BLACK MARKET CAPITAL

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Hedge funds and private equity offer unique investing opportunities, including the possibility for diversified and excess returns. Yet, current federal securities regulation effectively prohibits the public offer and purchase in the United States of these hedge fund and private equity investments. Public investors, foreclosed from purchasing hedge funds and private equity, instead seek to replicate their benefits. This demand drives public investors to substitute less-suitable, publicly available investments which attempt to mimic the characteristics of hedge funds or private equity. This effect, which this Article terms black market capital, is an economic spur for a number of recent capital markets phenomena, including fund adviser IPOs, special purpose acquisition companies, hedged mutual funds and specialized exchange traded funds, all of which largely attempt to replicate private equity or hedge fund returns and have been marketed to public investors on this basis. Black market capital has not only altered the structure of the U.S. capital market but has shifted capital flows to non-U.S. markets and engendered the creation of U.S. private markets. This Article identifies and examines the ramifications of black market capital. It finds this effect to be an irrational by-product of current hedge fund and private equity regulation, one likely harmful to U.S. capital markets. These are external costs inherent in the current regulatory scheme which the SEC has not recognized. The SEC should consequently undertake a thorough cost-benefit analysis of its hedge fund and private equity regulation. Based on the available evidence, such an analysis is
likely to conclude that the benefits of a regulatory scheme permitting the public offer of hedge funds and private equity funds as a component investment of a diversified portfolio not only exceed its costs but is superior to current regulation.
INTRODUCTION

Hedge funds and private equity have become influential forces in American capital markets. They are also controversial. Both hedge funds and private equity have been stridently criticized for their exorbitant fees and the spectacular profits of some of their managers, their involvement in a number of high-profile, controversial transactions and investment scandals, and the systemic and idiosyncratic risks these investments pose. Yet, their out-size presence has undoubtedly altered the structure of U.S. capital markets: twenty-eight percent of the aggregate amount of announced domestic takeovers in 2007 involved private equity while hedge funds have emerged as vocal public company shareholder activists and a source of market liquidity, diversification, and risk-management. The influence of these two investment classes is only likely to increase. Hedge funds held an estimated $2.79 trillion in assets as of the close of 2007, a 16.95% increase over the previous year. Meanwhile, private equity domestically raised an estimated $302 billion in equity commitments in 2007, a nineteen percent increase over the prior year when $255 billion was raised, and an amount

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1 I define the terms hedge funds and private equity infra Parts I.B and I.A, respectively.
3 Dealogic Database (search data on file with author).
4 See infra notes 83-85 and accompanying text.
which will likely sustain well over a trillion dollars in new corporate acquisitions.\(^6\)

Private equity and hedge funds, in particular, are capital markets phenomena which have achieved significance only in recent decades. Yet, the primary regulatory law which purports to govern them, the Investment Company Act,\(^7\) dates to 1940, and the regulations thereunder governing open-end investment companies have largely been promulgated to regulate the mutual fund industry.\(^8\) The Securities and Exchange Commission ("SEC") has refused to accommodate the differing structure and operation of hedge funds and private equity. Instead, the Investment Company Act and its related regulation effectively prevent hedge funds and private equity from accessing the public market for investors.\(^9\) Hedge funds and private equity consequently avoid application of the Investment Company Act by forgoing public capital-raising; they alternatively raise capital from high net-worth investors and pension and other investment funds in the U.S. private market or otherwise in foreign fund-raising which excludes U.S. investors altogether. In either case, the


\(^7\) 15 U.S.C. §§ 80a-1 to 80a-64 (2007).

\(^8\) The Investment Company Act defines an open-end investment company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." A closed-end investment company is defined as "any management company other than an open-end company." Id. § 80a-5(a). Because they permit redemptions, hedge funds and private equity funds are classified as open-end investment companies under the Investment Company Act.

ordinary, retail U.S. shareholder is effectively precluded by SEC rules from investing in these opportunities.  

This is a historically unintended by-product of regulation promulgated when hedge funds and private equity in their current form were largely non-existent. However, the SEC and other federal regulators, namely the Federal Reserve System and Treasury Department, have been content to preserve and even firm up these barriers. In public comments, officials of all of these agencies have repeatedly asserted that hedge funds should remain outside the public markets, closed off to the average investor. These officials justify this exclusion largely due to the alleged risk involved in these investments and the perceived inability of the average investor to prudently judge such risk.  

They do not often mention private equity in these comments but impliedly group private equity, with hedge funds by association, as equally inappropriate.  

The SEC in particular is active in this crusade, and is currently in the rule-making process to further

10 For a further discussion of these laws and the regulation of hedge funds and private equity, see infra Part II.

11 See, e.g., Anthony Ryan, Remarks of Assistant Secretary for Financial Markets, On Hedge Funds, World Hedge Fund Forum (Mar. 6, 2007) available at http://www.ustreas.gov/press/releases/hp296.htm ("The risks associated with direct investment in [hedge] funds are most appropriately borne by investors with . . . sophistication . . ."); Testimony Concerning the Regulation of Hedge Funds by Chairman Christopher Cox, U.S. Securities & Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006), available at http://www.sec.gov/news/testimony/2006/ts072506cc.htm (hedge funds "are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors.") [hereinafter COX SENATE TESTIMONY]; Testimony of Patrick M. Parkinson Deputy Director, Federal Reserve Board Division of Research and Statistics Before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (May 16, 2006) available at http://federalreserve.gov/boarddocs/testimony/2006/20060516/default.htm (the federal securities laws "effectively allow only institutions and relatively wealthy individuals to invest in hedge funds. Such investors arguably are in a position to protect themselves from the risks associated with hedge funds") [hereinafter Parkinson Testimony].

12 See infra notes 154-155 and accompanying text for a discussion of this practice in the context of SEC rule-making.
place both hedge fund and private equity investments effectively outside the investing reach of individuals.13

Ordinary investors may not necessarily agree with the judgment of their government officials.14 There are benefits to investing in hedge funds and private equity that are not available with traditional investments. Indeed, the success of hedge funds and private equity is partly attributable to the historical ability of some of these funds to earn extraordinary risk-adjusted positive returns over other investment classes and strategies. Hedge fund and private equity investments include other ostensible benefits, such as diversification, more managed risk, and the ability to leverage capital at a lower interest rate than the average investor would otherwise be capable of or have access to.15 Likely because of these perceived benefits, this Article finds evidence of high demand among individual investors for hedge fund and private equity investments. But there is no supply for most; it is effectively foreclosed by U.S. regulation.

The regulatorily created imbalance between supply and demand for these investments has resulted in a predicted economic effect arising upon the prohibition of a desired good. Average investors substitute a permitted investment with characteristics as close as possible to hedge funds or private equity.16 This is an effect this Article terms black

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13 See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. 33-8766, ¶ 87,736 (Dec. 27, 2006) [hereinafter ACCREDITED INVESTOR PROPOSING RELEASE]. I discuss this regulatory proposal infra notes 141-143 and accompanying text.

14 For example, the SEC recently received hundreds of comment letters from individual investors objecting to the SEC's proposal to raise the minimum wealth thresholds for investment in hedge funds and private equity over and above the traditional accredited investor limitations. See Kara Schnell, On the Outside of Hedge Funds Looking In, WALL ST. J., Sept. 1, 2007, at B1.

15 For a further discussion of these benefits, see infra Part I.

16 Investors also purchase these investments through surreptitious means on a true black market. They alternatively make foreign purchases where these public investments are legally permitted.
market capital. For example, public investors have eagerly invested in initial public offerings of hedge fund and private equity advisers, both permissible public investments which have been marketed as hedge fund or private equity substitutes. This is not only evidence of black market capital, but it is an irrational effect of SEC regulation. Hedge fund and private equity advisers appear to be riskier and less-suitable investments than an investment in the funds of these managers themselves. The result is an unwelcome distortion to the structure of our capital markets. Another example of this comes from special purpose acquisition companies ("SPACs"). A SPAC is a public derivative form of private equity which has been touted to investors on this basis. In 2007, there were sixty-six initial public offerings raising $12.02 billion by SPACs comprising twenty-five percent of all U.S. initial public offerings for that year and twenty percent of the aggregate money raised. The recent popularity of SPACs, which are a controversial investment class due to their high risk characteristics, again appears due almost wholly to investor demand for "private equity-type" investment. These and other illustrations will be detailed in this Article to reveal the apparent irrationality, out-datedness and possible adverse market effects engendered by current SEC investment company regulation.

A secondary or "gray" market is an inevitable consequence of any prohibitory or burdensome regulation. Yet, the SEC has failed to wholly acknowledge the negative social costs of black market capital. In this vein, the SEC has yet to undertake any cost-benefit analysis of its effective prohibi-

17 However, unlike a true black market, these substitute investments are legal.
18 See infra notes 161-165 and accompanying text. Hedge fund and private equity advisers are the managers of hedge funds and private equity funds; they establish, administer and invest these funds. I further discuss their role infra at Part IV.A.
19 I discuss this further infra at Part IV.A.
20 For a discussion of the organizational structure of SPACs, see infra notes 170-177 and accompanying text.
21 Dealogic Database (search data on file with author).
22 See infra at Part IV.A.
tion on the public offering of hedge funds and private equity funds. By highlighting the problem of black market capital, this Article exposes this SEC regulatory failure. All regulation has costs. This axiom applies to the SEC's current regulatory scheme for both hedge funds and private equity. Accordingly, if it is to remain, the SEC should justify it by conducting a thorough cost-benefit study of public investment in hedge funds and private equity as well as black market capital investments.

In the final Part of this Article, I survey the available evidence informing this question, rephrasing it as one going to whether the SEC should adopt an open market solution—regulation permissive of the public offer of, and investment in, hedge funds and private equity. I find that the benefits of adopting an open market solution appear to prospectively outweigh the possible costs and other objections. Moreover, this weighing highlights the apparent superiority of the open market solution to the current regime. This solution would not only end a primary force driving black market capital, but would also permit average investors to benefit from possible extraordinary returns, reduced risk and increased diversification provided by these investments. Reform is also

23 Nor has the SEC relied upon such tools for its other hedge fund and private equity regulation. This is a recurring problem with SEC rule-making, which often fails to comprehensively undertake cost-benefit analysis during the rule-making process. See generally Edward Sherwin, The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort, 12 STAN. J.L. BUS. & FIN. 1 (2006) (discussing the failure of the SEC to employ cost-benefit analysis in its rule-making). For a discussion of the difficulties of financial regulation cost-benefit analysis, see Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 YALE J. REG. 253, 257-65 (2007).

likely to bring systemic benefits. The public offerings fostered by these reforms would cast more light on the presently secretive practices of hedge funds and private equity. This should assist regulators in monitoring system-wide effects of these investments and aid in preventing market-wide failures such as the collapse of Long-Term Capital Management.25 Ultimately, allowing these funds to publicly offer securities and list will also place the U.S. capital market on more competitive footing, allowing it to contend with foreign markets which now freely permit and compete for such offerings and listings.

Possible objections or costs to such a regime include the inability of the common investor to comprehend these investments and their sometimes cyclical nature, possible undue risk of these investments, administrative burden of SEC regulation, and the problem of placing an SEC imprimatur on hedge fund and private equity investment. This Article finds that these and other arguments are either not compelling or require further study. In particular, the oft-cited argument that these investments are too “risky” often rests on possible systemic risk created by these investments, particularly hedge funds. This conflates legitimate concerns over the systemic risk of these investments with their individualized or idiosyncratic risk. The systemic risk of these investments is the potential and actual risk that they inflict on the system itself, the U.S. capital market. Examples of this type of risk include increased market volatility as a consequence of hedge fund market trading, adverse market fluctuations due to hedge fund or private equity over-leverage, and the extreme case of fund collapse with adverse effects on the national or global financial system.26 Conversely, individual-

25 I briefly discuss the implosion of Long-Term Capital Management's hedge fund and the regulatory response infra at notes 133-135 and accompanying text.

26 For a discussion of the systemic risks associated with hedge funds, see Nicholas Chan et al., Do Hedge Funds Increase Systemic Risk?, 91(4) ECON. REV. 49 (2006). For a thorough description of systemic risk in the context of hedge fund regulation see Troy A. Paredes, On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, 2006 U. ILL. L. REV. 975, 983-87. There is no agreement over the ex-
ized risk is unique: it is the risk to particular investors specific to their investment in hedge funds or private equity funds without regard to any systemic or systematic market risk. There is an important distinction between regulation of the investing activities of hedge funds and private equity, i.e., regulating systemic risk, and the ability of public investors to access these investments, which mainly raises issues of individualized or localized risk. If viewed through this lens, the beneficial properties of these investments, including lower potential volatility and diversification, mitigate this particular concern.

This Article is organized as follows. Part I details the historical development of hedge funds and private equity. Part II sets forth the current federal regulatory scheme for these

27 Prof. Steven Schwarcz defines systemic risk as "the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (x) the failure of a chain of markets or institutions or (y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility." Id. at 14-15. In contrast, systematic risk is generally undiversifiable risk.

