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ARTICLES

PROTECTION OF PRIVATE EQUITY INVESTORS UNDER THE DODD-FRANK ACT

Doris Toyou

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ARTICLES

PROTECTION OF PRIVATE EQUITY INVESTORS UNDER THE DODD-FRANK ACT

Doris Toyou[*]

ABSTRACT

In securities law, investor protection means that an issuer of securities, here partnership interests for private equity, must register with the Securities and Exchange Commission ("SEC") and be subject to disclosure, reporting, record-keeping compliance and examination programs. 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 the business of private equity is conducted. 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 laws 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. This Article offers to

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expand transparency by additional public disclosure of investment returns, fees, and managers' income.

For other policy issues unrelated to the protection of investors, that is, jobs or tax, Title IV of the Dodd-Frank Act does not offer the appropriate setting. Applying or enacting legislation concerning tax, labor or bankruptcy laws can better curve the controversial practices of private equity firms.

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DOI 10.5195/jlc.2019.159 ● http://jlc.law.pitt.edu

TABLE OF CONTENTS

Introduction 118
I. Private Equity and Private Funds 120
  A. Private Equity and Venture Capital 123
  B. Private Equity and Hedge Funds 125
  C. Structure of Private Equity Funds and Limited Investor Protection 126
  D. The Sophisticated Investor Dilemma 129
II. Policy Issues with Private Equity Economics 133
  A. The Use of Debt (versus Equity) to Finance the Acquisition of Companies 133
  B. Private Equity and the Labor Market 137
  C. Private Equity Fees 139
  D. Taxing Carried Interest 141
III. The Regulation of Private Equity by the Dodd-Frank Act 145
  A. Arguments Opposing Regulation of Private Equity 145
  B. Rationale for Private Equity Regulation 148
  C. The Private Fund Investment Advisers Registration Act of 2010 150
    1. The Exception: Some Private Funds are Exempt from Registration 151
    2. The Venture Capital Fund Adviser Exemption 152
    3. The Private Fund Adviser Exemption 154
    4. The Foreign Private Adviser Exemption 155
  D. Private Funds Reporting Requirements 156
    1. Private Fund Reporting for Investors: Item 7.B and Section 7.B(1) of Schedule D 157
    2. Private Equity Disclosure for the Assessment of Systemic Risk 158
    3. Who Must File Form PF 159
IV. The SEC Presence Exam Initiative Program and Enforcement Activities 160
  A. Non-Sharing Monitoring Fees 161
  B. Shifting Expenses 162
  C. The Use of Consultants to Avoid Sharing Fees 163
Conclusion 163

Vol. 37, No. 2 (2019) ● ISSN: 2164-7984 (online) ● ISSN 0733-2491 (print)
DOI 10.5195/jlc.2019.159 ● http://jlc.law.pitt.edu

INTRODUCTION

Although no evidence was put forth that private equity funds represented a threat to the financial system or the entire economy, Treasury Secretary Timothy Geithner described the economic situation prevailing in September 2008 in the following way:

> 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]

In 2009, confronted with the worst financial crisis since the Great Depression, the new Obama administration and Congress decided to regulate advisers to private equity, venture capital and hedge funds ("private funds"). The choice to regulate private funds exhibited a new regulatory approach to the financial system, the goal of which was to assess any risk to the markets and understand how all its players interacted. Thus, financial players, even those dealing with sophisticated investors, would conduct their business within the regulatory framework of the securities laws.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter "Dodd-Frank," "Dodd-Frank Act" or the "Act"),[2] enacted in 2010, regulates, for the first-time, advisers to private equity funds. It closed the regulation gap between retail investors and sophisticated investors as all investment advisers, with some exceptions, were required to register with regulators. By doing this, the Act realized a regulation overhaul long in the making.

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

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Title IV of Dodd-Frank, entitled "Regulation of Advisers to Hedge Funds and Others," contains most of the sections that regulate advisers to hedge funds, private equity, and venture capital funds. With only fourteen sections, Title IV's regulation relies mostly on the rulemaking authority of the Securities and Exchange Commission (hereafter "SEC" or "Commission").

Title IV of the Dodd-Frank Act amends the Investment Advisers Act of 1940 by adding a "Private Fund Investment Advisers Registration Act." The scope of the regulation focuses on the "public interest," the "protection of investors," and the "assessment of systemic risk," with these words appearing in Title IV and repeated throughout the Act.

Critics of this regulation argued that systemic risk—risk associated with the interconnection of financial systems[3]—was not caused by private equity (or private funds) but was the result of poor regulatory enforcement on financial institutions. Conversely, those in favor of regulating private equity—and private funds—viewed the Dodd-Frank Act as an important step forward to more transparency for complex financial investments (delivering protection for investors).[4]

In Part I, this Article first provides a brief background on private equity funds, their organization and structure, and how they compare with other common private funds (venture capital and hedge funds). Part II highlights policy issues specific to private equity and discusses the use of debt, jobs,

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[3] *See, e.g.*, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Written Testimony of Andrew W. Lo Prepared for the H. Comm. on Oversight on Gov't Reform*, 110th Cong. 2–5 (2008) (Statement of Andrew Lo, Harris & Harris Group Professor, MIT Sloan School of Management.), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217 (Explaining systemic risk and noting that financial markets do not need more regulation but more effective regulation. This implies that hedge funds and other intermediaries part of the "shadow banking" system to provide more transparency on information related to assets under management, leverage, liquidity, counterparties, and their holdings. The shadow banking system "*consisting of investment banks, hedge funds, mutual funds, insurance companies, pension funds, endowments and foundations, and various broker/dealers and related intermediaries*.").

[4] *See generally* Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87, 101 (2012) (Arguing the focus on systemic risk by Dodd-Frank has eclipsed the need for investor protection, even and particularly for sophisticated investors dealing with hedge funds.); *see also* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 205–06 (2008) (An important goal of securities laws is regulating financial risk, which requires efficiency in capital markets. Thus, regulating systemic risk is part of that same goal.).

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fees and the controversy on tax laws. Part III describes the Dodd-Frank Act and in Part IV, this Article concludes with the enforcement activities made by the Securities and Exchange Commission and offers steps to achieve better disclosures for investors.

I. 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 Oreo, Ritz Crackers and Winston cigarettes.[5] Private equity acquisitions of companies are often associated with greed, lay-offs, asset stripping and bankruptcy, frequently resulting from leveraged buy-out debts.[6] Buyout activities, which are a segment of private equity, tend to overshadow other positive impact private equity financing can generate.[7]

Private equity can be defined as capital raised by private sources rather than public fundraising to finance the acquisition of companies on behalf of

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[5] *See generally* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 308, 515, 537, 542 (20th ed. 2009) (Relating the $25 billion RJR Nabisco deal, the biggest LBO at the time.). 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 1980s the investment bank Drexel Burnham Lambert ("Drexel"), under the leadership of Michael Milken and Leon Black spurred the 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. 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. 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.

[6] *Id.*

[7] CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY xviii, 15 (1st ed. 2010) (A fundamental difference between U.S. and Europe is the use of private equity to describe buyout transactions. Europeans tend to differentiate buyout with other private equity type capital increases that include venture capital and expansion capital, turn-around or other strategies.).

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qualified investors.[8] Private equity includes several subparts of financing such as venture capital, growth equity, buyout or distressed funds.[9] Private equity and venture capital are often used interchangeably.[10] However, private equity today describes funds using mainly debt to acquire controlling interest in stable companies, while venture capital funds invest in early stage, mid-stage, and late capital and finance acquisitions with equity. As we will see, the Dodd-Frank Act[11] makes a clear distinction between venture capital and private equity and provides two separate regulatory regimes.

Investment managers, also known as sponsors, raise capital with investors to create one or several private equity funds. Fund managers manage private equity funds typically structured as General Partners or other managing entities (collectively designed "GP" or "GPs"). GPs act on behalf of the investment fund.[12] The management company, affiliated with the GP, provides investment advisory services to the fund. The investment advisory, composed of founders and investment professionals of the private equity firm, provides daily operational activities to the fund (valuation of investment opportunities, administration).[13]

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[8] *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.).

[9] *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 a steep discount.); s*ee also* DEMARIA, *supra* note 7, at 78 (Angel investors, usually high net worth individuals, provide seed capital for small businesses before venture capital intervene.).

[10] *See* PAUL A. GOMPERS & 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. 2015) (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.).

[11] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 2 (Title IV: Regulation of Advisers to Hedge Funds and Others).

[12] NAIDECH, *supra* note 9, at 2.

[13] *Id.*

Private equity firms through their affiliates, usually GPs or managers, manage private equity funds. Thus, private equity firms are distinct entities from private equity funds.[14] Private equity funds are closed-ended investment vehicles that limit fundraising of investors' capital commitment for a period spanning from twelve to eighteen months.[15] After this fundraising period, the fund does not accept additional investor commitments.[16] The fund itself pools capital and has no other operations.

Private equity funds are structured as limited partnerships (LPs) or limited liability companies (LLCs), which 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 individual partner level.[17] Pass-through structures avoid double taxation (corporate and individual).[18] 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 their liability exists only for their capital contribution and they have no personal liability for the fund's debt.[19]

Since 2007, in order to raise additional cash from traditional venues, three large private equity firms have set a new trend by listing part of their business in the public stock exchange. The firms are Fortress Investment Group, Och-Ziff, and Blackstone.[20] Private equity firms go public in two

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

[15] NAIDECH, *supra* note 9, at 2.

[16] *Id.*

[17] 26 U.S.C. § 701 (2018).

