFORD, Working Paper No. 40/2011, 2011)

Phalippou Ludovic

Beware of venturing into Private equity, 23 J. ECON. PERSP., 147, 147-166 (2009)

The Hazards of Using IRR to measure Performance: The Case of Private Equity, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111796 (March. 27, 2009)

Phalippou Ludovic & Gottschalg Oliver, *The Performance of Private Equity Funds*, 22 REV. FIN.

STUD., 1747-1776 (2009)

Polsky Gregg D.

A Compendium of Private Equity Tax Games 2 (UNC Legal Studies Research Paper No. 2524593, 2014)

Private Equity Management Fee Conversions (Fla. Sate Univ. College of Law, LAW, BUS & Econ. Working Paper No. 08-18, 2008),

The Untold story of Sun Capital: Disguised Dividends, 556 TAX NOTES (Feb 3, 2014)

Ribstein Larry E.,

Private Ordering and the Securities Laws: The Case of General Partnerships, 42 CASE W. RES. L. REV. 1, 5 (1992)

Form and Substance in the Definition of a Security: The Case of Limited Liability Companies, 51 WASH. & LEE L. REV. 807, 810 (1994)

Rosenberg David, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 367 (2002)

Sahlman William A., *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON., 473, (1990)

Sanchirico Chris William, *The Tax Advantage to Paying Private Equity Fund Managers with Profits Shares: What Is It? Why Is It Bad?* 75 U. CHI. L. REV, 1075 (2008)

Schwarcz Steven L.

Private Ordering, 97 NW. U. L. REV. 319 (2002)

Systemic Risk, 97 GEO. L. J. 193, 205-6 (2008)

Sekhon Vijay, *Can the Rich Fend for Themselves: Inconsistent Treatment of Wealthy Investors* *under the Private Fund Investment Advisers Registration Act of 2010*, 7 HASTINGS BUS. L.J. 1, 6 (2011)

Shobe Jarrod, *Misaligned Interests in Private Equity*, 2016 BYU L. REV. 1435, 1440 (2016)

Spindler James C., *How Private is Private Equity, and at What Cost?* 76 U. CHI L. REV 311, 320 (2009)

Sunstein Cass R., *Problems with Rules*, 83 CALIF. L. REV. 953 (1995)

Welle Elaine A., *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 520-21 (1999)

INDUSTRY PUBLICATIONS

Dowd Kevin, *2007 vs. 2-17: A US PE Fundraising Throwdown*, PITCHBOOK NEWS & ANALYSIS (Jul. 19, 2017)

Guidelines for Responsible Investing, AM. INV. COUNCIL (2009), https://www.investmentcouncil.org/guidelines-for-responsible-investing/ (last visited Dec. 17, 2019)

ILPA Publishes Landmark Guidance On Private Equity Fee Reporting, INSTITUTIONAL LTD. PARTNERS ASS'N (Jan. 29, 2016)

IILPA Fee Reporting Template, INSTITUTIONAL LTD. PARTNERS ASS'N, (Oct. 2016)

What they are saying about Private Equity, AM. INV. COUNCIL (2017)

Evaluation of the Alternative Investment Fund Managers Directive, EUR. ECON. (2017)

Les 10 Chiffres clés du Capital-Investissement, FR. INV., (2018)

Q4 2018 Private Capital Fundraising Update, PREQIN (Jul. 1, 2019)

Private Equity International 2018 Fundraising Report Downloadable Data, PRIV. EQUITY INT'L (Jan. 16, 2019)

Private Equity Principles, INSTITUTIONAL LTD. PARTNERS ASS'N (Jan. 2011)

Private Equity Conflicts of Interest - Consultation Report, INT'L ORG. SEC. COMMISSIONS (2009)

Pension Benefit Guaranty Corporation- Delphi FAQs – General, PENSION BENEFIT GUARANTY CORP., https://www.pbgc.gov/about/faq (last visited Dec. 17, 2019)

Venture Monitor 4Q 2018, PITCHBOOK & NAT'L VENTURE CAP. ASS'N (Jan. 9, 2019)

The Top Five Private Equity Firms, PRIV. EQUITY INT'L. (last visited Apr. 12, 2018)

Cahan Manuel F. et al., Veil Piercing/Alter Ego Determinations – How Fund Managers Can Protect Themselves, PROSKAUER (Sep. 20, 2017)

Behind The Buyouts: Inside The World Of Private Equity, SERV. EMPS. INT'L. UNION (2007)