28 Because this Article focuses on the black market capital effect and the appropriateness of investor access to hedge funds and private equity, it concentrates primarily on the SEC regulation of these investments. The Commodities Futures Trading Commission ("CFTC"), Board of Governors of the Federal Reserve System, and Treasury Department all share regulatory responsibility with the SEC for regulation of hedge funds and private equity. The SEC, though, has only limited jurisdiction over the systemic risks posed by these investments. This is primarily confined to the SEC's membership on The President's Working Group on Financial Markets, regulatory supervision of investment bank holding companies, see 15 U.S.C. § 78q(i) (2006), responsibility for preserving the integrity of the investing markets, and public-profile as a market regulator and consequent ability to affect congressional lawmakers. The SEC, though, is the primary regulator of hedge fund and private equity access to the public and private securities markets for investors. As this Article will later highlight, this jurisdictional parsing is one that the SEC itself has often failed to engage in when considering regulation of hedge funds and private equity.
investments. Part III discusses and traces the history of SEC regulation of these investments. Part IV introduces the economics of black market capital and puts forth a number of illustrative examples of the distortive effects of today's SEC hedge fund and private equity regulation. Part V highlights the apparently irrational and anti-competitive consequences as well as the adverse market effects of black market capital. Having recognized the costs associated with the current regime, Part VI assesses the costs and benefits associated with a new, modern regulatory scheme for hedge funds and private equity, one which would permit the public offer and purchase of these investments. That Part also proposes one possible regulatory infrastructure for an open market solution. I conclude by highlighting some of the regulatory lessons drawn from this Article's discussion of black market capital, including the need for economic cost-benefit analysis in regulation, the sometimes unintended effects of regulating with regard to the precautionary principle, and the difficulty of regulating in an era of alternative market proliferation.

I. THE RISE OF PRIVATE EQUITY AND HEDGE FUNDS

This Part briefly outlines the place of hedge funds and private equity in today's U.S. capital market. Each of these investments has increasingly become a force in this market. Moreover, beyond their externalized effect, hedge funds and private equity have each historically provided unique and valued benefits to their investors, a key to their rise and importance. It is the investor demand for these benefits which create the impetus for black market capital.

A. Private Equity

Private equity is a generalized term used to refer to the acquisition of both public and private companies by private corporate investment entities utilizing a leveraged financing
structure. Private equity in its current form largely had its origins in the 1950s and 1960s with individual and family investors. It was not until the mid-1970s that private equity as practiced today by investment partnerships emerged. Thereafter, private equity rapidly grew in prominence during the 1980s; the creation of a high yield credit market by Michael Milken and the development of a thick takeover market created the infrastructure to support sizable private equity activity.

In recent years, private equity has achieved unparalleled influence illustrated by the following chart which sets forth the number of domestic takeovers involving private equity from 1999 through 2006:

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29 The term is sometimes used on a more general basis to include investment in any private company including venture capital investments. This Article specifically avoids the question of venture capital and other such "private" investments due to their own unique attributes, though logically this Article's ultimate proposal and observations are applicable to venture capital funds.


Private equity has historically been a cyclical asset class; it has largely exhibited correlative properties with the domestic credit and takeover markets.\textsuperscript{34} As Chart 1A shows, in recent years private equity reached a high tide. According to one survey, as of the close of 2006 there were approximately 2700 private equity funds.\textsuperscript{35} In 2007, these funds represented twenty-eight percent of announced domestic takeover activity or $439 billion in aggregate market value, thirty-one percent of international leverage loan volume, and thirty-six percent of international leverage loan volume, and thirty-six

\textsuperscript{33} This chart was taken from the KKR Registration Statement on Form S-1, No.333-144335, at 112 (Filed July 3, 2007) [hereinafter KKR Registration Statement]. The acronym “CAGR” stands for compounded annual growth rate and assumes a steady rate of growth over the relevant period.


\textsuperscript{35} See Morgan Stanley Roundtable on Private Equity and Its Import for Public Companies, 18 J. APP. CORP. FIN. 3, 10 (Summer 2006).
percent of the domestic high yield market. In that year private equity funds also accounted for thirty-one percent of total domestic initial public offering volume and thirty-two percent of offering proceeds. These statistics evidence the importance and relevance during this time period of the private equity cycle to the U.S. capital market. Private equity not only fuels the takeover and credit markets, but also the initial public offering market through private equity’s ultimate need to realize a sale.

Private equity's current prominence is ultimately attributable to its remarkable ability to raise large sums of equity capital to make and finance these acquisitions. The following chart sets forth private equity's new equity capital raised in the United States during the same period, 1999 through 2006:

Chart 1B

![U.S. Corporate Private Equity Funds Raised](image)

Source: Private Equity Analyst Plus

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36 Dealogic Database (search data on file with author).
37 Id.
39 This chart was taken from the KKR Registration Statement, supra note 33, at 112.
Chart 1B shows a sharp upward trend in private equity fundraising for the last eight years, a trend which continued in 2007, when private equity domestically raised an estimated $302 billion in new equity capital, a nineteen percent increase over the prior year.\(^40\) The reasons for private equity's accelerating success in attracting capital and investors is uncertain but has been attributed to its unique characteristics and performance.

The foremost reason postulated for private equity's recent fundraising success is the extraordinary absolute return it has engendered. While the leading studies on the issue are divided over whether private equity has historically beaten the return of the S&P 500 net of fees, the majority have found that thus far private equity has returned more than the benchmark index based on gross returns.\(^41\) Of more relevance, studies have found great heterogeneity in private equity returns with a survivorship and persistence bias.\(^42\) Here may lie a key to private equity's success. Unlike the mutual fund industry, private equity funds that beat their relevant benchmark market index have been found likely to repeat these results in subsequent fundraisings.\(^43\) This is illus-

\(^{40}\) See supra note 6.


\(^{42}\) See Kaplan & Schoar, supra note 41, at 1792, 1812.

\(^{43}\) Id. This has been attributed to the learned skill of private equity investing. See, e.g., Josh Lerner et al., Smart Institutions, Foolish Choices?: The Limited Partner Performance Puzzle, 62(2) J. FIN. 731, 733
trated in the recent disclosures made by The Blackstone Group ("Blackstone"), one of the largest private equity fund advisers, in connection with its pending initial public offering. According to its public filings, Blackstone, which had approximately thirty-one billion dollars in assets under management at the time of its filing in March 2007, has earned an annual return of 30.8% on investments gross of fees since the firm began in 1987, and an annual return of 22.8% net of fees.\textsuperscript{44} Investors in private equity have therefore historically had greater certainty of extraordinary returns by investing in pre-established, successful private equity funds.

Second and relatedly, private equity has historically provided a statistically significant "alpha." Alpha is an investment management term that refers to the ability of an investment manager to earn excess returns over those predicted for an investment based on its prior response to market movements, or "beta."\textsuperscript{45} Eliminating beta permits the manager's performance to be evaluated based upon the quality of their investment selections and not on market movements.\textsuperscript{46} Private equity funds have been found to historically provide superior risk-adjusted performance, or positive alpha, higher than that of matching levered investments in the S&P 500 Index.\textsuperscript{47} In this regard, these assets have additional

\textsuperscript{44} See Blackstone Group L.P., Registration Statement on Form S-1, No.333-141504, at 5 (Filed Mar 22, 2007). Similarly, KKR, another prominent private equity adviser, had an annual average return of 20.2% net of fee on its first ten private equity funds during a period spanning over thirty years. See KKR Registration Statement, supra note 33, at 4.

\textsuperscript{45} See ZVI BODIE ET AL., INVESTMENTS, 273 (5th ed. 2002).

\textsuperscript{46} Id.

\textsuperscript{47} See Alexander Peter Groh & Oliver Gottschalg, The Risk-Adjusted Performance of U.S. Buyouts (Nov. 14, 2006), available at http://ssrn.com/abstract=876273. This is particularly popular with investment managers who adopt a portable alpha strategy, adjusting the beta of their investment through leverage in order to concentrate on obtaining an alpha return.
diversification and risk-management properties. Private equity generally has only moderate correlation with the public equity and debt markets, giving investors a needed diversification element. Private equity's risk-ameliorating potential is also self-apparent; it is an investment in multiple private companies, diversifying away the high risk of a single private acquisition.

Finally, these funds provide a vehicle for investors to manage their finance and leverage. Inexperienced investors can invest in private equity, hiring the managers' expertise to negotiate, pick, and operate these acquisitions. Moreover, the financing that these funds incur to make these investments are on more beneficial terms and at a lower rate than an investor can otherwise typically negotiate for themselves. These are but a few examples of the expertise and benefits that these capital funds provide to investors.

Private equity's rise has changed the architecture of the U.S. capital markets by offering an economically viable private, rather than public, haven for companies. The creation of this market led the economist Michael Jensen to predict in 1989 that these investments could engender an "eclipse of

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49 This need for expertise is also one reason for the popularity of funds of funds, funds which invest in other hedge funds and private equity funds. See generally Richard K. Lai, Why Funds of Funds?, 5-8 (Feb. 15, 2006), available at http://ssrn.com/abstract=676999 (examining the financial and economic incentives engendering the utilization of funds of funds).

50 Private equity leverage and the largely debt as opposed to equity capital structure it creates is one reason for the positive returns of these transactions. See generally Ulf Axelson et al., Why are Buyouts Levered? The Financial Structure of Private Equity Funds (Jan, 4, 2007), available at http://www.business.uiuc.edu/weisbach/lbo%20funds%20final%20version%20jan2007.pdf.
the public corporation. He based this prediction upon his perceived superiority of the private company over the public company due to the reduction in agency and regulatory costs a private company could achieve. The high number of initial public offerings of companies previously acquired by private equity show that Jensen's prediction has not yet fully come to pass; value is still present in the public markets. Still, it cannot be denied that private equity has provided an increasingly available private alternative for companies. It has also benefited target shareholders by paying them change-of-control premiums, unlocking shareholder value for this widespread group.

Private equity, though, has raised system-wide market issues. Private equity often partners with target company management or affiliated shareholders in their acquisitions; this has led to complaints by unaffiliated shareholders of insider dealing and buy-outs at unduly low consideration to the detriment of these unaffiliated shareholders. Moreover, the leverage utilized by private equity creates greater individualized corporate and systemic risk. The bankruptcies in the late 1980s of a number of private equity companies due to

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52 For example, in one 5.5 month period alone, from January 1, 2007 to May 14, 2007, sixty-nine companies had initial public offerings raising $15.4 billion in aggregate proceeds. Twenty-three of these initial public offerings were private equity sponsored, raising $6.6 billion in aggregate proceeds. These figures do not include initial public offerings by SPACs and real estate investment trusts. See Yvonne Ball, Private Equity Seeks IPO Exits, WALL ST. J., May 14, 2007, at C5; see generally Jerry X. Cao & Josh Lerner, The Performance of Reverse Leveraged Buyouts, at 3 (Oct. 15, 2006), available at http://ssrn.com/abstract=937801 (reviewing previous academic studies of private equity sponsored initial public offerings).

over-leverage led in part to the 1989 collapse of the high yield market and were one cause of the subsequent bear stock market.\textsuperscript{54} Concerns of over-leverage in private equity and possible system-wide distortion still exist.\textsuperscript{55} The high number of private equity firms flush with capital chasing acquisitions has at times created talk of a private equity bubble driving stock market prices to heights possibly divorced from their appropriate valuation.\textsuperscript{56} Finally, the recent wave of private equity firms exercising termination rights or invoking material adverse change or other clauses in their agreements to “walk” from transactions has tarnished the reputation of this industry and possibly made sellers more wary of entering into transactions with private equity firms.\textsuperscript{57}

Despite these issues, as well as recent market volatility and a market-wide credit liquidity crunch which have diminished private equity activity, there is no doubt that private equity will likely remain an important driver in our capital markets, attracting widespread attention and providing investors unique and desired historical benefits, particularly the opportunity for investors to yield excess returns.

B. Hedge Funds

Hedge funds differ from private equity in that hedge funds implement investment strategies while private equity is an asset class unto itself. The term hedge fund can be


\textsuperscript{56} See, e.g., Andrew R. Sorkin, The Great Global Buyout Bubble, N.Y. TIMES, Nov. 13, 2005, at C1 (reporting on the question of whether a “bubble in private equity industry is about to bust”).

\textsuperscript{57} See Andrew R. Sorkin, If Buyout Firms Are So Smart, Why Are They So Wrong?, N.Y. TIMES, Nov. 18, 2007, at C1 (“Private equity firms have recently been reneging on their billion-dollar buyouts as if the deals came with a 30-day money-back guarantee.”).
traced to a 1949 fund founded by Alfred Winslow Jones dedicated to selling stock simultaneously short and long to hedge risk; the term "hedge fund" was naturally applied to describe it.\textsuperscript{58} Today, although there is no agreed singular definition for hedge fund, the term is used to refer to a much broader array of investment strategies than the singular one employed by Winslow Jones. In its broadest sense the term now refers to actively managed investment pools which invest in market opportunities to produce risk-adjusted positive returns.\textsuperscript{59}

While the term hedge fund is dated to a 1949 fund, hedge funds have existed in some form since the eighteenth century origins of the U.S. capital market itself.\textsuperscript{60} Like private equity, hedge funds have only recently achieved prominence. The modern-day emergence of hedge funds can be attributed to a 1986 article in \textit{Institutional Investor} highlighting the extraordinary returns of the Tiger Fund.\textsuperscript{61} The article spurred investor interest and financing; since that time hedge funds have increasingly attracted investment and human capital. The following chart sets forth the aggregate capital invested in, and new capital raised by, hedge funds in the period 1990 through 2006:

\begin{center}
\begin{tabular}{|c|c|}
\hline
Year & Capital Invested (in billions) \\
\hline
1990 & 12 \\
1991 & 15 \\
1992 & 20 \\
1993 & 25 \\
1994 & 30 \\
1995 & 35 \\
1996 & 40 \\
1997 & 45 \\
1998 & 50 \\
1999 & 55 \\
2000 & 60 \\
2001 & 65 \\
2002 & 70 \\
2003 & 75 \\
2004 & 80 \\
2005 & 85 \\
2006 & 90 \\
\hline
\end{tabular}
\end{center}


\textsuperscript{60} Indeed many of the funds existent in the 1920s, the failure of which were the impetus for the Investment Company Act, adopted investing practices associated with those employed by today's hedge funds. See HUGH BULLOCK, \textit{THE STORY OF INVESTMENT COMPANIES}, 14-42 (Columbia Univ. Press 1959).