[18] *Id.*

[19] *Id.*

[20] *See* SEC. & EXCH. COMM'N, THIRD AMENDED AND RESTATED LIMITED 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 (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 (June 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

different ways: either by offering a piece of the management company to the public, or by floating shares in the private equity fund. The public can buy and sell shares of private equity firms in the public market.[21] Unlike most companies traded on a stock exchange and organized as corporations, private equity firms list their shares 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 have to conform with fiduciary duties whereas public nonincorporated companies (at least in Delaware) can waive these duties.[22] The structures of Fortress and Och-Ziff resemble a public corporation while Blackstone is closer to a privately-held company.[23]

A. Private Equity and Venture Capital

Venture capital and private equity are sometimes used interchangeably to describe a pool of funds that are utilized to invest in early stage versus those established companies.[24] Technically, venture capital monies go towards early, mid- or late-stage businesses without a significant track record. This presents risk, but also potential for high rewards.[25] Successful companies having benefited from venture capital investing include Apple Computer, Intel, Federal Express, Microsoft, Sun Microsystems, Compaq, and many others.[26] Like private equity, venture capital firms employ professionally managed firms taking equity positions in private companies at

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Zucherman, *For Private-Equity Clients, Worries Over Public Listing*, WALL ST. J. (June 25, 2011), https://www.wsj.com/articles/SB10001424052702304231204576406052688509710 (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-budged.html (Blackstone's share trades at the same $31 per share ten years after the initial public offering. The result seems modest and does not outperform the S&P.).

[21] 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 have democratized private equity.).

[22] *Id.* at 470.

[23] *Id.* at 486.

[24] *See* GOMPERS & LERNER, *supra* note 10.

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

[26] *Id.* at 482 (These companies have received early stage venture capital money, then went public.).

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different stages of their development.[27] Both venture capital and private equity serve as intermediaries acting on behalf of investors.

Venture capital and private equity typically structure 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).[28] Venture capital and private equity managers also use the two twenty compensation (two for management fees and twenty for profits or value creation). However, unlike private equity, venture capitalists do not charge their portfolio companies with monitoring or other transaction fees.

Private equity and venture capital also maintain significant differences. Venture capital and private equity invest in different types of companies: venture capitalists invest in companies that do not have discretionary cash to back up the service of debt service and its objective aims at value creation.[29] In particular, venture capitalists invest in startups, and they do not use long-term leverage or short-term funding to finance their portfolio companies. They use cash in return for an equity share of the company's stock. There is no use of leverage because startups cannot bear debt interest payments and often cannot present enough collateral.[30] The risk generated by venture capital is entrepreneurial and technological, with a failure of approximatively one-third of companies in a portfolio.[31] In contrast, private equity typically invests in companies with solid cash flow, whose cash flow can sustain the payment of debt service. Here, the objective considers streamlining a company's operations for better efficiency and profitability.[32]

Finally, the venture capital industry provides information to the SEC, as limited partnerships are securities (as defined by the Securities Act of 1933)[33]

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[27] *Id.*; *see also* JAMES L. PLUMMER, QED REPORT ON VENTURE CAPITAL FINANCIAL ANALYSIS 11–12 (1987) (Explaining that stages of venture capital include seed investments, start up, first, second, third, fourth stages and liquidity.).

[28] Sahlman, *supra* note 25, at 517.

[29] *See id.*

[30] *Regulating Hedge Funds and Other Private Inv. Pools: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the Comm. on Banking, Hous., and Urban Affairs*, 111th. Cong. 63 (2009) (Statement of Trevor R. Loy, Founder and General Partner, Flywheel Ventures.) [hereinafter *Regulating Hedge Funds and Other Private Investment Hearing*].

[31] *Id. See also* Sahlman, *supra* note 25, at 482 (some failures of venture capital investments include Ovation Technologies, Osborne Computer, Ztel, and Gavalian).

[32] *Id.*

[33] Securities Act of 1933, 15 U.S.C. § 77b(1) (2018).

and fund offerings must either be registered under that act or find an exemption.[34] Funds usually rely on the private sale offerings and Rule 506 that provides an exemption from registering securities with the SEC.[35] Rule 506 imposes filing Form D—a disclosure document with information about the fund, its advisers, its investors, and securities sold.[36]

B. Private Equity and Hedge Funds

Hedge funds are often compared to unregulated mutual funds.[37] They are blind pools seeking positive return. They differ from private equity with different features. Hedge funds have immediate funds in cash, contrary to private equity funds, which receive capital contributions and commitments from their investors.[38] Unlike private equity, hedge funds accept new investors into the fund and existing investors can participate in the fund periodically.[39] Also, unlike private equity, which distributes proceeds to investors after liquidation of an investment, hedge funds usually sell assets and reinvest the funds periodically.[40] While private equity investors usually cannot sell their partnership interest until a period of time has concluded (up to ten years), hedge fund investors may redeem their interest after a "lock-up" period of one year or more.[41] Further, hedge funds are private investment funds for the wealthy that require minimum investment amounts, many to reach hundreds of thousands or more. Mutual funds are public investment funds generally open to all, or most investors.

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[34] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 65.

[35] 15 U.S.C. § 77d(2) (1982).

[36] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 65–66 (Venture capital industry has always opposed regulation because they believe they are already regulated with disclosure made to the SEC and subjecting the venture capital industry to additional SEC registration could damage its activity. The argument is that the economic contribution by venture capital cannot justify the need for more regulation that "could hamper venture activity.").

[37] *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 does provide all the protections to investors (such as disclosure).).

[38] NAIDECH, *supra* note 9, at 18 (Typically, an investor subscribes to capital commitment to a fund. Payment do not occur at once but in installments until fully subscribed.).

[39] *Id.*

[40] *Id.*

[41] SEC. & EXCH. COMM'N: OFFICE OF INV'R EDUC. AND ADVOCACY, SEC PUB. NO. 139, INV'R BULLETIN: HEDGE FUNDS 2 (2012).

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Private equity and hedge funds sometimes converge as both seek to expand their activities beyond their original scope. For instance, private equity buyout managers now invest in debt and financial instruments such as options, credit instruments or derivatives[42]—a business once conducted by hedge fund managers. Conversely, hedge fund managers can invest in private funds and compete for the same business as private equity firms.[43]

C. Structure of Private Equity Funds and Limited Investor Protection

Private equity funds structure as LPs and LLCs and form mostly in the state of Delaware. Delaware statutes[44] have fiduciary rules that codify common law fiduciary duties (that is, the duty of care, the duty of loyalty, and the obligation of fair dealing).[45] In Delaware, fiduciary duties are default

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[42] 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 buyout firms like Blackstone, Apollo, KKR, or Carlyle, raise new funds specialized in alternative assets.).

[43] *See* Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity*, 54 BUFF. L. REV. 251, 262–63 (2006) (Noting that hedge funds take active role in companies' management the same way that private equity managers do.).

[44] *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974) (Delaware corporate laws have 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 9, at 3 (Stating that large and complex transactions occur in Delaware as it is a familiar and safe jurisdiction for investors. Delaware's courts have expertise, experience, and the State is considered one of the most sophisticated in the United States. In addition, the low cost of administrative process and service providers make Delaware an attractive state.).

[45] *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 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 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.* at § 15-103(b)(3). The duties of loyalty and care are not waivable, nor can they be eliminated in the partnership agreement. *Id.* at § 15-103(b)(3)(i). However, agreements between partners may identify specific types or categories of activities not deemed in violation of the duties.

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rules[46] and nonincorporated entities such as LPs or LLCs can reduce or eliminate them.[47]

Thus, consistent with the freedom of contract principle, Delaware enables LPs and LLCs to eliminate their fiduciary duty.[48] Parties' sole obligation consists of maintaining an implied contractual covenant of good faith and fair dealing in their contractual relationship.

Some scholars applaud Delaware's flexibility and its contractarian view,[49] which they argue best serves the interest of parties, including passive investors. Limited partnership agreements provide very little protection for investors, and managers have no legal duty to conduct business in the best interest of their investors.[50] Unlike shareholders of incorporated companies, investors in limited partnerships have less power since there is no mandatory oversight body imposed on managers.[51] As Delaware partnerships have no mandatory fiduciary duties, investors may face abuse, which can take the form of excessive management fees, self-dealing or other practices.[52] If an agreement waives the fiduciary duty, managers have little obligations than those expressly put forth in the limited partnership agreement.[53] Carefully drafting the limited partnership agreement and "reputational constraints" on

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

[47] *See* 6 DEL. CODE § 17-1101(d) (2006) (For LLCs language almost identical with 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 in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

[48] *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 duties may state the following, "[t]he general partners assume no duties to the limited partners except those explicitly herein.").

[49] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1093 (2003) (Noting the U.S. venture capital experience is overwhelmingly a product of private ordering, an extremely effective contracting structure covering all phases of venture capital investing.).

[50] Rosenberg, *supra* note 48, at 367.

[51] *Id.* at 383.

[52] *Id.*

[53] *Id.* at 390.

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managers would best protect investors.[54] Thus, the importance of reputation suffices to encourage managers to act in the best interest of LPs.[55] Reputational constraints act as a deterrent that may counterbalance any mistreatment by managers.[56] Likewise, limited partners observe reputational constraints by limiting their interventions in the business of the fund[57] and seem "wary of being perceived as litigious," which could limit their participation in future investments.[58]

Other scholars consider private ordering ineffective to solve agency problems created by the limited partnership structure.[59] GPs and LPs often have divergent interests.[60] Resolving agency conflicts can occur with strong legal checks on agents by private enforcement or by monitoring through contract design.[61] Reputation alone cannot deter unscrupulous behaviors from GPs or LPs.[62] Examinations and enforcement activities done by the SEC since 2014 confirm that strong enforcement better resolves agency issues.[63] 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.[64]

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

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[54] *Id.* at 373.

[55] *Id.* at 366 (In the context of venture capital, Delaware laws creates the best environment to incentivize managers to well perform because their reputation is at stake.).

[56] *Id.* at 373.

[57] *Id.* at 394.