Shapiro Robert J. & Pham Nam D., *American jobs and the impact of private equity transactions*, SONECON (2008)

ONLINE NEWSPAPERS

Alden William,

Private Equity Takes Steps Toward Wooing Smaller Investors, N.Y. TIMES: DEALBOOK (Apr. 25, 2014, 4:42 PM)

Tax Expert Sees Abuse in a Stream of Private Equity Fees, N.Y. TIMES DEALBOOK (Feb. 3, 2014)

Beltran Luisa, *Moody's: PE Firms Took Out at Least 35 Dividend Recaps This year, Worth More than $11 bln*, PE HUB (Jul. 12, 2012),

Financial Times Editorial Board. 2016, *A Tax Break that Wall Street Cannot Defend*, FIN. TIMES, (Jan. 4, 2016)

Fleischer Victor, *How a Carried Interest Tax Could Raise $180 Billion*, N.Y. TIMES: DEALBOOK

(June 5, 2015)

Fitzgerald Patrick, *PBGC Will Take Over Hawker Pensions*, WALL ST. J: BUS. (Dec. 27, 2012)

Gadiesh Orit et al., *When Private Equity Goes Public*, FORBES (Jun 15, 2007)

Girouard John E., *The Sophisticated Investor Farce*, FORBES.COM (Mar. 24, 2009)

Goldfarb Jeffrey, *Ten Years After Going Public, Blackstone Stock Hasn't Budged*, N.Y. TIMES: DEALBOOK (June 22, 2017)

Kapur Sahil et al., *How the Carried Interest Break Survived the Tax Bill*, BLOOMBERG: POL. (Dec 22, 2017)

Lattman Peter, *Judge Orders Auction in a Rebuke to Delphi Plan*, WALL ST. J.: L. (June 12, 2009)

Lubben Stephen J., *Debt-Exchange Offers Get a New Lease on Life*, N.Y. TIMES: DEALBOOK / BUS. & POL'Y (Jan. 20, 2017)

Lykken Alex, *Understanding Dividend Recaps*, PITCHBOOK (Jan. 20, 2014)

Maremont, Mark & Spector, Mike, *Blackstone to Curb Controversial Fee Practice*, WALL ST. J. (Oct. 7, 2014)

Mason Jeff & Bull Alister, *Obama camp targets Romney firm as job-killing "vampire,"* REUTERS (May 14, 2012)

Maremont, Mark & Spector, Mike, *Blackstone to Curb Controversial Fee Practice*, WALL ST. J.(Oct. 7, 2014)

Michaels Dave, *SEC Chairman Wants to Let More Main Street Investors In on Private Deals*, WALL ST. J.: MKT.I FIN. REG. (Aug. 30, 2018, 4:54 PM)

Morgenson, Gretchen, *The Deal's Done. But Not the Fees*, N.Y. TIMES (May 24. 2014)

Naidech Scott W., *Private Equity Fund Formation*, PRAC. L. CO. (2011)

Ng Serena, *Firms move to scoop up own debt*, WALL ST. J. (Aug. 24, 2009)

Palast Greg, *Mitt Romney's Bailout Bonanza*, NATION (Nov. 5, 2012)

Primack Dan, *Private Equity's New Tax Problem*, CNN MONEY (Feb. 3, 2014)

Raju Srinivas M. & Remming, Jillian G. *Fiduciary Duties in the Alternative Entity Context,* AM. BAR ASS'N (Aug. 16, 2012)

Rufus Koren James, *Calpers' Private Equity Fees Under the Microscope*, L.A TIMES (Jul. 8, 2016)

Smith, Yves, *NY Times Gretchen Morgenson Exposes More Layers of Private Equity Fee Chicanery*, NAKED CAPITALISM, (Oct. 19, 2014)

Stothard Michael & McCrum Dan, *Private equity eyes dividend 'recaps'*, FIN. TIMES (Oct. 23, 2012),

The UAW'S Defined Benefactor, WALL ST. J.: REV. & OUTLOOK, (Jul. 25, 2009)

The Locusts: Privaty Equity Firms Strip Mine German Firms, SPIEGEL ONLINE (Dec. 22, 2006**,** 07:16 PM)

Vardi Nathan, *The Obama-Romney War Over Private Equity Is Just Beginning*, FORBES (June 8, 2012)

Zucherman Gregory, *For Private-Equity Clients, Worries Over Public Listing*, WALL ST. J. (June 25, 2011)