This chart reveals the tremendous growth in hedge fund assets under management.\(^6\) This growth continued into 2007; as of the end of this year hedge funds held an estimated $2.79 trillion in assets.\(^6\) The number of hedge funds has increased exponentially with this additional capital. Estimates put at 9462 the number of hedge funds as of the year 2006 compared to an estimate of sixty-eight active hedge funds in 1984.\(^6\) With their number, size, and free access to leveraging credit, hedge funds have come to dominate trading in the U.S. markets; in 2006 these investment vehicles accounted for approximately twenty to fifty percent of the liquidity in equity markets, twenty-five percent of the trading volume for below investment-grade debt, fifty-eight percent

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\(^6\) This chart was taken from the Och-Ziff Capital Management Group LLC, Registration Statement on Form S-1, No.333-144256, at 123 (filed July 2, 2007) [hereinafter Och-Ziff Registration Statement].  
\(^6\) Assets under management in this chart includes sums added through positive returns.  
\(^6\) See supra note 5.  
of the trading volume for credit derivatives and forty-seven percent of the trading volume for distressed debt. Moreover, in their pursuit of extraordinary positive returns, hedge funds are increasingly adopting innovative investment strategies, including activist investor positions in public companies. This and other hedge fund investing strategies, such as their widespread involvement in corporate restructurings, are altering the structure of our capital markets.

The remarkable rise of hedge funds, like private equity, can be attributed to the unique and compelling characteristics of hedge fund investments. As in the case of private equity, foremost is the historical ability of hedge funds to earn extraordinary returns. Measuring returns in the hedge fund universe is more difficult than for private equity due to the larger number of hedge funds, their diversity of strategy, survivorship, backfill, and liquidation biases, and inadequacy of data measurement and data reporting. Studies,

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68 See, e.g., Roger G. Ibbotson & Peng Chen, Sources of Hedge Fund Returns: Alphas, Betas, and Costs (Sept. 2006), available at http://ssrn.com/abstract=733264 (finding that hedge fund alphas were significantly positive at 3.04% in a sample of 3500 hedge funds from the TASS database during the period January 1995 through April 2006).

69 Survivorship bias is the tendency to exclude from a performance study funds which are no longer operating; since these funds likely no longer exist because of poor performance, the result is to bias the performance results upwards. Backfill bias is caused by the tendency of fund ad-
though, have found that aggregate hedge fund returns gross of fees are superior to those of the S&P 500 albeit with strong caveats about the quality of the data and adjustments for size, longevity, and investment strategy. These findings are supported by the performance of the Credit Suisse/Tremont Hedge Fund Index. This asset-weighted index tracks the returns of more than 4500 hedge funds; it has outperformed the S&P 500 by 36.5% during the period 1994 to 2007. These findings may understate real hedge fund performance given that numerous hedge funds included in these studies and the Credit Suisse/Tremont Index target other lower benchmarks and aim for lower but less volatile and more certain returns. Moreover, hedge fund returns have been found to have significant heterogeneity; more sizable funds have tended to deliver higher extraordinary returns, while certain well-known hedge funds have consis-

visers to report returns to databases only after a few years of operation and only then if their returns are superior; poor performing funds might never be reported. These poor performing funds are therefore excluded from performance studies. Finally, liquidation bias is the tendency of fund advisers of failing funds to simply stop reporting returns to databases at some point during the fund decline. Consequently, the full losses of a hedge fund in such a situation are often not included in performance studies. Other biases also affect performance studies, such as fraudulent reporting and the difficulty of assessing the value of hedge fund's often illiquid investments. See generally Bing Liang, Hedge Funds: the Living and the Dead, 35(3) J. FIN. QUANT. ANAL. 309 (Sept. 2000) (analyzing various survivorship and reporting biases in prior hedge fund empirical analysis).


72 Bloomberg Data Terminal (search data on file with author).


74 See Fung et al., Hedge Funds: Performance, Risk and Capital Formation (July 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=778124 (finding that capital flows into alpha producing hedge funds have an adverse effect on their risk-adjusted future perform-
tently delivered superior returns over extended periods of time.\textsuperscript{75}

Studies have also found that hedge fund returns in the aggregate have a much-valued estimated high alpha of approximately three percent, albeit with the same caveats about the quality of the data.\textsuperscript{76} This is likely a strong reason for the success of hedge funds, their demonstrated ability to provide positive risk-adjusted returns over time, and the increasing amount of capital this has attracted. Moreover, many hedge funds have strong diversification properties due to their low correlation with the U.S. equity market and other market benchmarks.\textsuperscript{77} This is aptly illustrated by the

\textsuperscript{75} For example, the primary fund of Och-Ziff Capital Management Group LLC, OZ Master Fund Ltd., which had approximately $17.6 billion in assets under management as of April 30, 2007, returned 12.2\% net of fees in a recent five-year period compared with 8.5\% for the S&P 500, and in the approximate thirteen-year lifetime of the fund has returned seventeen percent compared to 11.5\% for the S&P 500 during the same time period. Och-Ziff Registration Statement, supra note 62, at 6.


following chart which compares the performance of the S&P 500 to the Credit Suisse/Tremont index for the period from 1994 to 2007:

Chart 1D

![S&P 500 vs. Credit Suisse/Tremont Hedge Fund Index Performance](chart)

Source: Bloomberg

Chart 1D shows the low co-movement of the two indexes and the diversification that hedge funds can provide against market-wide down-turns; indeed the two indexes have historically had counter-cyclical tendencies. Moreover, the multitude of different hedge fund strategies provides investors with a menu of options for further diversification as well as risk-management. For example, a hedge fund can itself

respect to the correlation between hedge funds and equity markets). But see Chris Brooks, & Harry M. Kat, *The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors*, 5 J. ALT. INV. (2002) (finding high positive correlation between hedge fund indices and equity markets). Hedge fund returns may be trending down, though, as additional funds enter the market. See Robert Whitelaw & Sujeet Banerjee, *Hedge Funds For The Rest Of Us*, J. INDEXES (2007) (“With a huge increase in both assets under management and the sheer number of funds, it is becoming increasingly difficult for hedge funds to realize the necessary alpha to support their high relative fee structure.”).

For example, The Credit Suisse/Tremont Hedge Fund Index divides funds into ten primary subcategories based on their investment strategy. See Credit Suisse/Tremont Hedge Fund Index, Monthly Performance Overview, *available at* http://www.hedgeindex.com/hedgeindex/en/default.
take hedging positions as part of its investment strategy, which an individual investor might not be able to do, thereby providing the investor with previously unobtainable risk-adjusted returns in the underlying investments. In addition, hedge funds can relatively quickly alter investment strategies to be strongly responsive to market forces and opportunities. Finally, hedge funds allow for dynamic market investment. The vast experience of hedge fund managers and their strong incentive-based fee system, provide desired investment assistance to investors. This desire partly explains the rise of hedge funds of funds—funds that invest in multiple hedge funds thereby providing investors technical expertise in these investments and unobtainable access to industry information as well as a more diversified hedge fund investment portfolio.

The rise of hedge funds has significantly altered the structure of the U.S. and global markets. Hedge fund trading activity now provides deep liquidity to both the equity and derivatives markets. And the spectacular rise of the worldwide $347 trillion notional derivatives market is, in fact, attributable largely to hedge funds and their willingness to take counter-party risk hedging on virtually any type of investment. Hedge funds also theoretically can reduce

aspx?cy=USD (last visited Feb. 4, 2008); see also Fung & Hsieh, supra note 77, at 11-12 (defining various categories of hedge fund investing).

79 Cf. Ramin Baghai-Wadji & Stefan Klocker, Performance and Style Shifts in the Hedge Fund Industry 3-4 (Feb. 27, 2007) (stating "we also demonstrate that funds with bad performance which change style can expect a performance improvement in the period following the strategy change, whereas top performers which alter their strategy are more likely not to benefit from the style shift"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920444.

80 This fee system is discussed infra at notes 117-124 and accompanying text.


systemic and specific investment risk through their use of derivatives and hedging. Finally, hedge funds have served valuable roles in our capital markets, such as providing an influential activist investor voice in both restructurings and public company governance as well as serving as counterparties in highly complex financial transactions that other regulated entities such as banks may not be able to.

Hedge funds have also raised significant concern among investors and regulators. Hedge fund trading strategies and their leveraging of investments conceivably create undue individualized and systemic risk. The $4.6 billion implosion of the hedge fund run by Long-Term Capital Management in

In comparison, in 1987 only $867.6 billion in notional interest rate and currency derivatives were outstanding compared to $285.7 trillion as of year-end 2006. Id.


1998 aptly illustrated both of these possibilities. These funds have also been accused of taking aggressive steps to arbitrage regulation and game market systems as well as having undue involvement in insider trading schemes.

Lately, hedge funds have also come under fire for short-term corporate activism, which detractors charge is debilitating to public companies. Hedge funds have also been accused of decoupling voting rights from equity shares to inappropriately influence shareholder votes inversely to their economic stakes. Finally, their increasing status and the phenomenal wealth earned by their managers has caused worry about the creation of system-wide inequality and issues of distributive justice.

As with private equity, though, hedge funds have become an integral and important driver to our capital market, providing investors distinctive and sought after historical benefits, particularly the chance to earn excess positive returns.

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87 For a history of this financial calamity, see ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House Trade Paperbacks 2000).


89 For example, in April 2005, German Vice Chancellor Franz Müntefering called hedge funds "locusts" due to their shareholder activism with respect to Deutsche Börse. See Mark Landler, International Business; Blaming the Foreigners, N.Y. TIMES, May 5, 2005, at C1.


91 See Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, (forthcoming 2008) (examining the taxation of hedge fund and private equity profits within a variety of contexts, including distributive justice and regulatory gamesmanship grounds).
II. THE REGULATION OF PRIVATE EQUITY AND HEDGE FUNDS

The public profile of hedge funds and private equity in the United States has been shaped by two statutes enacted in 1940: the Investment Company Act and the Investment Advisers Act ("Advisers Act"). This Part discusses the architecture of these Acts, highlighting in particular their fundamental incompatibility with the structure of today's hedge funds and private equity funds. The effect is a de facto bar on hedge funds and private equity funds publicly accessing the U.S. capital markets so as to avoid the full application of these Acts. In this prohibition lies the regulatory foundation for black market capital.

A. The Investment Company Act

The Investment Company Act was adopted in 1940 to regulate investment fund practices. It is and was a creature of that time, enacted to reform inappropriate 1920s investment fund practices which came to light in the wake of the stock market crash of 1929. The Act applies to any entity deemed to be an investment company. The Act's definition of an investment company encompasses any corporate entity which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. This definition is exceedingly broad, but there are a multi-

94. 15 U.S.C. § 80a-3(a)(1)(A) (2007). The definition also encompasses any issuer which "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 percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." Id. § 80a-3(a)(1)(C).
tude of complex exemptions to the definition. If an entity meets the definition and cannot otherwise find an exemption it must then register with the SEC as an investment company. A registered investment company then comes under the full aegis of the Act and its promulgated rules as well as the regulatory supervision of the SEC.

The Investment Company Act and its related Rules are in large part designed to regulate modern day investment companies now commonly known as mutual funds. More specifically, the Act and its Rules have been promulgated by the SEC to accommodate and regulate the current and specific structure of mutual fund investments without real regard to the effect of these laws on many other species of open-end investment companies otherwise potentially subject to the Act. A consequence is that the typical hedge fund or private equity fund operates in conflict with this regulatory regime. These conflicts are pervasive, and if the Act and its related Rules fully applied to hedge funds or private equity funds, it would end the ability of these funds to exist in their current form and maintain their unique investment attributes.

First, private equity by its very nature requires leverage and borrowing. A private equity acquisition is typically twenty to thirty percent equity financed; the remainder is debt. Hedge funds also employ leverage and borrowing in order to boost returns and adjust their risk-profile. But the Investment Company Act limits leverage and borrowing by generally requiring that an investment company maintain

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95 Determining if an entity qualifies for such an exemption can be a difficult, intricate task and, in fact, there is an entire treatise on the definitional scope of an investment company and its exemptions. See ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT: EXEMPTIONS AND EXEMPTIONS (2003).

96 15 U.S.C § 80a-7(a) (2007).