[58] *Id.*

[59] *See generally* Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259 (2010).

[60] *Id.* at 263 (GPs might want to hide information, redirect resources for personal benefits or spend more time in other matters not related to current LPs' while LPs want GPs to work exclusively for the fund, identify investment opportunities.).

[61] *Id.* (Resolving agency problems of divergent interests of managers and investors can occur with strong legal checks on agents or by private enforcement or by monitoring through contract design.).

[62] *Id.* at 288–90.

[63] *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), 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 also poses the issue of clarity for procedures and methods used. Finally, agreements do not provide LPs with enough information and rights to monitor their investments.).

[64] *Id.*

million, registration and regulation are made with the state, that is, if the 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 of artifice to defraud their clients or prospective clients.[65] The prohibition extends to fraudulent, deceptive and manipulative business conducts. Since 2014, the SEC has rightfully used this provision against private equity firms to enforce this aspect of investor protection.[66]

D. The Sophisticated Investor Dilemma

Securities regulations require the registration of the purchase and sales of securities with the SEC. A "security"[67] has a broad definition that encompasses various types of investment vehicles such as stocks, bonds, and limited partnership interests in the case of private equity. The sale and purchase of securities, such as a partnership interest, triggers several securities laws:[68] the Securities Act of 1933[69] ("Securities Act"), the

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[65] 15 U.S.C. § 80b-6 (2012) ("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.").

[66] *See generally infra* Part III; *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.).

[67] *See* 15 U.S.C. § 77b(1) (2018) (Statutory definition provided by the Securities Act of 1933.).

[68] *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* 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); *see also* Martin, *supra* note 4, at 95 (Hedge funds used the same exemptions than private equity.).

[69] Securities Act of 1933, 15 U.S.C.S. § 77 *et seq.*

Securities Exchange Act of 1934[70] ("Exchange Act"), the Investment Company Act[71] ("Investment Company Act"), and the Investment Advisers Act of 1940[72] ("Investment Advisers Act").

The Securities Act requires registration with the SEC and makes it unlawful to offer or sell securities without registration unless an exemption applies. Private equity sponsors have used the private placement exemption offered to accredited investors to escape registration.[73] These 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 or have "accredited investors."[74]

Under the Advisers Act, private equity could avoid registration by relying on the exemption for investment advisers with fewer than fifteen clients who did not hold themselves out as investment advisers and did not register as investment companies.[75] The fifteen-client requirement counts the funds as clients rather than the individual investors in each fund.[76]

Private equity advisers preferred to opt out of securities regulation because regulation triggers obligations to disclose information,[77] and to maintain books and records that the SEC can examine and inspect.[78] Registration also provides rights of action and penalties for violation of disclosed obligations.[79]

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[70] Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.*

[71] Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, 80a-3 (An investment Company "means any issuer which—(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.").

[72] Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*

[73] 17 C.F.R. §§ 230.215, 230.501 (definitions used in Regulation D); *see also* 17 C.F.R. § 230.173.

[74] *Id.*

[75] Investment Advisers Act § 203(b)(3) (1970).

[76] *See* Goldstein v. SEC, 451 F.3d 873, 874 (D.C. Cir. 2006) (Invalidating the SEC ruling requiring that investors of a hedge fund be counted as clients of the fund's adviser instead of the fund itself, to benefit from the fewer than fifteen clients' exemption of the Investment Advisers Act registration.).

[77] Investment Advisers Act § 206.

[78] *Id.*

[79] Spindler, *supra* note 68, at 320.

Prior to Dodd-Frank, all exemptions were geared towards sophisticated investors, generally defined according to their wealth or knowledge. Because of perceived sophistication of these investors, the rationale implied that they did not need the kind of protection offered by the registration statement (often a prospectus) so long as these investors demonstrated the ability "to fend for themselves."[80] An investor can fend for himself if he shows access to the same kind of information found in a registration statement, and have the expertise and sophistication to evaluate it.

Investors in private equity and private funds are sophisticated investors. No statutory definition of sophisticated investors exists. However, courts and securities regulations make the distinction between those who possess financial education and wealth as opposed to those who do not.[81] Typically, private equity investors are pension funds, endowments and foundations, banks and insurance companies and wealthy individuals.[82]

The issue of applying wealth as a proxy of sophistication has proven inadequate.[83] 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, counted among those begging for government subsidies when their investments collapsed.[84] In addition, there is a huge difference in

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[80] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

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

[82] *See, e.g.*, FENN ET AL., *supra* note 10, 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.).

[83] Greg Oguss, Note and Comment, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. L REV. 285, 294 (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 complicated to provide enough protection.).

[84] John E. Girouard, *The Sophisticated Investor Farce*, FORBES (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 on "crooks, risk-junkies or incompetent regulators" but on 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.").

sophistication among those deemed sophisticated investors[85] and even within just one portion of an individual institution. For instance, a private equity fund can have investors composed of endowments, public or 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.[86] Within the category of endowment, it is also hard to believe that an endowment of three hundred million has the same sophistication as a ten-billion-dollar endowment. Investors can also process information differently.[87]

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 definitely do not have the same bargaining power with managers. Yet, they are all considered sophisticated.[88]

As previously mentioned, the protection of investors was not the sole purpose of regulating private equity. The government has revealed its intentions since the late 1980s due to controversies surrounding the private equity industry.

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[85] *See generally* Josh Lerner et al., *Smart Institutions, Foolish Choices? The Limited Partner Performance Puzzle*, 62 J. FIN. 731, 731 (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 choices.).

[86] *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.).

[87] *See* Troy A. Parades, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. REV. 417 (2003) (The effectiveness of securities laws depends on disclosure and how the disclosed information is used. Thus, how investors use the information is as useful as the disclosure itself.).

[88] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 77–81 (Testimony of Joseph A. Dear, Chief Investment Officer of California Public Employees' Retirement System ("Calpers"). Calpers is the largest public pension fund in the United States. It has invested in various private pools. In 2008, it represented approximatively $180 billion market value with annual payout obligations over $10 billion to California retirees. Calpers has invested in private equity since 1990 and in hedge funds since 2002 because Calpers believes private pools are good investments as they diversified its investment portfolio, and this created significant value. However, in 2009, Calpers welcomed an increased transparency for investors and regulators to detect fraud and reduce risks to the financial system. In particular, Calpers recommended that all funds (that included hedge funds, private equity, investment companies, advisers and brokers) register with the SEC as investment advisers and be subject to the Commission's oversight. Advisers had to make regular disclosures to regulators on a real-time basis, while disclosure to investors and the market could be on a delayed basis. Finally, investment advisers and brokers who provided investment advice to customers had to be held to the fiduciary standards of care and loyalty.).

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II. POLICY ISSUES WITH PRIVATE EQUITY ECONOMICS

Today, the influence of private equity firms goes beyond the circle of American corporate finance. Once a small niche part 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 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 960,231 Americans.[89] In 2016, fewer than 5,000 private equity firms held $2.5 trillion in assets under management.[90]

Since the eighties, private equity has displayed a unique model and economics that have been greatly criticized for the negative consequences of using mainly debt or leverage to finance corporate acquisitions.[91] Today, criticism of private equity economics has resurfaced—Congress has considered regulating the industry. The issues raised in the eighties still resonate today: does private equity economics benefit the economy by improving the operations of the acquired companies and creating jobs and wealth for the community? Or, is 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?

A. The Use of Debt (versus Equity) to Finance the Acquisition of Companies

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—which is mainly money raised from private equity investors, also known as limited partners—and a big portion of debt.[92] The use of debt, known as leverage, is central to the

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[89] *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).

[90] *Id.*

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

[92] *See generally* EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 47 (2014) (Debt includes a portion of loan provided by banks

private equity model:[93] private equity firms acquire viable but undervalued companies with solid cash flow.[94] The cash flow produced by the company will help service the debt used to finance the buyout acquisition.[95] The tax code tends to favor the treatment of debt compared to equity because debt, in the form of interest payments, can be deductible when determining taxable profits, whereas the equity—dividends distributed to shareholders or capital gains on shares—is not deductible.[96] However, the new tax law of 2017[97] marks a shift in debt deductibility since the law limits interest expense deductibility to 30% of a portfolio company's adjusted taxable income until 2021. This might have a significant effect on private equity financing through debt as the after-tax cost of financings for LBO's could significantly increase. Other sources of financing, such as equity, may replace debt financing.[98]

(commercial or investment), hedge funds, and other institutional investors. These are short-term loans repackaged into bonds in the form of collateralized loan obligation, "CLO," or commercial mortgage backed securities, "CMBS." A CLO is a debt obligation that pools multiple loans from businesses and passes them through different classes of owners in various tranches. A CMBS is a loan secured by a commercial real estate property.). *See also* Kaplan & Stromberg, *supra* note 14, at 121–46 (Some of these bonds are sold to investors as senior secured notes, which provides a claim on the acquired company's assets. *Id.* Other bonds include junior, unsecured notes that are sold to investors as high-yield bonds or "mezzanine debt" (subordinated to senior debt).). *Id.* at 124–25.

[93] APPELBAUM & BATT, *supra* note 92, at 24 (Citing 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% equity and 92% of debt.).

[94] *See, e.g.*, BURROUGH & HELYAR, *supra* note 5, at 371 (Noting that the backbone of any successful LBO "is a set of projections: profits sales, and most important, cash flow. Because they dictate the amount of debt a company can safely repay, projections are the key to formulating a bid. And the right bid means everything to an LBO: the higher price, the higher the debt. Too much debt can crush the healthiest companies.").

