

## THE CRYSTALLIZATION OF HEDGE-FUND REGULATION

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Eleven months after Dodd-Frank was signed into law,<sup>1</sup> the SEC issued final rules pertaining to Title IV of the Act, which calls for the registration of advisers to hedge funds and similar private investment vehicles.<sup>2</sup> This brief essay looks at the legislation and the rulemaking that followed from a procedural perspective. Namely, I focus on how much discretion Congress delegated to the SEC in shaping the final rules and the SEC's use of that discretion. I find that the legislation granted a great deal of rulemaking authority to the SEC—authority that extended to the central elements of the regulatory scheme—and that the Commission used this power to extend federal oversight to a wide swath of the private-fund marketplace.

### **1. Dodd-Frank's Legislative Framework**

Before getting into the lawmaking process, it helps to provide a brief overview of the hedge-fund legislation. Title IV of the Act, entitled "Regulation of Advisers to Hedge Funds and Others," substantially altered the regulatory landscape for advisers to private funds, i.e., hedge funds, private equity funds, and venture capital funds.<sup>3</sup> Previously, many of these advisers could avoid registration under the Investment Advisers Act (the "IAA")<sup>4</sup> by making use of the so-called "private adviser exemption," which provided in essence that advisers to fewer than 15 clients need not register.<sup>5</sup> The Act eliminated this safe harbor,<sup>6</sup> thereby broadly expanding the IAA's registration requirement. In its place,

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

<sup>2</sup> See §§ 401-419.

<sup>3</sup> See *id.*

<sup>4</sup> Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to -21 (2006).

<sup>5</sup> See Press Release, SEC, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (June 22, 2011), available at <http://www.sec.gov/news/press/2011/2011-133.htm>.

<sup>6</sup> Dodd-Frank Act § 403. The private adviser exemption was formerly § 203(b)(3) of the IAA. See Investment Advisers Act § 203(b)(3).

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however, Dodd-Frank added several other exemptions from registration. Most importantly, advisers to private funds with less than \$150 million under management were exempted,<sup>7</sup> as were “foreign private advisers”<sup>8</sup> and advisers to venture capital funds.<sup>9</sup>

The Act also put in place recordkeeping and reporting requirements for registered investment advisers. Under Dodd-Frank, these funds must track information pertaining to such things as their use of leverage, including off-balance sheet leverage, their counterparty risk exposure, their trading and investment positions, their asset valuation policies and practices, and the types of assets they hold.<sup>10</sup> The information is to be made available for SEC inspection and for potential filing with the Commission.<sup>11</sup>

Lastly, Dodd-Frank created a new category of investment advisers, “mid-sized advisers.” These are advisers with between \$25 million and \$100 million in assets under management.<sup>12</sup> Generally speaking, under the Act, if these funds are subject to state registration and examination, then they are not permitted to register with the SEC.<sup>13</sup> This is ostensibly an effort to delegate regulation of smaller funds to the states so that the SEC can focus on those that pose the greatest societal risk. The Commission estimates that this change will cause approximately 3,200 advisers to switch from federal to state registration.<sup>14</sup>

## 2. Rulemaking Discretion Granted to the SEC

Congress left the SEC with broad discretion with respect to how to fill in the details of this new regulatory framework. In fact, the provisions in this Title are replete with grants of administrative authority to the agency. At the outset, although the Act greatly expanded the IAA’s registration requirement, it left largely undefined what registration will now entail.<sup>15</sup> Though Dodd-Frank listed out several categories of information that registered advisers must track for the SEC, the Commission was left free to add other disclosure obligations, so long as the agency viewed them as “necessary and

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<sup>7</sup> Dodd-Frank Act § 408.

<sup>8</sup> *Id.* § 403.

<sup>9</sup> *Id.* § 407.

<sup>10</sup> *Id.* § 404.

<sup>11</sup> *Id.*

<sup>12</sup> Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950, 42,951 (July 19, 2011) [hereinafter, Implementing Release], *available at* <http://www.sec.gov/rules/final/2011/ia-3221fr.pdf>. *See also* Dodd-Frank Act § 410.