97 There are also specialized rules under the Investment Company Act for closed-end investment companies and business development companies ("BDCs").


an asset coverage of at least three hundred percent.\textsuperscript{100} Moreover, the hedging typically utilized by hedge funds is generally restricted for investment companies by the Investment Company Act limitations on shorting and purchasing securities on margin.\textsuperscript{101} Both private equity and hedge funds often also concentrate their investments and invest in illiquid investments and restricted securities, thereby decreasing diversification and potentially increasing alpha. These practices are also restricted by the Investment Company Act.\textsuperscript{102}

Moreover, hedge funds and private equity funds typically have contractually created lock-up periods for invested and committed capital. Private equity is generally the stricter of the two and requires up to a ten-year commitment whereas capital invested with hedge funds has an initial lock-up of six to eighteen months and thereafter can typically be redeemed at periodic times during the year subject to early redemption penalties if withdrawn at other times.\textsuperscript{103} The structure of these commitment and redemption provisions are in conflict with the general Investment Company Act requirement that

\textsuperscript{101} Id. §§ 80a-12(a)(1), (3) (1998).
\textsuperscript{102} See id. §§ 80a-5(b)(1), 13(a)(3). The Investment Company Act stipulates that generally an open-ended investment company may not hold fifteen percent or more of its assets in illiquid securities. See Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18,612, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,930, at 82,477 (Mar. 12, 1992). A security is considered "illiquid" if a fund is unable to promptly sell or dispose of the security in the ordinary course of business at its current value within seven days. See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Release No. 14,983 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,972 (March 12, 1986). In addition, an open-ended investment company electing to be treated as a "diversified" fund may not hold the securities of any one issuer in an amount greater in value than five percent of the value of the total assets of such management company and no more than ten percent of the outstanding voting securities of such issuer. 15 U.S.C. § 80a-5(b)(1) (2004).
\textsuperscript{103} See Jonathan Bevilacqua, Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds, 54 BUFF. L. REV. 251, 260-61 (2006).
open-ended investment companies permit redemptions at the current net asset value of such security computed daily.\footnote{104} The incompatibility of these restrictions is not just one of governance: as detailed supra, keystone attributes of both private equity and hedge funds are restricted or prohibited by the Investment Company Act. In either case, application of the Act's requirements places severe limitations on the investing ability of these funds, hampering their capacity to earn extraordinary positive returns and attract capital. For example, the limitations on leverage imposed by the Investment Company Act would make it impossible for a private equity fund to function—leverage is the keystone to their ability to acquire corporate entities.\footnote{105} It would likely also reduce the ability of hedge funds to earn superior returns.\footnote{106} This effect would be compounded by the reduced ability of these funds to attract human capital due to the reduced fees that could be earned under the Advisers Act and other requirements if the fund were public.\footnote{107} The overall result is that if the Investment Company Act were fully applied, a private equity or hedge fund could not maintain the characteristics that likely underpinned their previous success.\footnote{108}
Accordingly, hedge funds and private equity funds avoid registration as investment companies under the Investment Company Act by availing themselves of one of two exclusions. The first is under Section 3(c)(1) of the Investment Company Act which excludes from the definition of investment company any fund whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making a public offering of its securities.\textsuperscript{109} The second is under Section 3(c)(7) of the Investment Company Act which excludes from the definition of investment company any fund whose outstanding securities are owned exclusively by qualified purchasers.\textsuperscript{110} A qualified purchaser includes an individual who owns not less than five million dollars in investments or any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than twenty-five million dollars in investments.\textsuperscript{111} Thus, the difference between the two is that the Section 3(c)(7) exemption permits fundraising from an unlimited number of investors provided that they are qualified purchasers.\textsuperscript{112}

\textsuperscript{110} Id. § 80a-3(c)(7).
\textsuperscript{111} Id. § 80a-2(a)(51)(A).
\textsuperscript{112} See generally DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS § 3 (American Bar Association 2005) (outlining the differences between the § 3(c)(1) and § 3(c)(7) exemptions). To avoid the registration requirements under the Securities Exchange Act of 1934, as amended, a U.S.-based hedge fund or private equity fund will still cap the number of fund investors at 500. 15 U.S.C. § 78l(g) (2007).
B. The Investment Advisers Act

The Advisers Act was also adopted by Congress in 1940 to "substitute a philosophy of full disclosure for the philosophy of caveat emptor' in the investment advisory profession." Under the Advisers Act, investment advisers are required to register with the SEC. An investment adviser is any person who engages in the business of advising others as to the value of securities or as to the advisability of investing in securities. Investment advisers are required to register with the SEC on Form ADV, disclose their investment strategy, managers' background and financial condition, keep records in accordance with SEC rules, adopt compliance programs and a code of ethics, supply information to investors concerning their results of operations, and adopt proxy voting procedures. Registered investment advisers are also subject to SEC supervision and inspection. These rules are largely disclosure-based and unlike the case of Investment Company Act strictures, hedge fund and private equity advisers could comply with these rules without conflict to their core investing functions. This is not the case with respect to the Advisers Act restrictions on fees typically charged by hedge funds and private equity.

115 Id. § 80b-2(a)(11).
A hedge fund or private equity adviser usually charges a fee known as the “two-and-twenty.” This is a two percent annual management fee imposed on assets under management; in addition, the adviser is usually remunerated with twenty percent of the fund’s positive investment returns. This high performance fee has been found to be one of the keys to the excess returns and superior performance of hedge funds. But this performance fee is effectively prohibited...
for publicly-traded registered investment companies under the Advisers Act. Moreover, fund fees in general are limited by the fiduciary duties of the fund adviser imposed by federal law and rules promulgated by the Financial Industry Regulatory Authority (formerly the National Association of Securities Dealers). Accordingly, a publicly traded investment company has an effective fee cap and the fee cannot be a percentage of absolute investment performance—the result is that the total fee is lower than the industry norm for hedge funds and private equity. Notably, this fee cap does not apply if the investment adviser limits its advised funds to investors with a net worth at or in excess of $1.5 million or

(1999). Notably, both private equity and hedge fund advisers co-invest significantly in their funds. This has also been found to be a factor in the superior performance of hedge funds. See Vikas Agarwal et al., supra note 108, at 17 (finding that "[a] one-standard deviation increase in managerial ownership increases returns by 1.5% relative to a mean of 12.2% (a performance improvement of 12%) ").

121 A performance fee cannot be charged by a registered investment adviser unless all of its clients have a net worth at or in excess of $1.5 million or $750,000 or more in assets under management with the adviser. 15 U.S.C. § 80b-5(a)(1) (2007). Advisers to hedge funds and private equity funds which are exempt from registration under §§ 3(c)(1) or 3(c)(7) of the Investment Company Act are similarly exempted under Rule 205-3 of the Advisers Act from the limitations on performance fees. See 17 C.F.R. § 275.205-3 (2007); see also John C. Coates, IV & Glenn R. Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy (Aug. 2007), available at http://ssrn.com/abstract=1005426 (discussing the Advisers Act general restrictions on "excessive" investment adviser fees).

122 See 15 U.S.C. § 80b-6(2); FINRA Rule 2110, IM-2110-1, FINRA Manual (CCH), at 4111.51 Article III, § 1. In addition, the fund adviser must have a reasonable belief that it can provide gains in excess of any administrative fee charged. See H & H Investments, SEC No Action Letter, 1981 WL 25244, *1 (Sept. 17, 1981) (finding that a six percent adviser fee per month violates Section 206 of the Advisers Act unless the adviser has a reasonable belief that it can produce gains in excess of such charge).

123 The Advisers Act does permit investment advisers to charge "fulcrum fees." A fulcrum fee provides that an investment adviser can be compensated a fee that is paid or earned when the investment company's performance is equivalent to that of the index or other measure of performance. See 15 U.S.C. § 80b-5(b) (2007); 17 C.F.R. § 275.205-2 (2007).
$750 thousand or more in assets under management with the adviser.124

Advisers to hedge funds and private equity funds fall squarely within the definition of investment adviser under the Advisers Act.125 However, there is an exemption under Section 203(b)(3) of the Act to permit them to avoid registration.126 This exempts an adviser from registration "who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company."127 SEC rules permit an adviser to count each fund, rather than investor of a fund, as a client.128 Consequently, many U.S.-based private equity and hedge funds could avoid registration as advisers by advising no more than fifteen funds.129 However, the SEC

124 See supra note 121. An adviser to a BDC can charge a limited fee based on absolute investment performance. A BDC can also issue stock options, another form of incentive-based compensation, to its adviser. See 15 USCA §§ 80b-5(a)(1), (b)(3) (1996).

125 See, e.g., Abrahamson v. Fleschner, 568 F.2d 862, 869-71 (2d Cir. 1977) (holding that hedge fund general partners are "investment advisers" under the Advisers Act), overruled in part on other grounds by Transamerica Mortgage Advisers, Inc. v. Lewis, 444 U.S. 11 (1979).

126 Even if they avail themselves of this exemption, these advisers are still subject to the strictures of the antifraud provisions of the Advisers Act. See 17 C.F.R. § 275.206(4)-1 (2006).

127 15 U.S.C. § 80b-3(b)(3)-2 (2006). Other exemptions from registration are available to investment advisers who do business only with their state and do not advise on exchange-listed securities, id. § 80b-3(b)(1); only advise insurance companies, id. § 80b-3(b)(2); are charitable organizations, id. § 80b-3(b)(4); to church plans, id. § 80b-3(b)(5); and commodity trading advisers registered with the CFTC who do not primarily act as investment advisers, id. § 80b-3(b)(6).


129 Many of these advisers also advise funds which trade in commodity futures and are consequently deemed to be "commodity pools" by the CFTC; this places them in the statutory definitions of "Commodity Pool Operators" ("CPOs") and "Commodity Trading Advisers" ("CTOs"), respectively, under the Commodity Exchange Act. See 7 U.S.C. § 1a(5) (2000)
cited figures in 2004 indicating that up to fifty percent of hedge funds still voluntarily register under the Advisers Act; there are no compiled public figures for private equity funds.\textsuperscript{130} Advisers to hedge funds and private equity funds presumably so register in order to signal higher quality that comes with SEC supervision, to reduce the due diligence transaction costs of their investors, and to attract investment by pension and other investment funds.\textsuperscript{131}

(\textit{defining CPO); see also id. \textsection \textsection 1\textsection 6\textsection (a)(a) (defining CTA).} This historically required them to register with the CFTC and subjected them to similar requirements as registered advisers under the Advisers Act. \textit{See id. \textsection \textsection 6\textsection (m)} (2000). However, an exemption to this registration requirement for both CPOs and CTAs was promulgated in 2003 which permits these entities to avoid registration so long as their funds are not public and all of their investors are sophisticated, or "qualified eligible persons." \textit{See 17 C.F.R. \textsection \textsection 3.13(a)(4), 4.14(a)(8)(1)} (2007); \textit{see generally PHILIP MCBRIDE JOHNSON \& THOMAS LEE HAZEN, COMMODITIES REGULATION, \textsection \textsection 1.02[8]} (2003) (outlining the registration requirements for CPOs and CTAs under the CEA).


\textsuperscript{131} This is exemplified by one survey in 2004 which found that fifteen percent of those surveyed would limit their investments to funds whose advisers registered under the Advisers Act. \textit{See Deutsche Bank Equity Prime Services Group, 2004 Alternative Investment Survey (2004) (copy on file with author); see generally Stephen J. Brown et al., \textit{Optimal Disclosure and Operational Risk: Evidence from Hedge Fund Registration (Jan. 7, 2007), available at http://ssrn.com/abstract=918461} (examining hedge fund adviser filings with the SEC and finding that these filings likely disclose material information concerning hedge fund operational risk). The Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the rules promulgated thereunder, generally deem fund advisers who advise a fund with twenty-five percent or greater investment by ERISA-regulated benefits plans to be managing "plan assets" and subject them to certain requirements of ERISA and the federal tax code. \textit{See 29 C.F.R. \textsection \textsection 2510.3-101} (2007). Fund advisers who are subject to these ERISA obligations generally also register under the Advisers Act due to the overlapping nature of these provisions and consequent low transaction costs for such a registration.
III. THE SEC, PRIVATE EQUITY, AND HEDGE FUNDS

The Investment Company Act and the Advisers Act forcefully confine hedge funds and private equity to capital-raising in the private market. The SEC has historically been content to preserve this effective barrier, leaving these investments largely unregulated and unsupervised. But, as hedge funds and private equity achieve increasing prominence, the SEC attitude toward these investments has changed. In the new millennium, the SEC has increasingly cast a wary eye on these investments, embarking on a campaign to regulate hedge fund advisers and further restrict investors from investing in both hedge funds and private equity.

A. SEC Regulation of Hedge Funds

During the first forty years of the modern day existence of hedge funds, the SEC only sporadically publicly directed its attention to them.\textsuperscript{132} Moreover, on those occasions when it did publicly examine these investments, the SEC focused on system-wide ramifications of hedge funds. At no time did the SEC, at least publicly, address the general application of the Investment Company Act and the Advisers Act to hedge funds nor did it examine the general regulation of these investments or their advisers. This changed in 2002 as public wariness of hedge funds and outcry over their perceived risk grew, mainly in response to the 1998 implosion of the global macro hedge fund Long-Term Capital Management.\textsuperscript{133} In that year, the SEC's Division of Investment Management ("IM") initiated an informational inquiry into hedge fund ac-

\textsuperscript{132} The history of SEC review and regulation of hedge funds is detailed in HEDGE FUND STAFF REPORT, supra note 117, at app. A.

\textsuperscript{133} See, e.g., William Safire, Beware The Hedgehogs, N.Y. TIMES, Sept. 5, 2002, at A23 (arguing that "[o]ne cause of the unusual, unstable jerking around of the stock markets . . . is the kudzu-like growth of hedge funds . . . .")
tivities. In September 2003, IM issued its report on its fact-finding investigation and recommended a number of rule-making initiatives with respect to hedge funds, including registration of hedge fund advisers under the Advisers Act.