[95] Kaplan & Stromberg, *supra* note 14, at 139 (In the early 80s—considered the first wave of buyouts—the structure of debt represented 85-to-90% of acquisitions compared to 10-to-15% equity.); APPELBAUM & BATT, *supra* note 92, at 3 (A typical public company issues 30% debt and 70% equity. In the 2000s, the debt portion of leveraged buyouts financing was reduced to 70% versus 30% equity.); *id.* at 47 (During the second wave, the portion of equity rose to between 25% and 33%. Since the financial crisis of 2008, credit conditions have tightened, and the portion of equity is now 40%. Thus, in a typical buyout transaction, a private equity firm finances the acquisition of a company with essentially 40% of equity and 60-to-90% of borrowed money. That portion of borrowed money is called debt and is also known as leverage.).

[96] *See generally* RUUD A. DE MOOIJ, TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS (2011) (The use of leverage or debt is considered as another source of earnings for private equity firms due to the more favorable treatment of debt in the tax code compared to equity: debts are tax-deductible and reduce 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.).

[97] Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat 2054 (2017) [hereinafter TCJA].

[98] *See generally id.*

Pouring in huge amounts of debt was initially viewed as a way to discipline managers[99] because heavy debt payment forces a company to tighten its operations and spend money wisely. While the use of debt facilitates corporate acquisitions, it can also—when unsustainable—hinder economic prospects of a company and lead to bankruptcy.[100] In recent years,

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[99] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305–60 (1976) (This seminal article on agency theory notes that shareholders are "principals" and have a residual claim on the company. Directors and managers are "agents" of the company and act on behalf of the shareholders to maximize their profits.); *see also* Michael Jensen, *Agency and Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 328 (1986) (Managers must return to shareholders the free cash flow supplied by the corporation while using debt to finance new company's acquisition. Free cash flow is monies in excess of the company's resources that managers, instead of distributing to shareholders, put in to costly projects that do not enhance the value of the company. 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 and prevents wasting resources on low return projects.).

For a discussion on examining the corporation as a contractual relation, *see, e.g.*, Lehn et al., *supra* note 91, at 172–73 (Stakeholders, that is, workers, suppliers, creditors, and bondholders, contribute to the company's resources in exchange for a claim in the company's revenues. Both debtholders and stockholders provide financing to a firm in exchange for revenue. Debtholders receive interest payments in coupon until the final payment of principal due at maturity; stockholders receive dividend payments on the firm's residual claim. In many respects, debt and equity financing are not very different, as they both provide a residual claim on the company's assets. The difference between debt and equity lies in their protection afforded by the law in case the company goes in default: debtholders enjoy more protection than equity holders.); *see also* BURROUGH & HELYAR, *supra* note 5, at 134 (Borrowing heavily to acquire companies results on ruthless cost cutting and sale of unwanted businesses, as every dollar must pay the debt load.).

[100] There is a long list of firms filing for bankruptcy due to heavy debt load added by leveraged buyout: *see, e.g.*, Lillian Rizzo & Suzanne Kapner, *Toys 'R' Us, Once a Category Killer, Is Forced Into Bankruptcy*, WALL ST. J. (Sept. 19, 2017, 12:51 AM), https://www.wsj.com/articles/toys-r-us-once-a-category-killer-is-forced-into-bankruptcy-1505792620 (The assumption is the risk of bankruptcy in times on economic downturn because the company with high debt will not be able to adjust with changing market while sustaining its debt.).

Compare BURROUGH & HELYAR, *supra* note 5, at 352–53, 371, *and* APPELBAUM & BATT, *supra* note 92, at 97–101 (Listing a number of bankrupted companies during the financial crisis of 2008-2009. A disproportionally high level of private equity backed companies defaulted by the end of 2008. This includes Linens 'n Things who filed for bankruptcy then liquidated because they could not find a buyer, Fortunoff Fine Jewelry and Silverware, etc.), *Creditor Recoveries in Leverage Buyout Defaults in Line With Non-LBOs*, MOODY'S (June 5, 2012), https://www.moodys.com/research/Moodys-Creditor-recoveries-in-leveraged-buyout-defaults-in-line-with—PR_247637 (creditor recoveries of U.S. leveraged buyouts default are nearly equal to those in non-LBO defaults); *see generally* GEORGE A. AKERLOF & PAUL M. ROMER, LOOTING: THE ECONOMIC UNDERWORLD OF BANKRUPTCY FOR PROFIT 1–74 (1993) (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. Thus, a private equity firm takes the portfolio company into bankruptcy, with the plan of buying the company back and taking

the bankruptcy of private equity sponsored companies burdened with debt is also linked with the use of controversial "financial engineering" techniques completely unrelated to managers' discipline.[101]

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it out of bankruptcy. When the company is out of bankruptcy, it resurfaces with fewer debts and often is discharged from pension liabilities, which usually are transferred to the government (and taxpayers). In this scenario, bondholders and unsecured creditors lose part of their investment, workers often lose their jobs, and all or part of their benefits and pensions, which the government (and taxpayers) assume.).

[101] These controversial techniques of debt management include dividend recapitalizations ("dividends recaps"), buying one own debt at steep discount and debt exchange. *See, e.g.*, Alex Lykken, *Understanding Dividend Recaps*, PITCHBOOK (Jan. 20, 2014), https://pitchbook.com/news/articles/understanding-dividend-recaps (Dividend recapitalizations ("dividend recaps") are additional debt incurred by a portfolio company to allow the payment of dividends to its shareholders, the private equity firm (and its investors) and sometimes the management team of that company.); *accord* Michael Stothard & Dan McCrum, *Private Equity Eyes Dividend 'Recaps,'* FIN. TIMES (Oct. 23, 2012), https://www.ft.com/content/eac31cd6-1d12-11e2-abeb-00144feabdc0 (Dividend recaps are a way for private equity firms to extract value from a portfolio company. They were extensively used during the pre-crisis years in 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).); *see also* Luisa Beltran, *Moody's: PE Firms Took Out at Least 35 Dividend Recaps This Year, Worth More than $11 bln*, PE HUB NETWORK (July 12, 2012), https://www.pehub.com/2012/07/moodys-dividend-recaps/ (Reporting that during the peak of the market in 2012, a company such as HCA had made more than 6.7 billion in distributions and shares repurchase. Dividend recaps is a principal way private equity extract cash from their portfolio company.). 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 company exits the portfolio).

Dividend recaps also decrease the risk of private equity firms and their investors from losing money. However, dividend recaps add risk to the portfolio company because they subject it to potential financial strain and the risk of bankruptcy.

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 on the investment—private equity firms had to reduce the debt burden on companies they owned. APPELBAUM & BATT, *supra* note 92, at 80. One way to do this was to have a company buy back its own debt on the open market. When a company faces the prospect of bankruptcy, its bond trades at a steep discount to the face value. The company can take advantage of the discount and buy back its own debt on the open market. *See also* Serena Ng, *Firms Move to Scoop Up Own Debt*, WALL ST. J. (Aug. 24, 2009, 12:01 AM), https://www.wsj.com/articles/SB125080949684547827. This is advantageous for the company which can save millions of dollars, but it is disadvantageous for bondholders who are set to lose the amount saved by the company.

Debt exchange is another technique offered by the issuing company to exchange its outstanding debt for something else, often cash or new debt. *See, e.g.*, Stephen J. Lubben, *Debt-Exchange Offers Get a New Lease on Life*, N.Y. TIMES: DEALBOOK (Jan. 20, 2017), https://www.nytimes.com/2017/01/20/business/dealbook/debt-exchange-offers-get-a-new-lease-on-life.html?_r=0. This also benefits the company by reducing its debt load but at the expense of bondholders who are forced to forfeit earnings on the company's debt so as not to face the bankruptcy of issuing firms.

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B. Private Equity and the Labor Market

Job losses and benefit cuts are often associated with private equity takeovers even if these acquisitions also create opportunities. First, even critics of private equity firms recognize the benefit of private equity economics in small and middle markets—that is, companies valued between $25 million to $1 billion.[102] Second, even when a company eliminates jobs or ceases operations, workers and the community sometimes benefit. Finally, private equity transactions can contribute to saving ailing companies and creating jobs.[103]

Despite these positive outcomes, the public perception of private equity economics remains negative, especially due to high-profile political statements that have negatively portrayed the industry.[104]

Few reliable studies exist on the employment effects of a takeover, the quality of jobs created and the resulting labor relations. Information on private companies is scarce.[105] Studies sponsored by the private equity industry usually emphasize job-creation-post-leverage-buyout

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[102] APPELBAUM & BATT, *supra* note 92, at 127–60 (Crediting 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.).

[103] *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] (Private 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 were initially cut but ultimately added new jobs. When Onex took Spirit AeroSystems public, it provided a windfall for workers.). *See also* APPELBAUM & BATT, *supra* note 92, at 238, App. tbl.7A.1.

[104] *See, e.g.*, *Private Equity Firms Strip Mine German Firms*, SPIEGEL ONLINE (Dec. 22, 2006, 7:16 PM), http://www.spiegel.de/international/the-locusts-privaty-equity-firms-strip-mine-german-firms-a-456272.html (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 employee.). *See also, 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 (During the 2012 U.S. presidential campaign, the private equity industry, labelled as a "job-killing vampire," had to claim that the industry does not destroy jobs and communities.).

[105] APPELBAUM & BATT, *supra* note 92, at 193–238.

acquisitions;[106] but the data and methodology used are often biased and questionable.[107] Other studies using empirical evidence support the argument that companies post-leveraged-buyouts create fewer jobs than non-leveraged companies do.[108] In general, findings are consistent with the perceived notion of employment insecurity and destruction resulting from private equity transactions.[109]

Finally, consequences of private equity transactions on workers and their communities carry mixed blessings. LBOs can greatly enrich individual shareholders of acquired or defunct companies (consequently enriching their communities).[110] But the impact of private equity deals is clearly negative for workers and their communities when workers lose their jobs, pensions, and benefits.[111] In some instances, the government (and taxpayers) bear the cost

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

[107] *Id.* (The sponsorship of the study by a private equity trade group and eight large private equity firms raise the question of selection bias.).