<sup>13</sup> Dodd-Frank Act § 410. For the specific conditions limiting this exception, see § 410.

<sup>14</sup> Implementing Release, *supra* note 12, at 42,952.

<sup>15</sup> *See* Dodd-Frank Act § 403.

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appropriate . . . for the protection of investors, or for the assessment of systemic risk.”<sup>16</sup> Moreover, in constructing its disclosure regime, the SEC was empowered to segment registered fund advisers into different categories depending on size or type and to customize the information required accordingly.<sup>17</sup> Finally, subject to Dodd-Frank’s confidentiality restrictions, it was left up to the SEC to decide whether information mandated by the Act or the Commission would be filed with the SEC or merely subject to inspection.<sup>18</sup>

The SEC was also granted broad discretion over the disclosure obligations of private advisers exempted from registration. Even though private-fund advisers with under \$150 million in assets under management would not be required to register with the SEC, the agency was free to mandate that they “maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.”<sup>19</sup> Moreover, these advisers would now be subject to systemic-risk oversight—the SEC was tasked with determining whether the advisers’ funds pose systemic risk and empowered to impose regulations that reflect the risk posed.<sup>20</sup>

Nor does the exclusion of venture capital funds from the registration mandate mean that advisers to these funds are free from regulation. First, it was left up to the SEC to define what constitutes a venture capital fund.<sup>21</sup> Second, the agency was left with authority to imposed reporting and recordkeeping requirements on advisers to these funds as necessary to promote the public interest and protect investors.<sup>22</sup>

Finally, what constitutes a mid-sized adviser was also left for further consideration. Though Dodd-Frank applied this label to advisers with between \$25 million and \$100 million under management, these figures were made subject to alteration by SEC rulemaking.<sup>23</sup>

Thus, the Act, while it put in place a general structure for private-fund regulation, left much to be determined. Most importantly, although Dodd-Frank seemed to draw a bright line at \$150 million, the meaningfulness of this threshold for exemption was left in doubt. The distinction would mean a great deal if the SEC chose to enact comprehensive and invasive reporting requirements for registered advisers, while leaving unregistered advisers alone. To the contrary, the line would be all but eviscerated if the Commission chose to subject registered and unregistered advisers to a similar regulatory scheme. In

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<sup>16</sup> Dodd-Frank Act § 404.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* § 408.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* § 407.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* § 410.

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the end, the deferential nature of the Act meant that private-fund advisers would have to wait for final rules to see the nature of the regulatory regime to which they would soon be subject.

### 3. The SEC's Use of Discretionary Power

In carrying out its rulemaking, the SEC behaved as one might expect: it stayed within the outer limits of congressional intent, while extending regulation to the boundaries of the private-fund arena.

In fashioning the final rules, the SEC broadened and deepened the disclosure requirements for registered advisers. Under the newly adopted rules, such advisers will now be required to fill out a revised Form ADV (the investment-adviser registration document).<sup>24</sup> This amended form incorporates a number of changes. As the SEC explains,

As amended, Form ADV requires advisers to provide us with additional information about three areas of their operations. First, we require advisers to provide additional information about private funds they advise. Second, we expand the data advisers provide us about their advisory business (including data about the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals). Third, we require additional information about advisers' non-advisory activities and their financial industry affiliations.<sup>25</sup>

In light of these changes, not only are all advisers with greater than \$150 million in assets under management now required to register. They are also required to reveal more detailed and comprehensive information than was required under the previous registration regime.

Likewise, unregistered advisers will not be able to hide in the shadows. The SEC rules require that advisers who are exempt from registration because they either supervise less than \$150 million in assets or because they oversee venture capital funds must fill out and periodically update Form ADV<sup>26</sup>—the same form required for registered advisers. Exempt advisers are given some relief, however, in that they will be free to leave certain of the items in the form blank.<sup>27</sup> These advisers, for instance, will not be

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<sup>24</sup> Implementing Release, *supra* note 12, at 42,965.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 42,981.