In 2004, the SEC Commission by a three to two vote adopted IM's controversial hedge fund adviser registration recommendation by adopting new Rule 203(b)(3)-2 under the Advisers Act. As already noted, SEC rules require that an investment adviser register under the Advisers Act if it has more than fifteen clients. Rule 203(b)(3)-2 changed the prior SEC rule which had permitted an adviser to count each fund it advised as a client. Investment advisers meeting the definition of "private funds" would henceforth generally be required under the rule to look through their advised funds and count each investor as opposed to each fund as a client to determine whether the adviser was required to register. Notably, the rule deliberately excluded without significant explanation private equity advisers from this requirement. The rules required the majority of qualifying hedge fund advisers to register by February 1, 2006. But on June 23, 2006, the D.C. Circuit Court of Appeals vacated and remanded the SEC's hedge fund rule on the grounds that the SEC's "interpretation of the word 'client' comes close to vio-

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134 See HEDGE FUND STAFF REPORT, supra note 117, at i.
135 Id.
137 ADVISER REGISTRATION DISSENT, supra note 136 ¶ 81,505-06.
138 It did so by excluding from the definition of "private fund" any adviser to a fund that permitted its investors to redeem their ownership interests in the fund within two years of the initial investment. See id. ¶ 81,510-81,511. The response of many hedge fund advisers to this exemption was to simply add two-year lock-ups to avoid application of this new rule.
139 Id. ¶ 81,514.
lating the plain language of the statute," and was "arbi-

trary."\(^{140}\)

In response to the D.C. Circuit decision, the SEC aban-
donied its attempt to require hedge fund advisers to register under the Advisers Act. Instead, in 2006 the SEC proposed to further push hedge funds into the private sphere by tightening the restrictions on the type of investors who could invest in hedge funds. The SEC proposed that the definition of accredited investor under Regulation D be amended for "investment pools" (i.e., hedge funds and private equity) which rely upon the Rule 3(c)(1) exemption from registration under the Investment Company Act.\(^{141}\) Previously, an investor need only have had an aggregate net worth of $1 million, or an individual income that exceeded $200,000 (or joint income exceeding $300,000) in each of the two most recent years to qualify as an accredited investor under Regulation D, permitting investment in a Rule 3(c)(1) hedge fund or private equity fund.\(^{142}\) The proposed rule would raise the bar for investing in hedge funds and private equity funds by revising the definition of accredited investor such that a natural person could qualify only if he or she met the previous tests of net worth or income, and owned at least $2.5 million in investments.\(^{143}\)

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\(^{140}\) Goldstein v. S.E.C., 451 F.3d 873, 881 (D.C. Cir. 2006).

\(^{141}\) See ACCREDITED INVESTOR PROPOSING RELEASE, supra note 13, at 84,048.

\(^{142}\) Individuals can also have joint income with their spouses in excess of $300,000 to qualify. An individual must also have a reasonable expectation of reaching the same income level in the current year. 17 C.F.R. \$ 230.501 (2008). In addition to relying upon the Rule 506 offering exemption within Regulation D, funds also sometimes rely upon Rule 506's statutory foundation, Section 4(2), for their Securities Act offering exemption. See generally C. Edward Fletcher, III, Sophisticated Investors Under the Federal Securities Laws, 1988 DUKE L.J. 1081, 1120-26 (discussing the structure of securities registration exemptions). The SEC is currently considering raising these investment thresholds. See Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 87,939 (Aug. 3, 2007)

\(^{143}\) See ACCREDITED INVESTOR PROPOSING RELEASE, supra note 13, at 84,048. The SEC also proposed in this release a new antifraud rule under the Advisers Act to clarify, in light of the Goldstein decision, the SEC's
This recent SEC regulatory focus on hedge funds has been criticized as both schizophrenic and irrational. In its first regulatory foray, the SEC attempted to address system-wide issues of risk and transparency by requiring hedge fund advisers to submit to SEC oversight and regulation by registering under the Advisers Act. However, systemic risk issues are largely the regulatory purview of the Treasury and Federal Reserve. Both notably opposed the SEC's proposed regulation. Moreover, the registration requirements the SEC sought to impose were equivalent to Commodity Futures Trading Commission regulations at the time applicable to a majority of hedge funds.


145 The SEC relied heavily on the possibility of hedge fund adviser fraud to justify its adviser registration rule. However, the SEC was only able to cite fifty-one enforcement actions for hedge fund adviser misconduct. See ADVISER REGISTRATION ADOPTING RELEASE. supra note 128, at 81,494. In 2003, the year before adoption of the rule only three percent of combined CFTC and SEC enforcement actions were against hedge fund advisers. See Testimony of Patrick J. McCarty, General Counsel of the CFTC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 1 (July 15, 2004), http://banking.senate.gov/_files/mccarty.pdf (last visited Feb. 4, 2008).

146 See ADVISER REGISTRATION ADOPTING RELEASE. supra note 128, at 81,494 n.10. The SEC has skirted this bar by arguing that small investors are now widely invested in hedge funds through intermediaries such as pension funds, justifying its regulatory jurisdiction. See Speech by SEC Chairman: Remarks Before the Investment Counsel Association of America (Apr. 22, 2004), http://www.sec.gov/news/speech/ spch042204whd.htm (last visited Feb. 4, 2008).

The SEC then abandoned these concerns in its latest rule proposals, instead shifting its regulatory focus to protection of investors.\textsuperscript{148} Yet the rationale of this tactical change is equally puzzling. To justify placing hedge funds further off limits to investors, the SEC asserted:

> Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools.\textsuperscript{149}

Nowhere did the SEC cite a single financial or academic study about the problems or financial benefits of hedge funds to justify this statement or, indeed, the rule itself. Nor does the SEC make any cost-benefit analysis of its proposed regulation or otherwise recognize that there are any costs whatsoever. Thus, as Professor Troy Paredes has observed elsewhere, the SEC’s repeated recent attempts to regulate hedge funds on “risk” grounds appear more attributable to a precautionary approach and political considerations rather than any concrete economic or financial reason.\textsuperscript{150} This perception has had other real consequences; the SEC has informally taken the position that funds of funds—which sometimes register under the Investment Company Act and can feasibly structure themselves to sell securities publicly and list on a national exchange—would not be permitted to do so under the Investment Company Act.\textsuperscript{151} This approach pays heed to the general public’s often-expressed fear that these investments are complex, high risk, and disruptive to the U.S. capital market.

Ultimately, the organizational motivation behind the SEC’s attempted regulation of hedge funds is beyond the


\textsuperscript{149} See ACCREDITED INVESTOR PROPOSING RELEASE, supra note 13, at 84,053.

\textsuperscript{150} See Paredes, supra note 26, at 1006-16.

\textsuperscript{151} Interview with James Silk, Partner, Asset Management Group, Willkie Farr & Gallagher LLP (notes on file with author).
scope of this Article. Furthermore, the pre-clearance of investments for risk has been a concept repeatedly rejected in national securities regulation throughout the SEC's history. \footnote{See William O. Douglas, Protecting Investors, 23 \textit{Yale Rev.} 521, 524 (1934) (criticizing the failure of the recently adopted Securities Act to require pre-clearance of investments); see generally Mark A. Sargent, \textit{A Future for Blue Sky Law}, 62 U. \textit{Cin. L. Rev.} 471 (1993) (discussing historical pre-clearance of security issuances under state blue sky laws and tracing the abandonment of such review).} Whatever its rationale, the continued SEC foray is likely to further restrict investor ability to invest in hedge funds. This will only likely enhance the black market capital effect.

B. SEC Regulation of Private Equity

Since its emergence in the 1970s, the SEC has never conducted an extended public inquiry into its regulation of private equity. This is true even in the new millennium, as the SEC has preferred to focus its regulatory attention upon hedge funds, maintaining its historical "hands-off" approach towards private equity. The SEC inattention may be justified, but many have noted similar characteristics between hedge funds and private equity and accordingly criticized the logic of the SEC's seemingly singular focus on hedge funds. For example, the SEC effectively exempted private equity fund advisers from registration under its 2004 adviser registration rule. As the dissenting commissioners noted, this was an illogical distinction. The same reasons the SEC cited to require hedge fund adviser registration supported registration by private equity fund advisers, and the approving Commissioners had "not meaningfully differentiated between hedge funds and other private investment funds . . . \footnote{Adviser Registration Dissent, \textit{supra} note 136, at 81,540.}"

Moreover, the SEC's 2006 proposal to raise the wealth requirements for natural accredited investors would apply equally to fundraising by both hedge funds and private eq-
uity funds relying upon the 3(c)(1) exemption. In proposing this rule, the SEC made no distinction between the two investments. Instead, the SEC relied exclusively upon its previously stated findings with respect to hedge funds to support this regulation. Moreover, the SEC specifically excluded from the proposed rules venture capital funds due to "the benefit that venture capital funds play in the capital formation of small businesses." Yet, venture capital has been found to be a more risky investment than private equity, which is the implicit rationale for including private equity funds in these revised rules. Moreover, the SEC at no time explained its exclusion of private equity advisers from the 2004 rule and its inclusion of private equity funds in the 2006 proposal. These failures only further support charges of inconsistency against the SEC in its rule-making in this area.

The SEC has thus never explicitly justified or expressed an opinion on the Investment Company Act or the Advisers Act's exclusion of private equity from public capital-raising. Instead, when it has addressed this issue, the SEC has implicitly equated private equity with hedge funds, seemingly content with a result that excludes both from the public sphere.

IV. ON BLACK MARKET CAPITAL

A. The Economics of Black Market Capital

A black market's economic causes and effects are well documented. Its cause is relatively simple: a good is made scarcer or illegal by governmental action forbidding or limiting its sale or otherwise imposing production or sale restric-

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154 See Accredited Investor Proposing Release, supra note 13, at 84,048.
155 Id. at 84,051.
156 See generally John H. Cochrane, The Risk And Return Of Venture Capital, 75(1) J. Fin. Econ. 3 (2005) (finding first round returns of venture capital investments to be "very volatile" with a standard deviation of returns approaching 100%).
tions, such as price controls, which limit its availability. If the good is made illegal, people will economically react in one of two ways. The first is the legal option: people still desiring to consume the good will substitute. They will locate and purchase a product providing them with the next best utility. The result will be to create unnatural demand for this next-best good shifting the demand curve for it, reducing its supply and raising its cost. Alternatively, consumers will search and locate another market in which to purchase the good. This is either an illicit market—the traditional notion of a black market—at a higher than normal price, or a legal market in another jurisdiction.

Federal hedge fund and private equity regulation and increasingly hostile SEC rule-making produce similar black market effects in capital investing. Retail consumers desire to purchase investments in hedge funds and private equity for the particularized and unique benefits they offer. Yet, they are increasingly foreclosed from these options by federal securities regulation. Thus, they substitute investments that are the next best equivalent. Alternatively, investors make these investments illicitly or turn to other markets outside the United States to invest, particularly in Europe. This Article focuses on the legal aspects of this capital distortion, the investment in alternative investments in markets.

There is another side to the effect termed black market capital. Hedge funds, private equity, and other financial actors have their own economic desires; thus, as suppliers they react to investor demand by offering substitute alternative investment products. Moreover, the fund advisers' demand for investor capital and the barriers to this fund-raising in the public markets erected by current law have effected the creation of alternative markets to secure this capital and meet demand for these investments both in the United States and abroad.

157 The legal structuring of these products would be familiar to any tax attorney: the promoters avail themselves of irregularities or loopholes in the securities law to come as close as possible in their substitution.

158 Fund advisers' demand for capital is low, thus the demand for capital referred to here is more often for capital to be paid directly to the fund
These substitute and off-market investments and related market distortions are a capital markets phenomenon. They have had a significant distortive effect on the structure and course of the U.S. capital market, and are causing a fundamental shift in investing and corporate finance with widespread implications for the U.S. capital market and its competitive status in the global market. Moreover, black market capital shows that there has been a previously unrecognized, yet possibly significant cost associated with the SEC’s hedge fund and private equity regulation. This Part highlights the more significant examples and their impact on the U.S. financial market and the public sphere.

B. A Black Market for Alternative Investments and Markets

1. Fund Advisers

Recent hedge fund and private equity adviser initial public offerings are a significant example of black market capital. Hedge fund and private equity advisers are simply that: they are the corporate entities that create and administer the actual hedge funds and private equity funds. Their revenue and profit is derived principally from the so-called “two-and-twenty”—the typical two percent administrative fee that the adviser charges with respect to assets under management and a twenty percent profit-sharing fee with respect to fund profits over a pre-set hurdle rate. As such, their performance is derivative of the funds they advise; these funds need to grow in asset size and earn positive returns for the advisers themselves to accrue and increase revenue and profits.\(^{159}\)

\(^{159}\) These advisers also do earn revenue through direct investment in their funds themselves; this is a revenue-stream wholly dependent on fund performance.
The success or failure of a fund adviser is therefore almost wholly dependent upon the fortunes of the underlying funds. But, unlike the funds themselves, these corporate advisers do not automatically come under the aegis of the Investment Company Act. Rather, since they are companies whose business happens to be advising hedge funds and private equity funds, they are treated under the federal securities laws as normal operating companies. Consequently, these advisers can publicly raise capital without triggering the Investment Company Act. Therefore, they are a viable alternative for these fund managers to offer the public an opportunity to derivatively invest in hedge funds and private equity and share in the potential returns of these underlying investments.