[108] *See generally* Steven J. Davis et al., *Private Equity and Employment* (Nat'l Bureau of Econ. Research, Working Paper No. 17399, 2011).

[109] There are, however, distinctions to be made 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). *Id.* at 5–6. Going-private transactions are often associated with poor deal execution, as acquisitions occur at market peaks, producing higher valuations and over-leveraged transactions. *Id.* at 30. When this happens, job losses are higher because the acquired company divests part of its operations or ceases to exist. *Id.* By contrast, private-to-private transactions, which represent the majority of buyout transactions tend to create robust job growth the first two years post buyout. *Id.* at 30–31. In these instances, private-to-private transactions are associated with job reallocation, adjustments, and the acquisition of more companies and divestitures. *Id.* Second, industry types—manufacturing, retail and service—exhibit different results toward employment. *Id.* at 29. Thus, job losses or created by private equity buyouts are not a homogenous. Distinctions based on deal size, type and industry. Another factor that contributes to negative perception is the attitude exhibited by private equity owners towards the workforce and labor unions when a company changes ownership and becomes private equity owned: there is little communication or consultation with workers, which can vary from being engaging and constructive to outright hostile. *See also* SERV. EMPS. INT'L UNION, *supra* note 103.

[110] *See* BURROUGH & HELYAR, *supra* note 5, at 540, 541 (Citing the case of Pauline Carter, a retired RJR worker, twice widower, who had accumulated 42,500 shares of the company and netted $3 million after the LBO. Carter left $2.7 million to a local foundation to support charities. Carter's case, far from isolated, highlights how the buyout also accomplished good deeds in Winston-Salem's community.).

[111] APPELBAUM & BATT, *supra* note 92, at 193–238 (Analyzing case studies of companies held in private equity portfolio. Documenting 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.).

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of a buyout transaction when the private equity owner does not assume the responsibilities of the previous owner.[112]

C. Private Equity Fees

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.[113] General Partners receive income from their investors (Limited Partners) and portfolio companies. Investors provide management fees and share the profit, called carried interest. Management fees usually represent 2% 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.[114] 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.[115] The timing of a carried interest payment is also a factor in considering the compensation received by General Partners.[116]

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

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[112] *See, e.g.*, Greg Palast, *Mitt Romney's Bailout Bonanza*, THE 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 (last visited Feb. 16, 2019) (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.*, Patrick Fitzgerald, *PBGC Will Take Over Hawker Pensions*, WALL ST. J. (Dec. 26, 2012, 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).

[113] *See generally* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 218 (2009); *see also* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSP. 147, 147–66 (2009).

[114] Litvak, *supra* note 113, at 169.

[115] *Id.* at 175.

[116] *Id.* (The author considers timing of the distribution of carried interest as a third element of compensation—management fees and carried interest being the first and second respectively.).

agreements. These fees include transaction and monitoring fees.[117] Other fees can be added depending on the agreements.

Transaction and monitoring fees, though, arise only out of buyout agreements and seem not to exist with venture capital.[118] General Partners charge transaction fees when buying or selling a company that resemble the fees investment banks charge for mergers and acquisitions.[119] Monitoring fees represent the time and effort General Partners spend working alongside a company.[120]

Evidence suggests that private equity returns do not outperform the Standard and Poor's 500 Index ("S&P 500").[121] Results consistently show that private equity returns drift lower (net of fees) than the S&P 500 but returns outperform the S&P 500 when adding the fees (gross amount). Only when adding fees charged to investors and portfolio companies do private equity funds and venture capital earn returns exceeding the S&P 500. Surprisingly, the bulk—or two-thirds—of private equity income derives from the non-risky portion of the compensation package, that is management fees and portfolio companies' fees (transaction and monitoring).[122]

The question then arises, why do sophisticated investors put so much money into this type of investment when it offers no liquidity (not readily sold) long-term (ten-year period), with compensation terms difficult to understand? Some authors argue that sophisticated investors might be fooled, or they might misunderstand the information provided[123] particularly for the

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[117] *See generally* Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2313, 2309–14 (2010) (Management fees have four methods of assessment: as constant percentage of committed capital, a decreasing fee schedule, a constant rate of committed capital that can change over the years, and a method using a decreasing percentage. Transaction fees charged to portfolio companies resemble merger and acquisitions advisory fees charged by investment bankers. Monitoring fees compensate the fund for work performed with its portfolio company.).

[118] *Id.* at 2313.

[119] *Id.*

[120] *Id.* at 2314.

[121] *See generally* Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FIN. 1791, 1791–1823 (2005) (Based on a sample of funds covering the years 1980–2001, the average fund return net of fees are roughly identical than those of the S&P 500 Index.). *See also* Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1766–67 (2009) (Confirming previous findings by Kaplan & Schoar and noting that substantial performance of private equity derives from management fees and not incentive fees.).

[122] Metrick & Yasuda, *supra* note 117, at 2320 (Results are the same whether the fund is a venture capital or buyout.).

[123] *See* Lerner et al., *supra* note 85, at 731–64.

calculation of fees and returns.[124] Since Dodd-Frank, a flurry of negative press has erupted on the fees that private equity firms levy on their investors and portfolio companies.[125] Investors and regulators now question whether private equity investment is worth the risk taking into account the enormous fees investors pay. For instance, the State of California now requires its state pensions to disclose fees paid to private equity managers and other private funds.[126] Starting in 2017, California public pension plans must disclose fees and expenses reported by private equity funds in which the pension plans have invested.

D. Taxing Carried Interest

Private equity fund managers receive several streams of income and use different entities to collect that income.[127] The income comes from Limited Partners in one part, and in another part, from companies held in the portfolio.

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[124] *See* Litvak, *supra* note 113, at 175 (Finding apparent simplicity in carried interest terms leads to interpretation errors.); *see also* Phalippou, *supra* note 113, at 155–62 (Citing a statement from Calpers, one of the largest private equity investors. In 2008, Calpers made a statement expressing satisfaction with the returns received by its 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 wonders why Calpers would be so satisfied for what appears to be a disappointing rate of return.).

[125] *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; *see also* 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.

[126] *See* CAL. GOV'T CODE § 7514.7 ("California Assembly Bill 2833," introduced February 19, 2016), 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 (July 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 Limited Partners Association (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).

[127] Gregg D. Polsky, *A Compendium of Private Equity Tax Games* 2 (UNC Legal Studies Research Paper No. 2524593, 2014), https://ssrn.com/abstract=2524593 (A partnership, set up as management company, provides management services and receives the management fees for each fund. Another entity, set as general partner, manages each fund, usually established as limited partner. The general partner collects the carried interest.).

Commentators have qualified opaque and convoluted terms drafted in the compensation agreement.[128]

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.

The taxation of carried interest, i.e., profit sharing, is the biggest loophole that the private equity industry—successfully[129]—fights to preserve. That is, carried interest benefits from the favorable tax rate of long-term capital gains rather than ordinary income.[130]

Typically, the fee structure, referred to as two-twenty, means the 2% management fees and 20% carried interest.[131] 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 8%).[132] In addition to limited partners, private equity managers receive other streams of income from the companies held in their portfolios. These are fees paid directly by the portfolio company to the private equity owner and, these expenses cover for instance, 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

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[128] *See, e.g.*, Litvak, *supra* note 113, at 175–76 (Finding three sources of income: management fee, carried interest and a third element being an interest-free loan that venture capitalists receive from LPs. Distribution rules allow managers to determine when carried interest get paid because they can decide the time of liquidation, distribution to investors.); *but see* Phalippou, *supra* note 113, at 149–51 (Finding four set of fees from managers: annual management fee, carried interest, portfolio management fees, and extra fees and costs imposed on investors.).

[129] *See* TCJA, *supra* note 97 (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.

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

[131] *Id.* at 4.

[132] *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.).

interest receives the preferential treatment of capital gains.[133] This means that 2% management fees receive a federal marginal tax rate, which ranged up to 39.6% before the tax reform of 2017, whereas the 20% profits or carried interest are taxed at a 20% rate (it was 15% 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 from the preferential rate[134] and the deferral of income tax.[135]

Conversion means income from profits interest are taxed at a long-term capital gains rate rather than higher ordinary income rates.[136] 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 deferral occurs when profits are distributed.[137]

Deferral of income tax confers a timing advantage for private equity 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

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[133] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-885, PRIVATE EQUITY RECENT GROWTH IN LEVERAGE BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION (2008).

[134] *See generally* Greg D. Polsky, *Private Equity Management Fee Conversions* (Fla. State Univ. College of Law, Law, Bus. & Econ. Working No. 08-18, 2008), https://ssrn.com/abstract=1295443 (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—converted into carried interest.).

The issue whether carried interest should be taxed as ordinary income or capital gains is a question of partnership tax principles and the treatment made when a partner receives a partnership interest in return for services. In the current law, partnership equity has two components: capital interest and profits interest.

See Fleischer, *supra* note 130, at 10 (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. *Id.*). *See also* Fleischer, *supra* note 132, at 109 (Because capital interest has a determinable value, services rendered by the partner become immediately taxable income. Profit interests, however, having no liquidation value readily determinable, are not taxable income.).

[135] *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. 1071, 1075 (2008) (Controversies of profits interests or carried interest have consequences on how managers are taxed and the resulting effects on their investors.).

[136] *Id.*

[137] *See* Fleischer, *supra* note 130, at 11.

interests difficult to value, are taxed at liquidation (usually during the exit phase of the private equity strategy).

Deferred taxation of income benefits 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 of money and inflation.[138] Deferral of taxation provides to private equity firms an interest-free loan from the government[139] 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.[140] 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.[141] The detriment to investors is often reduced as most are tax-exempted entities.[142]

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.[143] Fairness dictates

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[138] *See generally* DONALD J. MARPLES, CONG. RESEARCH SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 9 (2014) (Tax deferral refers to the timing of tax payments which allows a taxpayer to control when he pays tax: paying tax in the future rather than today.).