<sup>27</sup> *Id.*

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required to complete Part 2 of the form (the so-called “client brochure”),<sup>28</sup> which contains information for clients and potential clients outlining in plain English the adviser’s qualifications, strategy and business practices.<sup>29</sup> On the other hand, however, such advisers remain subject to the reporting obligation of item 7, which mandates disclosure of certain detailed operational aspects of the private funds the advisers’ supervise.<sup>30</sup>

The requirements for exempt advisers is likely the area where the SEC pushed its authority the furthest. In fact, two SEC Commissioners, Kathleen Casey and Troy Paredes, dissented over these provisions. Both of them expressed the view that the regulatory burden on exempt advisers robbed the registration requirement of substance. As Commissioner Casey put it: the new rules mean that there is a “wholesale lack of any principled, meaningful distinction . . . between exempt advisers and registered advisers.”<sup>31</sup> She also lamented that there is “no substantiated justification on public interest or investor protection grounds for the decision to impose [such] requirements.”<sup>32</sup> Commissioner Paredes substantially echoed these concerns, though much of his dissent focused on the regulatory burden such requirements impose on venture capital funds, in particular.<sup>33</sup>

Finally, the SEC was given discretion to adjust the dollar range that Congress put in place to define mid-sized advisers—originally set at \$25 million to \$100 million.<sup>34</sup> The agency chose not to alter this range per se, but did make a technical amendment. The Commission put in place a buffer of \$10 million both above and below the \$100 million threshold.<sup>35</sup> Without getting into the details, the buffer is designed to provide advisers who fall near the line with some flexibility with respect to state versus federal oversight.<sup>36</sup>

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<sup>28</sup> *Id.* at 42,995, 42,997.

<sup>29</sup> Form ADV, Part 2, OMB No. 3235-0049, available at <http://www.sec.gov/about/forms/formadv-part2.pdf>.

<sup>30</sup> Implementing Release, *supra* note 12, at 42,962–63.

<sup>31</sup> Kathleen L. Casey, Prepared Statement at SEC Open Meeting on Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions For Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets under Management, and Foreign Private Advisers (June 22, 2011), available at <http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm>.

<sup>32</sup> *Id.*

<sup>33</sup> See Troy A. Paredes, Prepared Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940 (June 22, 2011), available at <http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm>. As a law professor, Commission Paredes also had the opportunity to study hedge-fund registration. See, e.g., Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, And Mission*, 2006 U. ILL. L. REV. 975.

<sup>34</sup> See *supra* Part 2.

<sup>35</sup> Implementing Release, *supra* note 12, at 42,957, 42,979, 43,011.

<sup>36</sup> *Id.* at 42,979. One aspect of SEC rulemaking I did not discuss is the agency’s systemic-risk

#### 4. Conclusion

Much has been made of the extent to which Dodd-Frank delegated the lawmaking task to administrative agencies. Hedge-fund registration is a case in point. In this instance, Congress was more than willing to delegate work to the SEC. Interestingly, it vested the SEC with authority, not only over technical details or transitional matters, but also over the heart of the regulatory scheme—who would be required to disclose and how much. For its part, the SEC was more than willing to sprint away with the baton. Although the agency never clearly overstepped its bounds, it took full advantage of the inchoate nature of the statute in order to bring transparency, not only to registered funds, but also to those that Congress had seemingly exempted from such oversight.

The process described herein certainly fits the narrative that portrays administrative bodies as the locus of lawmaking power. A narrower reading, however, is also possible. Perhaps the deference in this case can be explained by some combination of the following: (i) the uncertain policy grounds upon which hedge-fund registration rests; (ii) the exigency and breadth associated with Dodd-Frank as a whole; and (iii) Congress's unfamiliarity with the details of the complex securities laws at issue. In any event, this essay goes to show how limited yet equivocal legislation can lay the groundwork for an expansive and detailed regulatory framework.

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regulation. This oversight framework is still in the administrative process. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3145, 76 Fed. Reg. 8068, available at <http://www.sec.gov/rules/proposed/2011/ia-3145fr.pdf>.