As a black market capital substitute for hedge funds and private equity, demand among investors to invest in these adviser entities has been high. It was triggered by the first adviser initial public offering priced by Fortress Investment Group, LLC ("Fortress") on February 8, 2007. In the next year, fund advisers attempted to meet investor demand. The following table sets forth private equity and hedge fund adviser initial public offerings in the United States from the period February 8, 2007 through December 31, 2007:

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### Table 4A

<table>
<thead>
<tr>
<th>Adviser</th>
<th>Date of IPO</th>
<th>Amount of Offering (Excludes Greenshoe)</th>
<th>Assets Under Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fortress Investment Group, LLC</td>
<td>February 8, 2007</td>
<td>$634.291 million</td>
<td>$29.9 billion as of September 30, 2006</td>
</tr>
<tr>
<td>Blackstone Group L.P.</td>
<td>June 21, 2007</td>
<td>$4.133 billion</td>
<td>$88.4 billion as of May 1, 2007</td>
</tr>
<tr>
<td>GLG Partners Inc.</td>
<td>November 2, 2007</td>
<td>$3.4 billion</td>
<td>&gt;$20 billion as of June 1, 2007</td>
</tr>
<tr>
<td>Och-Ziff Capital Management Group LLC</td>
<td>November 13, 2007</td>
<td>$1.152 billion</td>
<td>$26.8 billion as of April 1, 2007</td>
</tr>
</tbody>
</table>

In 2007, these advisers raised an aggregate of $9,319 billion or 14.26% of the capital raised on the U.S. initial public offering market during this time period. The success of

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161 See Och-Ziff Capital Management Group, The Blackstone Group, (Prospectus), 1 (Nov. 13, 2007); Freedom Acquisition Corp., Definitive Proxy Statement Relating to a Merger or Acquisition, 5 (Oct. 11, 2007); The Blackstone Group, (Prospectus), 1 (June 21, 2007) [hereinafter BLACKSTONE PROSPECTUS]; Fortress Investment Group LLC, (Prospectus), 1 (Feb. 8, 2007) [hereinafter FORTRESS PROSPECTUS]. The GLG offering was accomplished through a merger with a SPAC, Freedom Acquisition Corp. rather than a direct offering of shares.

162 Aggregate initial public offering proceeds for 2007 were $65.34 billion. See Dealogic Database (search data on file with author). If GLG Partners is excluded, the figures fall to $5.919 billion and 9.1%, respectively. These figures do not include American Real Estate Partners L.P.'s August 9, 2007 acquisition for an initial payment of approximately $810 million of Carl C. Icahn's interests in the management company and general partners of the Icahn Funds which as of June 30, 2007 had approximately $7 billion in assets under management. See American Real Estate Partners L.P. Current Report on Form 8-K (Aug. 9, 2007). The transaction was generally viewed as an alternative way for this fund adviser to go public.
these investments is further exemplified by the intensity of this pent-up demand; the first offering by Fortress was twenty-seven times oversubscribed while Blackstone, which one news report described as "wildly" in demand, was seven to twelve times oversubscribed.\footnote{See Ben White, Retail Investors Get Fortress off to Flying Start on Wall Street, FIN. TIMES (U.K.) (Feb. 10, 2007); Andrew Bary, Top of the Market, BARRON'S (June 23, 2007). The strength of demand for these offerings was also evidenced by their aberrational corporate structures. Each of these offerings was made on terms substantially different from those typical of initial public offerings and in a manner adverse to public investors. For example, none of the securities offered by these entities provided for meaningful voting rights for public investors, instead leaving control entirely to the current management. This typically left not only operational matters but distributions of excess profits at their sole discretion. See, e.g., BLACKSTONE PROSPECTUS, supra note 161, at 24. In fact, the limited partnership structure utilized by Blackstone permitted it to sidestep the NYSE rules concerning independent directors and nominating and compensation committee requirements. See NYSE LISTED COMPANY MANUAL § 303A (2007). Moreover, in every one of these offerings, the adviser's management and pre-offer owners effectively sold a portion of their interests in the offering. These were highly unusual terms for a U.S. initial public offering. Typically, in an initial public offering, the sold security has full voting rights and the owners agree not to sell in the offering but rather hold their shares for a 180-day post-offering lock-up period. Voting rights are also provided as a basic corporate governance requirement to ensure proper shareholder monitoring and continued viability of a potentially long-term investment. The only offerings that have successfully deviated from these practices are those where demand is exceedingly heavy, such as in the recent offering of Google Inc.. See Alex Berenson, Google Says to Investors: Don't Think of Flipping, N.Y. TIMES, Apr. 30, 2004, at C1 (reporting that "Google can behave with so little regard for shareholders' wishes [by erecting a dual-class structure] because its business is so attractive that investors will be clamoring to buy stock no matter what conditions the company sets"). This is likely because studies have found that holders of dual class stock tend to exercise their private benefits of control in greater amount and that their reduced cash flow rights in relation to their voting control negatively effects firm value. See Paul A. Gompers et al., Extreme Governance: An Analysis of Dual Class Firms in the United States, 6 (2007), http://ssrn.com/abstract=562511 (last visited Feb. 4, 2008) ("We find strong evidence that firm value is positively associated with insiders' cash-flow rights.").}
to access Blackstone's funds but otherwise had access to initial public offerings: investors with one million to ten million dollars in investable assets. Moreover, throughout the news media as well as in industry analyst reports, the reason for the popularity of these offerings was attributed to the opportunity for investors traditionally shut out of hedge fund and private equity investments to finally participate.\footnote{See Joel Bel Bruno, *Blackstone Courts Wealthy Buyers in IPO*, AP Wires, June 13, 2007, http://www.foxnews.com/wires/2007Jun13/0,4670,BlackstoneIPO,00.html (last visited on Jan. 23, 2008) (reporting that there “is expected to be strong interest in the deal from those institutions and wealthy investors who have never before had access to the world of private equity”), Michael de la Merced, *Fortress Goes Public, a First for Hedge Funds Inside U.S.*, N.Y. Times, Feb. 9, 2007, at C2 (reporting that the Fortress initial public offering “was eagerly anticipated because it gives a much bigger pool of investors the opportunity to share in the returns of hedge funds and private equity”); Yung Kim, *Fortress Success to Spur Followers*, HedgeWorld News, Feb. 12, 2007, available at http://www.reuters.com/article/newIssuesNews/idUSN0943292320070209 (last visited July 31, 2007) (“The listing also gives anyone with a trading account and some cash the opportunity to do an end run around” SEC rules prohibiting listing of private equity and hedge funds); White, *Retail investors, supra note 163 (quoting Professor Jay Ritter as stating “I find the valuation [for Fortress] amazing . . . . Apparently there is huge demand from small investors to get into hedge funds and private equity. And I suspect (that) when other similar funds see this kind of valuation, there will be a rush to the public markets.”); Gregory Zuckerman et al., *Hedge-Fund Crowd Sees More Green As Fortress Hits Jackpot With IPO*, Wall St. J., Feb. 10, 2007, at A1 (“By selling shares of the underlying management company via a public offering, Fortress gave a wider swath of investors a way to jump on the so-called private-money bandwagon.”).}

Finally, demand for these investments has come almost solely from the demand-side. Hedge fund and private equity advisers are relatively low capital businesses.\footnote{Although some have theorized that there is also a demand element in these offerings in order to provide these advisers with an additional financing source, an acquisition currency or a meaningful equity currency to award employees. Jenny Andersen, *Some Hedge Funds Decide That Relying on Banks Is Just Too Risky*, N.Y. Times, Dec 1, 2006, at C5.} These offerings were thus not a product of these fund advisers' need for capital, but rather the result of investor demand for partici-
pation in their business.\textsuperscript{167} Consequently, in all of these offerings the bulk of the capital raised was not invested into the fund adviser business but rather flowed directly to the advisers’ pre-offer owners.\textsuperscript{168} In the Blackstone offering alone, its management received proceeds of approximately $5.2 billion in connection with the transaction.\textsuperscript{169}

2. SPACs

A similar black market capital effect has occurred with SPACs. SPACs are companies organized to purchase one or more operating businesses. The equity funds to acquire these businesses come from an initial public offering by the SPAC. At the time of the offering, the actual target acquisitions are unknown; it is only afterwards that the SPAC's organizers will begin to identify and attempt to acquire these businesses.\textsuperscript{170} The SPAC's organizational documents will typically provide it eighteen to twenty-four months to agree or complete an acquisition before the SPAC is required to liquidate and return the remaining offering proceeds to investors.\textsuperscript{171} During this interim period, the proceeds of the

\textsuperscript{167} These funds, with the exception of GLG Partners, Inc., are currently structured as partnerships or LLCs and elect to be treated as a publicly traded partnership for income tax purposes. The future offering market for these investments may be affected by current state and federal proposals to treat these publicly-traded funds as public corporations for income tax purposes. See Victor Fleischer, \textit{Taxing Blackstone}, 9-12 (Sept. 13, 2007), \textit{available at} http://ssrn.com/abstract=1012472.

\textsuperscript{168} The only exception is the pending KKR public offering. The funds raised in this offering, if it occurs, are to be allocated to KKR’s efforts to expand into new businesses beyond fund management. KKR Registration Statement, \textit{supra} note 33, at 16.

\textsuperscript{169} See \textit{BLACKSTONE PROSPECTUS}, \textit{supra} note 161, at 20-24.

\textsuperscript{170} This is a risk factor often highlighted in these transactions. See, e.g., Endeavor Acquisition Corp. Registration Statement on Form S-1, No. 333-128440, at 10 (Sept. 20, 2005) ("Since we have not yet selected a particular industry or target business with which to complete a business combination, we are unable to currently ascertain the merits or risks of the industry or business in which we may ultimately operate").

initial public offering are held in a trust or escrow account. A typical SPAC also requires that its initial acquisition or acquisitions constitute at least eighty percent of its net assets excluding deferred underwriters' discounts and commissions, though lately this threshold has been creeping down towards a sixty percent hurdle rate. Investors have a right to pre-approve this acquisition and if they vote against it and follow certain perfection procedures they are entitled to redeem their shares for a pro rata share of the remaining offering proceeds held in trust.

SPACs are a species of private equity: these are capital pools organized to acquire individual businesses. But because of the general requirement that the initial acquisition comprise eighty percent of its assets, SPACs typically only acquire a single privately-held business. Despite these important distinctions, SPACs otherwise attempt to mimic private equity returns by employing comparable structures and practices. For example, SPACs utilize similar leverage to increase the size and potential returns of their acquisitions. The managers of SPACs are also typically provided twenty percent of the initial share offering at nominal amounts; ownership they are required to maintain until and after consummation of an acquisition. This ostensibly provides them with a similar incentive compensation scheme as private equity advisers.

Like fund advisers, demand for SPACs has been heated and increasing. From 2003 to 2007, 144 SPACs have raised

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174 See Barker & Hadin, supra note 172, at 6.
175 See Yvonne Ball, Acquisition Vehicles Gather Steam, WALL ST. J., June 18, 2007, at C5 (stating one reason for the popularity of SPACs is "that they offer private-equity firms a way to sell businesses without taking them public").
176 See Barker & Hadin, supra note 173, at 38.
Over $18.1 billion in offering proceeds. With the increasing prominence of private equity, the growth of SPACs has also accelerated. The following chart sets forth the number of SPAC initial public offerings for the period from 2003 through 2007 and the aggregate gross amount of their offering proceeds:

Chart 4B

As Chart 4B shows, in 2007, sixty-six SPACs completed initial public offerings raising $12.02 billion in aggregate gross proceeds. This compares with no offerings in the entire period from the late 1990s through 2002. The size of individual SPAC offerings has also increased. In 2005, over two-thirds of SPAC initial public offerings were for $100 million or less. But in 2006, forty SPACs announced initial public offerings for an aggregate amount of $3.4 billion, and over half attempted to sell more than $100 million in securities.

179 Id.
180 Dealogic Database (search data on file with author).
181 See Barker & Hedin, supra note 173, at 38. As of February 1, 2008, only twenty-five of the 151 SPACs which had gone public since 2003 had actually consummated a business combination, and another twenty-three
Then in 2007 there was the first billion dollar capital raising by a SPAC, the $1.035 billion dollar initial public offering by Liberty Acquisition Holdings Corp. With this rise in offerings has come an increase in mainstream private equity participation. Managers from traditional private equity funds are now forming their own SPAC vehicles as alternatives to commencing their own private equity funds.

The rise of SPACs, as with hedge fund and private equity fund advisers, has been attributed to their perceived properties as a substitute for private equity fund investments. Analysts covering these investments almost uniformly refer to them as public opportunities for private equity investment and repeatedly assess their quality in comparison to private equity. Media similarly and repeatedly describe these investments as opportunities for public investors to invest in private equity and pin their emergence on the public's closed-off desire for such investments. In short, the SPAC


For example, on October 1, 2007, Thomas O. Hicks, the founder and former CEO of the renowned private equity firm Hicks Muse Tate & Furst, completed a $480 million initial public offering for the SPAC, Hicks Acquisition Company I, Inc. See Hicks Acquisition Co. I, (Prospectus), at 1 (Oct. 1, 2007). Marathon Acquisition Corp., a SPAC formed by Michael Gross, a founder and former partner with Apollo Management, L.P., also raised $300 million in a 2006 initial public offering. See Marathon Acquisition Corp., (Prospectus) (Aug. 25, 2006).

See, e.g., Lynn Cowan, Blank Checks Generate New Interest, WALL ST. J., Dec 24, 2007, at C1 (reporting that "Citigroup bankers say one reason they began to underwrite such deals was investor demand for private-equity type investments with shorter timelines than actual private-equity funds").

See, e.g., James Altucher, Get Low-Risk Exposure to Private Equity, FIN. TIMES. (U.S.), May 10, 2005, at 12 ("Spacs are an intriguing way for retail investors, and even hedge funds, to get in on the private equity game."); Eleanor Laise, Private Equity Targets Littler Guy, WALL ST. J., Nov. 8., 2006 ("Private equity is taking Wall Street by storm. Now it’s getting easier for individual investors to get a piece of the action."); Richard Siklos, Former Media Executives Give New Life to 'Blank Check' Corpora-
phenomenon has been publicly attributed and promoted as a private equity substitute, one the public can now freely access.