[139] Polsky, *supra* note 127, at 8 (Arguing that carried interest compensation provides four distinct benefits: (1) deferral of tax liability from services provided throughout the life of a fund has the "effect of an interest-free loan from the government," (2) when income is realized, it is taxed at the lower rate of 15% instead of 35%, (3) there is no income tax, and (4) absorption of capital losses and capital carryovers are possible unlike with management fee income.).

[140] Fleischer, *supra* note 130, at 13.

[141] *See* Sanchirico, *supra* note 135, at 1075–76.

[142] *See* PETER R. ORSZAG, THE TAXATION OF CARRIED 10 (2007), https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/09-06-carriedinterest_testimony.pdf.

[143] *See, e.g.*, Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 104 (2008) (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. The rationale was to tax Blackstone and the like entities using PTP structure as corporation for tax purpose. The bill did not intend to affect other private equity firms remaining privately held. The bill viewed as a response to private equity gamesmanship did not prosper in Congress.).

closing the loophole by taxing carried interest as ordinary income.[144] 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.[145] This tax loophole benefits private equity owners to the detriment of the government and taxpayers.[146] The revenue provided by carried interest or losses incurred by the government is not clear since no public data exists. However, some estimates value the carried interest loophole as high as $180 billion over ten years.[147] Notwithstanding controversial business practices, private equity firms have managed to evolve free of regulation until the Dodd-Frank Act of 2010.

III. THE REGULATION OF PRIVATE EQUITY BY THE DODD-FRANK ACT

A. Arguments Opposing Regulation of Private Equity

The 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.[148]

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

[145] *See* APPELBAUM & BATT, *supra* note 92, at 30.

[146] *Id.*

[147] 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.*").

[148] *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

Opponents of private equity (and private funds) regulation have raised several objections that justify, in their view, why private equity should continue to benefit from the many exemptions of securities laws.[149] Opponents of regulation argue the following:[150] 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 against fraud, insider trading, and manipulation. Market discipline also holds advisers of private equity funds accountable to their investors.[151]

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.[152] It does not acknowledge the purpose of the gap, leaving flexibility to investors to privately organize their businesses.[153] Closing a gap is adverse to 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.[154]

Moreover, opponents of regulation warn of potential costs to the financial market and the economy when private funds require additional regulatory scrutiny. Do the costs associated with the new regulation carefully balance the interests at stake?[155] The answer might differ depending on the type of funds. Adding more regulation could adversely affect the industry by reducing efficiency, liquidity to the securities markets, capital flow to innovations, or restructuring of companies.[156]

IMPACT 154 (Edward I. Altman ed., 1998) (In 1989, the fallout from the RJR Nabisco deal included many congressional hearings on LBOs related to tax, banking, securities and labor laws.).

[149] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30.

[150] *Id.* at 82–87 (Commissioner Troy A. Paredes did not endorse the position of Andrew J. Donohue, the SEC Director of the Division of Investment Management and opposed registration of hedge funds and other private funds. Kathleen L. Casey similarly dissented. *Id.* at 87–89.).

[151] *Id.* at 83.

[152] *Id.*

[153] *Id.*

[154] *Id.* at 84.

[155] *Id.*

[156] *Id.* at 85. *Compare Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, *with Venture Capital Hearing*, *supra* note 148. The venture capital industry advanced the same arguments back in the 1980s. At the time the National Venture Capital Association was composed of 80

Finally, even if legislators authorize regulation of private funds, should this regulation occur through the Securities Act of 1933,[157] the Company Act of 1940[158] or the Advisers Act of 1940? Another regulatory option could expand the rulemaking authority of the Securities and Exchange Commission.[159]

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capital firms with combined assets of more than $1.5 billion. *Id.* at 76. In the 1980s, many venture capitalists 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).

[157] *See Venture Capital Hearing*, *supra* note 148, at 77–78 (Proposing bill H.R. 7554 to amend the Securities Act of 1933 to 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 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.).

[158] *See* Investment Company Act of 1940, *supra* note 71, 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 148, at 78–79 (The Investment Company Act contains many prohibitions that are 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 U.S.C.S. § 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.).

[159] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 38 (statement of Andrew J. Donohue, Director, Div. of Inv. Mgmt., Sec. & Exch. Comm'n) (the SEC 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 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 objecting to expanding of SEC rulemaking authority as it does not provide regulatory predictability and creates uncertainty.).

B. Rationale for Private Equity Regulation

In 2009, many congressional discussions occurred aiming at regulating hedge funds and other private funds.[160] While capital markets became increasingly interwoven, private funds operated outside a regulatory framework. Reliable data on private funds prevented the government and regulators 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. Preventing systemic risk resulting from the financial crisis provided the opportunity to expand regulation to these entities.[161]

The Securities and Exchange Commission has long advocated for regulation of private funds.[162] The Commission supported registering private fund advisers under the Investment Advisers Act because for the past two decades, hedge funds, private equity and venture capital have played an increasingly essential role in capital markets, but the regulatory setting has not evolved to deal with the growth and market importance of these funds. The SEC has incomplete data about the advisers of these funds, and this represents 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,[163] but this initiative failed before an appellate court in 2006.[164]

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[160] *Id.*; *see generally* Douglas M. Branson, *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 (2014).

[161] *But see Venture Capital Hearing*, *supra* note 148 (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.).

[162] *Id.*; *see also Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 34–38 (statement before the Subcommittee to support the registration of private funds presented by Andrew Donohue, Director of Investment Management of the Commission).

[163] *See* 17 C.F.R. §§ 275, 279 (2005).

[164] *See Goldstein*, 461 F.3d 873 at 874; *see also* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) (Holding that General Partners of a partnership were "investment advisers' within the meaning of the Investment Advisers Act and deleting an earlier footnote stating that hedge funds were investment advisers to each of the limited partners and not the partnership.).

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.[165]

The option to regulate private funds through the Investment Adviser Act has advantages for investors because it allows 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.[166]

Registration also would allow the Commission to enforce the fiduciary responsibilities of investment advisers, as the antifraud provisions of the Advisers Act enforce fiduciary duties, such as avoiding conflicts of interest (or disclosure).[167] Registration provides the SEC the authority it needs to enforce the Act with on-site compliance examinations and identify issues investors cannot determine for themselves,[168] such as safekeeping, or performance representation. Registration could also work as a deterrent since registration can prevent market abuse and manipulation of trading activities,

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[165] *Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, 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% of registered advisers have 10 or fewer employees).).

[166] *Id.* at 87–89 (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.).

[167] *Id.* at 37.

[168] *Venture Capital Hearing*, *supra* note 148, at 187–96 (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.).

insider trading or improper short-selling activities.[169] Registration also serves 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.

C. The Private Fund Investment Advisers Registration Act of 2010

Title IV of Dodd-Frank entitled the Regulation of Advisers to Hedge Funds and Others, adds a new section to the Investment Advisers Act of 1940: The Private Fund Investment Advisers Registration Act (the "Private Fund Act").[170] It requires advisers to "private funds" with assets under management over $150 million to register with the SEC and submit periodic records, reports and bookkeeping.[171]

The rule prescribes that investment advisers of a private fund must register with the Securities and Exchange Commission or the State (if less than $150 million under management), unless an exception applies.[172] A private fund adviser means an issuer that is an investment company under the Investment Company Act of 1940, except in those cases when one uses Section 3(c)(1) or 3(c)(7) of that Act.[173] The Dodd-Frank Act eliminates the private adviser exemption under which an 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 any investment adviser to register.[174]

There are exemptions to the registration requirement, including three new exemptions created by the Dodd-Frank Act: for advisers of (i) venture capital funds, (ii) private funds with less than $150 million in assets under management, and (iii) foreign private advisers.[175]

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[169] *See Regulating Hedge Funds and Other Private Investment Hearing*, *supra* note 30, at 37.

[170] 15 U.S.C.§ 80b-20, LEXIS NOTES (2018).

[171] *See generally* Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L.J. 125 (2012).

[172] 15 U.S.C. § 80b-2(a) (2018).

[173] *Id.*

[174] 15 U.S.C. § 80b-3(b) (2018).

[175] *See* 17 C.F.R. § 275 (2011).

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1. The Exception: Some Private Funds are Exempt from Registration

The Advisers Act and Dodd-Frank contain several exemptions from registration and create two new types of exemptions: first, the "specifically exempted" advisers, not subject to reporting or recordkeeping requirements[176] (for example, foreign private advisers), and second, another category of exempt reporting advisers, exempt from registration but NOT reporting: for instance, exempt reporting advisers advising venture capital funds and those advisers to private funds with assets under management of less than $150 million.[177] For these type of advisers, exemption means the advisers do not register with the Commission but must report their activity in a limited fashion.[178]

Exempt reporting advisers must complete and file reports on the Form ADV,[179] which is electronically filed through the Investment Adviser Registration Depository (IARD).[180] Unless a temporary hardship[181] 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, albeit lighter reporting compared to non-exempt advisers. The reporting consists of the same Form ADV used by advisers to register with the SEC.[182] Exempt reporting advisers complete only Part 1A of the Form ADV. They must list basic information[183] (Identifying Information, Form of Organization, Control Persons), like whether they are

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[176] *Id.* (Registration does not apply to a foreign private adviser.); 15 U.S.C. § 204(a) (2018) (prescribing maintenance of records for examinations by the Commission will not apply).

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

[178] *See* Investment Advisers Act § 204(a) (1940) (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. Sections 203(l) and 203(m) are not "specifically exempted" because they are still subject to reporting and recordkeeping with the Commission.).

[179] 17 C.F.R. § 275.204-4(a) (2018).

[180] SEC'Y AND EXCH. COMM'N, FORM ADV 5–7 (2017).

[181] 17 C.F.R. § 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.).

[182] 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.

[183] SEC. & EXCH. COMM'N, FORM ADV 1–6, 10, 24–25 (2017).

exempt reporting advisers and for which exemption they qualify (SEC Reporting by Exempt Reporting Advisers).[184] Other information aims at detecting potential conflicts of interest with advisers' other businesses (Other Business Activities)[185] and affiliations (Financial Industry Affiliations and Private Fund Reporting), along with the report on the disciplinary history of the adviser and its employees (Disclosure Information).[186] 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).[187]

2. The Venture Capital Fund Adviser Exemption

The Private Fund Act exempts venture capital fund advisers from registration[188] and limits the reporting requirement.[189]

Venture capital defines any private fund that[190] (1) pursues a venture capital strategy;[191] (2) holds no more than 20% of the fund's capital contributions in non-qualifying investments;[192] (3) does not use leverage

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[184] *Id.* at 8.

[185] *Id.* at 15–16.

[186] *Id.* at 16–17, 22–26.

[187] *Id.* at 17–18, 47–55.

[188] 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.

[189] *See* 17 C.F.R. § 275 (2011).

[190] 17 C.F.R. § 275.203(I)-1(a)(1) (2010) (A venture capital is a private fund as opposed to publicly traded, one that represents to investors and potential investors that it pursues a venture capital strategy ("holding out").).

[191] 17 C.F.R. § 275.203(I)-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.").

[192] *See id.* at 23–30 (Noting that to qualify as an exempt reporting adviser, an adviser must advise a venture capital fund that acts as a private fund that invests in qualifying investments or short-term holdings. A qualifying investment is defined as: (i) equities acquired directly by the private fund; (ii) equity securities issued by a qualifying portfolio company in exchange for directly acquired equities issued by the same qualifying portfolio company; and (iii) equity securities issued by a company of which the qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and is received in exchange for directly acquired equities of the qualifying portfolio company. This definition aims at

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other than qualifying short term borrowing;[193] (4) does not offer redemption rights to its investors;[194] (5) has not registered under Section 8 of the Investment Company Act of 1940;[195] and is not a business development company pursuant to Section 54.[196] The rule also includes a grandfather

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differentiating venture capital from other funds such as hedge funds or private equity. 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% 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 an open-end management investment company registered under Section 8 of the Investment Company Act of 1940.). *See also* 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's investment; and (iii) is not an investment company or a private fund.); *see also* 17 C.F.R. § 275.203(I)-1(a)(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.).

[193] 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% 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. 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% threshold for non-qualifying investments.).

[194] 17 C.F.R. § 275.203(I)-1(a)(4) (2018) (Explaining that the definition of venture capital excludes redemption rights to investors, except in extraordinary circumstances (usually events beyond the control of the investor). However, investors are entitled to receive distributions on a pro rata basis. This definition does not differentiate between hedge funds and private equity.).

[195] 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.).

[196] *See generally* 17 C.F.R. § 275.203(l)-1 (2018).

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provision for preexisting venture capital funds.[197] The adoption of this 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, which limits potential systemic risk.

3. The Private Fund Adviser Exemption

The Private Fund Act creates an exemption for private fund advisers and requires 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.[198] Pursuant to the Act, the Commission adopted Rule 203(m)-1.[199]

The exemption applies to U.S. advisers acting solely as advisers to qualifying private funds,[200] to the extent the assets under management[201] do not exceed $150 million.[202] A qualifying private fund is a private fund that is not registered under Section 8 of the Investment Company Act and does not qualify as a business development company.[203]

The regulatory assets under management include securities portfolios for which the investment adviser provides continuous and regular supervisory or management services as of the date of filing Form ADV.[204] The value of the regulatory assets under management is calculated on current

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[197] 17 C.F.R. § 275.203(I)-1(b) (2018) (Describing how a private fund can also qualify as venture capital if (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; and (3) and does not sell securities to any person after July 21, 2011.).

[198] Dodd-Frank Act, § 408 (2010).

[199] *See generally* 17 C.F.R. § 275.203(l)-1 (2018).

[200] Investment Adviser Act of 1940, § 202(29) (Defining private fund as "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.").

[201] 17 C.F.R. § 275.203(m)-1(a)(1)(2) (2018).

[202] 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. Form ADV Item 5.F defines regulatory assets under management to provide a uniform method of calculation.).

[203] 17 C.F.R. § 275.203(m)-(d)(5) (2018).

[204] See SEC. & EXCH. COMM'N, FORM ADV (2017).

market value or fair value of the assets.[205] The frequency of calculations occurs annually in accordance with General Instruction 15 of Form ADV.[206]

Section 203(m)'s exemption 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.[207] The less than $150 million assets requirement applies only to advisers whose principal office and place of business is located in the United States; it does not apply to a non-United States adviser with a principal place of business outside the United States.[208]

4. The Foreign Private Adviser Exemption

The Dodd-Frank Act eliminates the private adviser exemption and creates a foreign private adviser exemption instead.[209] The foreign private adviser exemption exempts a foreign adviser from registration and reporting. The Dodd-Frank Act defines "foreign private adviser" as 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 in private funds advised by the investment adviser; (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 a business development company pursuant to Section 54 of the Investment Company Act of 1940.[210]

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[205] *Id.* at 7–10.

[206] 17 C.F.R. § 275.203(m)-1(c) (2018) (Referring to General Instruction 15 to the Form ADV which mentions the annual updating of the $150 million threshold to maintain the exempt reporting adviser status.).

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

[208] 17 C.F.R. § 275.203(m)-1(d)(2) (2018) (Referring to Section 275.222-1(a) which defines place of business as: "(1) an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) 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.").

[209] Dodd-Frank Act, § 403 (2010).

[210] 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 such as: "investor," "in the United States," "place of business" and "assets under management.").

D. Private Funds Reporting Requirements

As noted above, the Dodd-Frank Act amends the Investment Advisers Act by adding The Private Fund Investment Advisers Registration Act (herein "Private Fund Act"), a new section for private funds.[211] The Private Fund Act is aimed at private funds and new recordkeeping and reporting provisions to the existing reporting requirements.

In 2011, the Securities and Exchange Commission adopted amendments to existing rules to implement Title IV, the regulation of advisers to hedge funds and other private funds of Dodd-Frank.[212] The Act has considerably modified the original Form ADV to help oversee investment advisers and collect additional data from them.[213] Notably, the biggest modification consists of the private funds category,[214] which gathers information about advisers and the funds they advise. In addition, data related to advisory businesses are expanded (such as the adviser's employees, type of clients advised, compensation arrangements, etc.) as well as information about potential conflict of interests. Finally, Form ADV adds reporting on information about non-advisory activities and financial industry affiliations.[215]

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[211] 15 U.S.C. § 80b-2(a) (Amending Section 202(a) of Investment Advisors Act of 1940 by adding (29) "private fund" and defining it as "an issuer that would be an investment company, as defined in section 3 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.").

[212] *See* SEC. & EXCH. COMM'N, RELEASE NO. IA-3221, RULES IMPLEMENTING AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940 (2011), SEC.GOV, https://www.sec.gov/rules/final/2011/ia-3221.pdf (Discussing Release No. IA-3221 that follows 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).).

[213] *See generally Form ADV (Paper Version): Uniform Application for Investment Adviser Registration and Report Form by Exempt Reporting Advisers*, SEC.GOV, https://www.sec.gov/about/forms/formadv-part1a.pdf (last visited Feb. 16, 2018) [hereinafter *Form ADV*]; *see also* Instruction 2 to *Form ADV (Paper Version) Uniform Application for Investment Advisor Registration and Report Form by Exempt Reporting Advisers General Instructions*, SEC.GOV, https://www.sec.gov/about/forms/formadv-instructions.pdf (last visited Feb. 16, 2018) [hereinafter *Form ADV Instructions*] (Explaining that the form 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, amends these reports and submit an exempt reporting adviser.).

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

[215] *See id.* (Discussing Item 7 related to financial industry affiliations.).

Vol. 37, No. 2 (2019) ● ISSN: 2164-7984 (online) ● ISSN 0733-2491 (print)
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1. Private Fund Reporting for Investors: 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. Aside from exceptions, this triggers the reporting on Section 7.B(1) of Schedule D for each private fund advised,[216] regardless of the form of the private fund or if the fund is a related person of the adviser.[217]

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, 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[218] and other information on whether the private fund is a "master fund" in a master-feeder arrangement.[219] 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, or other private equity fund.[220]

The form reduces financial information to a minimum, as it requires only the current "gross asset value" of the private fund.[221] However, the form does not include other sensitive information in the final version of the release,

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[216] 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, in case for instance of solicitation of clients advised.

[217] *See* SEC. & EXCH. COMM'N, FORM ADV: INSTRUCTIONS FOR PART 1-A, GLOSSARY OF TERMS, RELATED PERSON 7 (2017), https://www.sec.gov/rules/final/2011/ia-3221-appc.pdf.

[218] SEC. & EXCH. COMM'N, FORM ADV: PART 1-A, SECTION 7.B(1) A. OF SCHEDULE D 47 (2017), https://www.sec.gov/about/forms/formadv-part1a.pdf.

[219] *Id.* at 48.

[220] *Id.* at 50; *see also id.* at 24.

[221] SEC. & EXCH. COMM'N, FORM ADV 50 (2017).