3. Alternative Markets

Black market capital has not only engendered substitute investment products, but it has also resulted in the emergence of substitute markets themselves. At least two substitute alternative markets can be identified as a partial by-product of current foreclosing hedge fund and private equity regulation. First, SEC regulation has spurred the creation of domestic, private, unregulated markets for U.S. investors to invest in hedge fund and private equity funds and their derivative products. Second, current prohibitory hedge fund and private equity regulation has provided an incentive to fund advisers to utilize foreign markets to satisfy public demand for these funds and their own capital needs.

The rise of private alternative markets under the shadow of SEC regulation is an expected economic effect of foreclosing or burdensome regulation. Here, such markets would predictably cater not only to private equity and hedge funds but also to other corporate entities who wish to avoid general public company regulation which they perceive as inordinately restrictive and economically inefficient. This would be an effect similar to the one which has occurred in the market for non-U.S. share offerings in the United States. These offerings have shifted from the public listings market to the private market in order to avoid U.S. regulation.186 For hedge funds and private equity funds in particular, such a market would be attractive because it would enable these entities to achieve the advantages of liquidity, transparency,

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and other public market benefits that are unavailable to them or accessible only on a sub-optimal regulatory basis.

In May of 2007, the investment bank Goldman Sachs & Co. launched just such a market named the "GS Tradable Unregistered Equity OTC Market" with the acronym GSTrUE. The market's first listing was Oaktree Capital Management LLC ("Oaktree"), a hedge fund adviser with over forty billion dollars in assets under management, which sold approximately fourteen percent of itself for more than $800 million in a widespread solicitation of a number of potential investors.\(^{187}\) Goldman Sachs representatives at the time publicly stated little about the market or Oaktree's offering except that they viewed GSTrUE as a viable alternative listing market for hedge funds, private equity and operating companies who wish to avoid SEC regulation.\(^{188}\) GSTrUE is thus a "black market" that is the product of greater regulatory dissatisfaction than merely the Investment Company Act and Advisers Act, but is still driven in part by these regulatory forces. This is aptly illustrated by Goldman's public comments that GSTrUE was being marketed heavily to hedge funds and private equity, and that its first listing was a hedge fund adviser, and second listing was Apollo Management L.P., the private equity adviser.\(^{189}\)

In the wake of GSTrUE, Bear Sterns, JP Morgan and the Nasdaq each established their own private stock markets and a third group of investment banks, including Merrill Lynch, Lehman Brothers, Morgan Stanley, and Citi announced plans to establish a similar market named OPUS-


\(^{188}\) See Mark DeCambre, Goldman Aims at NYSE, STREET.COM, June 14, 2007, http://www.thestreet.com/googlen/newsanalysis/walstreet/10362518.html?cm_ven=GOOGLEN&cm_cat=FREE&cm_ite=NA (last visited Feb. 4, 2008). To qualify the market for Rule 144A offerings, GSTrUE has limited trading only to qualified institutional buyers with over $100 million in investable assets.

And on November 12, 2007, all of these investment banks announced that they would consolidate their markets into a single private market, Portal Alliance, in an attempt to bring greater liquidity to these previously segmented markets.

The second alternative market affected by black market capital is the foreign market. In this age of global capital markets, an increasing number of U.S. private equity and hedge funds, as well as non-U.S. advisers have responded to U.S. regulatory prohibitions by going abroad to publicly raise capital. From 2006-2007, twenty-six private equity and hedge funds and funds of funds made initial public offerings on the Euronext and London Stock Exchange raising approximately $15 billion. This includes the offerings by KKR of KKR Private Equity Investors LP, which raised five billion dollars and by Apollo Management of AP Alternative Assets LP, which raised $1.5 billion both on Euronext Amsterdam.

These funds are flourishing in Europe for a number of reasons. First, for U.S. alternative asset advisers this is the only avenue for public capital raising if they wish to raise permanent capital from public "retail" investors. Second, for some of these advisers, it is a vehicle to tap into demand and offer U.S. investors a public investment opportunity. Accordingly, some funds have explicitly courted U.S. investors. For example, Ripplewood Holdings LLC targeted quali-

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192 Dealogic Database (search data on file with author).

193 See Vipal Monga, Apollo IPO: Smaller, for a reason, DAILY DEAL, June 16, 2006 (reporting on AP Alternative Assets LP initial public offering); Heather Timmons, Opening Private Equity’s Door, at Least a Crack, to Public Investors, N.Y. TIMES, May 4, 2006, at C3 (reporting on KKR Private Equity Investors initial public offering).

194 Id. (quoting a private equity analyst on the IPO of KKR Private Equity Investors LP as stating “[i]t opens private equity up to a whole new group of investors”).
fied U.S. investors in a €729 million capital raising and list-
ing on Euronext Brussels for RHJ International fund, a hold-
ing company for Ripplewood’s Japanese and other busi-
nesses. RHJ International specifically provided a private
placement offering tranche for individual U.S. investors with
a net worth of five million dollars to invest in its offering
through a certificated restricted security. This U.S. in-
vestment is a common economic effect of black markets for
any good; consumers simply find another legal market to
purchase and consume it. But the increasing prevalence of
these offerings is driven by investor demand for these in-
vestments from both European and U.S. retail investors, a
demand and supply shaped by the foreclosing nature of U.S.
regulation.

4. BDCs, STACs, ETFs and Indexes

Finally, other black market capital indicators now exist
throughout the U.S. capital markets; these are also substi-
tute products which partially derive their existence, or are
otherwise marketed, as substitutes for private equity or
hedge funds. For example, in the past few years many pri-

cate equity or hedge fund advisers have sponsored business
development corporations (“BDCs”). Typically, these cor-

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195 See RHJ International Annual Report for the Fiscal Year Ended
196 See Ronald Cami, Public Vehicles Still Hold Buy-Out Allure, LEGAL
249E6F3608EDD0C8852571BD006B12EA.pdf (last visited Aug. 13, 2007).
197 See Edward Evans, Funds: Small Investors Tap into Buy-Outs,
cles/2006/04/10/bloomberg/bxfund.php.
198 Investment Company Act rules restrict their full ability to invest
by limiting affiliate transactions with their adviser sponsors. See 17
199 BDCs are subject to the Investment Company Act albeit with cer-
tain exemptions to accommodate their structure. See generally Adoption
of Permanent Rules Exempting Business Development Companies and
Certain of Their Affiliates from Provisions of the Investment Company
porations invest primarily in debt securities associated with private equity transactions and are specifically marketed as private equity substitutes.\textsuperscript{200} From January 1, 2004 to June 30, 2007, fifteen BDCs had initial public offerings raising an aggregate amount of approximately three billion dollars.\textsuperscript{201} The largest of these was the Apollo Investment BDC sponsored by Apollo Management which raised $930 million in a single offering.\textsuperscript{202} In 2006 it was estimated that publicly-traded BDCs had approximately seventeen billion dollars in assets under management compared to only one billion dollars in 1997.\textsuperscript{203}

The structured trust acquisition company ("STAC") is another derivative structure that has arisen and is marketed as a private equity substitute.\textsuperscript{204} STACs are tax-structured corporate entities which initiate offerings to acquire pre-set portfolios of businesses. They subsequently manage and operate these businesses but also adopt a pre-set acquisition agenda. Fund advisers can thus utilize this structure to roll-up their private equity investments and monetize them through a public share offering.\textsuperscript{205} Since 2005, there have been two U.S. initial public offerings by STACs raising an


\textsuperscript{201} Thomson Financial Database (search data on file with author).

\textsuperscript{202} See Geraldine Fabrikant, \textit{Private Firms Use Closed-End Funds to Tap the Market}, N.Y. TIMES, Apr. 17, 2004, at C.

\textsuperscript{203} See Krus et al., supra note 200, at 2.

\textsuperscript{204} See, e.g., Christopher M. Zochowski, \textit{PCAP recap}, DAILY DEAL, July 9, 2007 (asserting that the STAC-structure "provides several distinct advantages over other" private equity structures such as BDCs, SPACs and fund adviser offerings).

\textsuperscript{205} For an overview of this structure, see Krus et al., \textit{supra} note 200, at 5-7.
aggregate of approximately $898 million. The largest of these was the offering by Macquarie Bank for Macquarie Infrastructure Company Trust for approximately $665.3 million. While the use of these structures thus far has been limited, as market familiarity with this structure grows, practitioners believe that STACs are likely to gain increased prominence as tax-efficient private equity substitutes.

Exchange-traded funds ("ETFs") and indexes, which attempt to track private equity or hedge fund performance, have also emerged. The PowerShares Listed Private Equity Portfolio, launched on October 17, 2006, is an index of thirty fund advisers, STACs, BDCs, and other similar companies designed to mimic private equity returns. As of January 4, 2008, Powershares had $121.4 million invested in it. Powershares is thus far the only U.S. private equity derivative ETF, although a number of these exist in Europe where they can include actual private equity funds in their component investments. However, there does exist in the United States multiple single strategy "hedge fund-type" ETFs.

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206 The second was an offering by Compass Diversified Trust which raised $232.875 million. See Compass Diversified Trust, Prospectus, at 1 (May 16, 2006).
207 See Macquarie Infrastructure Company Trust, Prospectus, at 1 (Dec. 21, 2004).
208 See Zochowski, supra note 204 (stating that STAC's "success to date is impressive, and they are gaining substantial recognition by PE managers and investment banks").
211 See, e.g., Steve Johnson, BGI to Launch Buy-out ETF, FIN. TIMES, Mar. 19, 2007 (reporting that "Barclays Global Investors will tomorrow launch the first exchange traded fund based on Standard & Poor's Listed Private Equity index, which was itself unveiled only a week ago").
212 A perusal of the full list of all existent ETFs finds numerous "hedge fund-type" ETFs such as iPath JPY/USD Exchange Rate ETN, Oil Ser-
Many investment advisers now also recommend that clients use these single-product ETFs if they want to “build their own” hedge fund.\textsuperscript{213}

These ETFs are also often based on index products which attempt to achieve similar returns. For example, the Red Rock Listed Private Equity Index,\textsuperscript{214} is the baseline index for the Powershares ETF. The Red Rock index is promoted as “a means to track the performance of private equity firms.”\textsuperscript{215} One estimate lists twenty-one such indexes for hedge funds such as the Merrill Lynch Equity Volatility Arbitrage Index which attempts to replicate the returns of an S&P 500 volatility arbitrage strategy and has a related ETF.\textsuperscript{216} A number of academics have also recently published papers setting


forth models for creation of synthetic hedge funds.\footnote{217} Skillful retail investors can now make investments "akin" to having actually invested in their own hedge fund.\footnote{218}

Finally, a new breed of mutual fund has been created—the hedged mutual fund. These funds employ "hedge fund like" trading strategies and employ leverage and hedging to the extent permitted under the Investment Company Act.\footnote{219} As with other black market investments, hedged mutual funds are marketed to retail investors specifically as hedge fund substitutes.\footnote{220} To accommodate this growth and these new funds, Morningstar has created a new mutual fund category: "Long/Short Equity."\footnote{221} According to Morningstar, as of De-

\begin{footnotesize}

\footnote{218}{Professors Kat & Palaro are now marketing their hedge fund replication technique, known as FundCreator, to the general public. See http://www.fundcreator.com/ (last visited Feb. 17, 2008).}

\footnote{219}{See Vikas Agarwal et al., Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds (May 9, 2007), available at http://www.cfr-cologne.de/download/workingpaper/cfr-07-04.pdf.}

\footnote{220}{See Forward Launches Hedge Fund in Sheep's Clothing, ALLABOUT ALPHA, Jan. 14, 2007, http://allaboutalpha.com/blog/2007/01/14/forward-launches-hedge-fund-in-sheep-s-clothing/ (commenting on Forward Management's launch of a hedged mutual fund and stating "here's an example of a mutual fund that is pursuing an all-out hedge fund strategy") (last visited Feb. 4, 2008); Phil Davis, Hedge Fund Entrepreneurs Could Change Retail Landscape, FIN. TIMES (U.K.), Apr. 17, 2006 (reporting that hedged mutual funds "known as 'poor man's hedge funds,' are becoming increasingly popular in the United States"); Frederick P. Gabriel Jr., More Mutual Fund Firms Add Portfolios That Employ Hedging, INV'T NEWS, Jan. 23, 2006, at 3 (reporting that "[i]n an effort to get in on the rising popularity of hedge funds," the Janus Capital Group, Inc. and JP Morgan Chase & Co. have launched hedged mutual funds); Russ Wiles, Hedged Mutual Funds Offer Defense Strategy, CHI. SUN TIMES, Feb. 14, 2005, at 77 (reporting that "[i]t's the ultimate in blue-collar snob appeal: a growing number of mutual funds now mimic hedge funds").}

cember 31, 2007, there were 162 mutual funds in this category.²²²

V. ON IRRATIONALITY, DISTORTION, AND ANTI-COMPETITIVENESS

Black market capital has thus produced distortive effects within the U.S. capital market by shifting capital flows into investments which attempt to mimic the characteristics of hedge funds and private equity. It has also shifted capital flows to non-U.S. markets where public investors are permitted to invest directly in hedge funds and private equity. In this penultimate Part, I discuss the potentially economically harmful consequences of black market capital. I highlight the effect’s irrationality—how current hedge fund and private equity regulation drives retail investment demand towards arguably less suitable substitute investments. I conclude by detailing the potentially harmful effect of this regulation on the competitive position of the United States in the global capital and listings markets.