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.[222]

2. Private Equity Disclosure for the Assessment of Systemic Risk

Some private funds, those registered with the SEC, are required to disclose additional information through the Form PF.[223] On October 31, 2011, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission adopted Form PF final joint rules.[224] [225] Form PF collects information of private funds to assess systemic risk. The Dodd-Frank legislation mandates that the Commission collects information to assess systemic risk posed by private funds and provides the information collected to the Financial Stability Oversight Council ("FSOC" or "Council"),[226] a newly created governmental body under the Department of Treasury.[227]

Thus, Form PF represents the main monitoring tool to collect systemic risk information. The Commission and the CFTC also use Form PF as an attribute for their other regulatory programs, examinations, investigations, and investor protection. Unlike Form ADV, information collected on Form PF is not shared with the public. The SEC uses and shares the information on

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[222] Few argued the disclosure of detailed financial information was too sensitive and carried competitiveness issues.

[223] SEC. & EXCH. COMM'N, FORM PF: REPORTING FORM FOR INVESTING ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISERS 1 (2014), https://www.sec.gov/about/forms/formpf.pdf [hereinafter SEC. & EXCH. COMM'N].

[224] 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 (2011).

[225] 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.

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

[227] 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.).

Form PF with other agencies including the CFTC and the FSOC[228] on a nonpublic and confidential basis.

3. Who Must File Form PF

An investment adviser must complete and file Form PF if it:[229] (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 adviser ("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.[230] 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 of the Form PF on an annual basis. Only a large private fund manager—defined as any large hedge fund adviser, large liquidity adviser or large private equity adviser[231]—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,[232]
- Large liquidity fund advisers having at least $1 billion in combined money market and liquidity fund assets under management,[233] and

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[228] Investment Advisers Act of 1940 § 204(b)(A)(B) (2018) (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.).

[229] SEC. & EXCH. COMM'N, *supra* note 223, at 2 (The 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.).

[230] *See id.* at 1.

[231] *See id.* at 59.

[232] *See id.* at 2; *see also id.* at 59 (Providing definition for large hedge fund adviser and referring back to Instruction 3.).

[233] *Id.* at 55, 59 (At the last day of any month in the fiscal quarter immediately preceding the most recently completed fiscal quarter; defining large liquidity fund adviser 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*

- Large private equity advisers, those with at least $2 billion in private equity fund assets under management as of the last day of the most recently completed fiscal year.[234]

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.

Following the enactment of rules mandated by the Private Fund Act, the SEC proceeded with an in-depth examination of the private equity industry.

IV. 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.[235] The laws of partnership mirror the agency relationships existing between an agent and its principal, where the agent owes fiduciary duties to the principal.[236]

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[237] and others, such as the International Organization of Securities Commissions ("IOSCO") released a report to that effect in 2009.[238] The Private Equity Conflicts of Interest report addresses regulatory concerns and notes that conflicts of interest happen at four different stages:

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management; and (ii) such adviser's *regulatory assets under management* that are attributable to *money market funds* that it advises.").

[234] *Id.* at 59 (Defining large private equity adviser by reference to filing Section 4 of Form PF and referring to Instruction 3.).

[235] ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 221–83 (4th ed. 2013).

[236] *See Meinhard*, 164 N.E. 545 at 546.

[237] *Venture Capital Hearing*, *supra* note 148.

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

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fund raising, investment, management and exit. Disclosure to Limited Partners seems the proper action to mitigate this specific risk. Since Dodd-Frank, private equity and other private funds must register with the Commission.[239] Under the Investment Advisers Act, conflicts of interest that violate fiduciary duties violate securities laws.

In 2012, the Commission[240] started the Presence Exam Initiative program.[241] The program aimed to engage 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.[242] The examinations revealed that half of the advisers violated their fiduciary duties to their funds and their Limited Partners,[243] even though mechanisms to avoid conflicts existed in most cases.

Organizational documents of partnerships usually provide 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.

A. Non-Sharing Monitoring Fees

LPAs often indicate that the adviser may receive fees from its portfolio companies for services provided by the adviser (this includes fees for break-

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

[240] 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.

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

[242] *See* Bowden, *supra* note 63; *see also* Marc Wyatt, Acting Dir., Office of Compliance Inspections and Examinations, *Private Equity: A Look Back and a Glimpse Ahead*, SEC. & EXCH. COMM'N (May 13, 2015), https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[243] *Id.*

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). These transaction fees from portfolio companies are in addition to management fees paid by Limited Partners (ranging from 0.75% to 1.5%).[244] 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, 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.[245]

However, the adviser needs to inform the fund and Limited Partners when it receives monitoring fees, accelerated fees or other fees, so it shares them with the funds and Limited Partners.[246] 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.[247]

B. Shifting Expenses

An adviser shifts expenses in various ways by transferring expenses between several funds when it manages or allocates portfolio company

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[244] *See, e.g.*, *WL Ross & Co. LLC*, Investment Advisers Act Release No. 4494, at 3 (Aug. 24, 2016).

[245] *Id.* at 4 (LPA defined "assets of the Partnership" invested in securities of companies).

[246] *See, e.g.*, Blackstone Management Partners L.L.C., Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (The adviser inadequately disclosed to limited partners and Limited Partnership Advisory Committee (composed with selected limited partners) the termination of monitoring fees and receipt of accelerated future monitoring fees. Only the monitoring fees were disclosed to the funds and limited partners prior to their commitment to the fund but the practice of accelerated monitoring fees were not. These were subsequently disclosed via distribution notices, quarterly management fee reports or SEC filings after the adviser had already taken accelerated fees.).

[247] *See WL Ross & Co. LLC*, *supra* note 244, at 5 (The private equity fund adviser failed to disclose its fee allocation practices to some private equity Funds it advised resulting for the Funds to pay higher management fees of $10.4 million between 2001 and 2011. LPAs provided that transactions 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 retaining 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.).

expenses between different funds, or when it misallocates expenses between the adviser and the fund.[248]

C. The Use of Consultants to Avoid Sharing Fees

This practice occurs when an adviser terminates a portfolio company's advisory fees and replaces 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.[249]

From 2014 and 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,[250] or if it will consider a new course of action.

CONCLUSION

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. In addition, unflattering news headlines have influenced private equity advisers to modify some controversial fee practices.[251]

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[248] *See, e.g.*, JH Partners, LLC, Investment Advisers Act Release No. 4276 (Nov. 23, 2015) (From 2006 to 2012, the adviser and some principals provided $62 million in direct loans to the Funds' portfolio companies (interim financing for working capital and other urgent matters) without disclosing it to the Funds and its limited partners. The securities interest by the adviser and principals were senior to equity held by the Funds. The adviser failed to disclose the loans or the seniority of the loans to the advisory board, nor did the adviser obtain the advisory board consent.).

[249] *See, e.g.*, Fenway Partners, LLC, 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.).

[250] *See* APPELBAUM & BATT, *supra* note 92.

[251] *See, e.g.*, 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* 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; *see also, e.g.*, Yves Smith, *NY Times Gretchen Morgenson Exposes More Layers of Private Equity Fee Chicanery*, NAKED CAPITALISM (Oct. 19, 2015), http://www.nakedcapitalism.com/2015/10/ny-times-gretchen-morgenson-discusses-more-layers-of-private-equity-fee-chicanery.html.

Investors demand more transparency[252] and state legislatures, such as in California, now impose new disclosure requirements for those public pension plans that have invested in private equity or other private funds.[253] Starting in 2017, public pension plans must disclose fees and expenses reported by private equity funds in which the pension plans have invested.[254]

Disclosure has provided greater transparency about the business of private equity. 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 tools 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.[255] 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 of Form PF, but investors and the public could have access to it (it could be 10-K or 10-Q or making public part of the information contained in Form PF). These disclosures will allow an effective alignment of interests between private equity managers and their investors, because it

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[252] *ILPA Publishes Landmark Guidance on Private Equity Fee Reporting*, INST. LTD. PARTNERS ASS'N (Jan. 29, 2016), https://ilpa.org/wp-content/uploads/2015/06/ILPA-Fee-Reporting-Template_Press-Release-FINAL1.pdf.

[253] *See* CAL. GOV'T CODE § 7514.7 (2018) (West 2018) (Public investment fund must require disclosures by alternative investment vehicles and report the information.).

[254] *Id.*

[255] *See* Phalippou, *supra* note 113, at 159 (The IRR is not a good measurement because it does not give the actual return received by investors and the fund's real worth. It provides arbitrary results as funds manager can report the performance by pooling several funds instead of reporting each fund separately. Bias comes in when higher performance, especially obtained in fund early days, can hide bad performance.).

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will provide appropriate tools to compare and make sure that what a fund has advertised corresponds to the reality as seen in financial results.

Since private equity no longer represents a niche investment but touches all aspects of the economy, it defies belief that such 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 generated by their investment.

Having access to detailed financial data could enhance the likelihood that investors use the anti-fraud provision under the Exchange Act 10b and rule 10b-5.[256] This provision provides a private right of actions for private equity investors and does not require the registration of an investment adviser with the SEC. It has nevertheless, been largely overlooked by private equity investors who usually do not bring issues to courts to confront GPs.[257] Investors dissatisfied with a fund's performance prefer to withdraw from consecutive funds raised by the same GP.[258] One explanation of this absence of lawsuits is the lack of quality information provided by GPs that limits 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, a causation. Thus, by limiting disclosure and the kind of information provided to investors, GPs also limit the possibility of litigation.[259] The limited options to exit an investment through a secondary market also hinder the chances of 10b-5 actions.[260] Investors should negotiate ex ante exit options to better serve their interests.

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[256] *See* Spindler, *supra* note 68, 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, *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).

[257] *See* Rosenberg, *supra* note 48, 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, 312–13 (2010) (Detecting market conditions in violation of conflicts of interest and anti-fraud statutes may be difficult to detect.); *accord* Black, *supra* note 256 (registering with SEC will enable investors to sue private equity firms based on securities law anti-fraud provision 10b-5).

[258] *See* Ordower, *supra* note 257, at 310–11 (Preferring to "withdraw from the fund quietly," even when the investor has a private right of action afforded by securities law.).

[259] *See* Spindler, *supra* note 68, at 331.

[260] *Id.*