A. Black Market Capital’s Irrational and Distortive Effects

1. Black Market Investments

Black market capital has engendered the rise of a number of alternative investments. Yet, these investment opportunities are hedge fund or private equity substitutes and largely attempt to mimic the characteristics of these primary foreclosed funds themselves. This is the ultimate consequence of the structure of the Investment Company Act and the Advisers Act, the promulgated rules thereunder, and the black market capital effect they produce. These laws foreclose hedge funds and private equity fund investment, but permit black market substitute investments and markets. This is largely a regulatory accident. The SEC has never publicly

considered the distinctions and ramifications of these black market capital investments. Instead, they exist due to unintended structural and legal distinctions embedded in current law governing hedge funds and private equity.

But, as detailed supra Part IV, black market capital investments have properties equivalent to, and often derivative of, hedge fund and private equity investments. To this extent, they are often marketed as substitutes for publicly prohibited direct investment in hedge funds and private equity. Yet, the Investment Company Act and Advisers Act do not regulate them or otherwise regulate them on a less graduated basis than full-fledged traditional investment companies. If hedge funds and private equity investments are restricted, the similarity of black market capital investments to them should lead to an equivalent prohibition. Alternatively, a meaningful reason for this distinction should be articulated—something which has yet to occur.

Moreover, black market capital creates internal and external costs—costs which the SEC has yet to recognize. Because of their derivative nature, black market capital investments appear to be more risky on an individualized basis than the hedge fund and private equity investments they substitute for. The consequence is that public investors who purchase black market capital investments bear more risk in their investment portfolios and aggregately inject such heightened risk into the U.S capital market itself than if they were permitted to invest in hedge funds and private equity. This is aptly illustrated in the case of the black market investments profiled supra in Part IV.

Start with hedge fund and private equity advisers. An analysis of these investment opportunities reveals that they are subject to more risk than direct investment in their advised funds. This is because the future income of an adviser is dependant upon the fund advisers' capacity to continually earn extraordinary positive returns. If the adviser does not achieve such returns, fund investors, except in the most exigent circumstances, are still left with some or all of their principal, but have diminished returns or losses. However, if the fund adviser does not continuously obtain appropriate
positive returns, it not only loses the profit stream from this reduced return but fund investors will also readjust their portfolio to allocate their capital to other funds and fund advisers. Comparatively diminished returns and investment losses thus have a greater long-term impact on the fund adviser itself than on the fund investees.\(^2\)\(^2\)\(^2\) This effect is aptly illustrated by the 2006 implosion of the Amaranth Partners fund. The fund adviser, Amaranth Advisers, was put out of business by the collapse of the fund due to losing commodities trading positions, but investors in the fund itself were nevertheless returned approximately thirty-five percent of their capital; small solace, but at least a measure of their capital.\(^2\)\(^2\)\(^4\) Thus, fund adviser investments are not only more volatile cash flow streams than their derivative hedge fund and private equity investments, but also create potential for increased adverse system-wide effects due to their enhanced risk profile, a risk which is partly shifted onto the market itself.

A SPAC has similar suboptimal risk-bearing characteristics vis-à-vis the private equity fund investment for which it ostensibly substitutes.\(^2\)\(^5\) A purchase of SPAC securities is typically an investment in a single, to-be-determined acquisition. At the time of his or her purchase, a public investor is

\(^{223}\) See, e.g., Andrew Bary, Mediocrity Rewarded and Rewarded and Rewarded . . . , BARRONS, Nov. 19, 2007 ("A major risk with Och-Ziff is that, unlike traditional asset managers, it gets the bulk of its revenue from incentive fees on its hedge funds. . . ."). Moreover, these offerings are new and untested as public investing entities; their public status may raise unique unforeseen problems in the future. For example, the lowered investment compensation for the fund managers which is put into effect in such an offering may create a future unworkable structure as the current holders retire and replacement managers who have not been compensated through the initial public offering demand market compensation and an accompanying ownership interest.


\(^{225}\) See generally Helen Avery, M&A: Whacked by Spacs?, EUROMONEY, June 1, 2006, at 2-4 (reviewing a variety of unique risks posed by public investment in SPACs).
uncertain what business or industry the SPAC will enter, the size of the SPAC’s acquisition, the leverage it will bear, and whether the SPAC’s management will have any facility in the industry of the investment. Their influence on these matters is instead limited to a vote on the acquisition. However, this vote is one that has an inherently coercive aspect to it; a nay vote entitles an investor only to their share of the remaining offering proceeds, an amount that is less than their original investment. In addition to the economic calculus, loss aversion and framing may cognitively bias investors to approve the acquisition in a hopeful attempt to recoup their initial investment.\footnote{See generally Lawrence A. Cunningham, Behavioral Finance and Investor Governance, 59 Wash. & Lee L. Rev. 767, 771 (2002) (discussing “the cognitive biases that behavioral finance exposes” in the context of individual investing); see also Terrence Odean, Are Investors Reluctant to Realize Their Losses, 53 J. Fin. 1775 (1998) (concluding that investors are more reluctant to realize losses in investments than gains).} A SPAC investor is also left relying upon the SPAC sponsors to select an appropriate target. Yet these sponsors often lack the buy-out expertise that fund advisers have, typically do not have the equivalent level of resources, experience or investment affiliations, and often are not as well versed in the industry of their acquisitions as fund adviser principals are.\footnote{See Bruce Rader & Shane de Búrca, SPACs: A Sound Investment or Blind Leap of Faith?, 20 Insights: Corp. & Sec. Law Adv. 1, 2 (Jan. 1, 2006); see generally Jenny Anderson, Crave Huge Risk? This Investment May Be for You, N.Y. Times, Sept. 23, 2005 (highlighting the risk factors associated with public investing in a SPAC).} The result is that they are arguably less likely to make similarly successful investing choices as private equity fund advisers.

Moreover, SPACs are marketed as private equity substitutes but lack the diversification that is inherent in a private equity fund. Private equity funds can diversify their risk by investing in multiple companies; a SPAC does not have similar capability. Single company private equity acquisitions of this nature have also been found to bear significantly more individualized risk than investment in a private equity fund.
itself.\textsuperscript{228} Ultimately, a typical SPAC investor is left owning an investment in a lone company with an approximate twenty percent ownership stake provided to the SPAC’s sponsors at negligible cost.\textsuperscript{229} This structure attempts to replicate the compensation structure of private equity, but with significantly more risk than a private equity fund investment itself.\textsuperscript{230}


\textsuperscript{229} A SPAC acquisition of a private company also side-steps many of the purposeful informational disclosure requirements of the Securities Act and the Exchange Act because the proxy statement to approve the transaction, which includes the relevant financial and other information, is not immediately filed, yet investors can trade the SPAC shares in the interim in anticipation of the acquisition. In addition, the typical requirement that a SPAC consummate an acquisition within eighteen months can create additional distortions in bargaining incentives by the SPAC managers as they face pressure to complete an acquisition within this timetable. See, e.g., Endeavor Definitive Proxy Statement on Schedule 14A, at 66 (Nov. 28, 2007) (citing as a reason for agreeing to pay increased consideration the minimal time remaining for the SPAC to complete the acquisition).

\textsuperscript{230} The unique risk-profile of SPACs made them quite controversial when they first appeared as blank check companies in the 1980s, and many were associated with poor corporate governance practices and outright fraud. See Diana B. Henriques, Wall Street: Cleaning Up Penny-Stock Fraud, N.Y. TIMES, Apr. 15, 1990, at C15. The SEC ultimately adopted Rule 419 under the Securities Act to regulate their activities. See Blank Check Offerings, Release No. 33,6932, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,937 (Apr. 13, 1992). However, if the SPAC has net tangible assets in excess of five million dollars upon the successful consummation of its offering, it is exempt from Rule 419 because it no longer is considered a “penny stock,” and Rule 419 only applies to “penny stocks.” 17 CFR § 240.3a51-1 (2007). The majority of SPACs rely on this exemption to escape the requirements of Rule 419 and instead contractually agree to similar but less demanding terms. See generally Elizabeth Hester, Comeback of ‘Blank-Check’ Stock Issues has U.S. Regulators Worried, INT’L HERALD TRIB., Sept. 6, 2006, at 19 (discussing prior scandals in the 1980s and early 1990s associated with predecessor forms of SPACs). The problems and risks associated with SPACs have led both the Nasdaq and the New York Stock Exchange to refuse to list these vehicles; in the
The comparison of these derivative investments to the hedge fund and private equity fund investments they attempt to replicate ultimately exposes the aberrational market and costs which black market capital engenders. Investors pursuing the benefits of hedge funds and private equity invest in suboptimal investments compared to hedge fund and private equity investments themselves. These deficiencies also highlight the obsolescence and irrationality of current hedge fund and private equity regulation. Black market capital investments, derivative of private equity and hedge fund investments, are equally as risky and arguably more so than the fund investments for which they substitute. This is aptly illustrated not only in the case of fund advisers and SPACs but also with BDCs and STACs that are marketed as substitutes for private equity and hedge fund returns. Yet, the SEC is increasingly prone to further restrict public investment in hedge funds and private equity on the basis of their alleged undue risk. The failure of the SEC to similarly apply such regulatory scrutiny to these black market capital investments is inexplicable, particularly in light of the apparent greater risk and negative social costs they impose.

2. Black Market Markets

The black market markets that have arisen in part due to black market capital raise similar issues of regulatory irrationality and uneconomic market distortion. This is true both of non-U.S. market investing and emergent U.S. private markets. These markets now offer opportunities to invest in hedge funds and private equity and their derivative products. Yet, this investment is economically inefficient from both a regulatory and investor perspective.
U.S. investors investing in hedge funds and private equity in foreign markets do so legally through brokerage accounts that provide access to foreign trading markets. This product is increasingly provided by U.S. brokerages and utilized by U.S. investors. Moreover, the SEC is internally considering loosening the restrictions on foreign trading in the United States to permit greater access by U.S. investors to non-U.S.-listed securities. Yet, U.S. investors who invest abroad lack even the bare protections of the federal securities laws and the private and public enforcement these laws provide. The transaction costs associated with such investments are higher, transparency and pricing are often less than optimal, and execution is delayed. The result is that U.S. investors are permitted to legally invest in these investments, but do not have the benefits of the U.S. securities law enforcement and supervisory regime or the U.S. brokerage protection scheme. The rationale for this distinction is questionable. If the SEC considers hedge fund and private equity investments too risky for U.S. public investors, there is no reason the SEC should permit U.S. investors to make foreign purchases of such investments. This is particularly true since a foreign investment is made without SEC regulatory oversight and provides investors with no effective U.S. securities law remedy; it can therefore be a more risky and costly investment than a prohibited U.S.-based purchase of hedge funds and private equity funds.

Private markets in the United States such as Portal Alliance do not raise similar issues of public investment and

235 See Lucchetti, supra note 233, at C.
236 See Davidoff, supra note 186, at 129-44 (discussing the differentials between various non-U.S. securities regulatory schemes and the U.S. one).
SEC oversight as non-U.S. market investment. Investors trading on these U.S.-based private markets are limited by securities laws to individuals and institutional investors who otherwise regularly qualify to invest privately in hedge funds and private equity. These investors choose to invest on these markets and in these products because of the investment opportunity and the greater benefits of liquidity and transparency that they provide over and above a wholly unlisted investment. Yet, these are likely to be thin markets; bid/ask spreads for securities are likely to be wider and liquidity lower. Consequently, these investments are suboptimal; investors may prefer a full, publicly traded security on a thicker national market to meet these financial deficiencies. But the offerors of these securities may not want to subject their companies or funds to current federal securities regulation, and the funds are, in any event, prohibited from listing. This result may be rational if this regulation is considered necessary by the SEC. If it is not, the SEC may be engendering uneconomic conditions. In either case, the SEC has never fully conducted this cost-benefit economic analysis.

3. Black Market Capital's Competitive Harm

The redirected capital flows engendered by black market capital also harms the U.S. competitive position in the global capital and listings markets. Hedge funds and private equity funds that would otherwise offer securities in and list on a U.S. public market are foreclosed from doing so. But inves-

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237 At a minimum, this would be the bare limitation established by Rules 501 and 506 of Regulation D. 17 C.F.R. § 230.405 (2007). But, as a practical matter, these markets are for now likely to limit investment to those investors who qualify under Section 3(c)(7) of the Investment Company Act, and even further to investors qualified to invest in Rule 144A issuances; generally, institutions with $100 million in investable assets. 17 C.F.R. § 230.144A(a)(1) (2007).

tor demand still exists, and fund advisers wish to profit. These funds thus have incentive to offer their securities and list abroad where they are capable of meeting this demand and otherwise capture the benefits of a publicly-listed fund. This results in a loss to the U.S. economy of the investment banking, legal, accounting, stock exchange and other revenue such an offering and listing produces. It also produces a long-term loss as non-U.S. markets build up a critical mass of human and other infrastructure to support these offerings and listings. This is likely to create path dependencies in the global capital market favoring these non-U.S. markets that eradication of the current U.S. regulatory barrier on hedge fund and private equity listings may be unable to overcome.

The European exchanges, perhaps realizing their head-start, are rapidly developing regulatory architecture to accommodate and compete for hedge fund and private equity listings. The principal markets in Europe competing for these listings are the Euronext and the London Stock Exchange ("LSE"). Euronext has traditionally had a regulatory advantage over the LSE since the LSE has imposed additional listing and offering strictures incremental to those required by the Euronext, which only requires the bare minimum mandated by E.U. regulation. In addition, the

239 There is precedent for this phenomenon. In 1963, Congress enacted an interest equalization tax on non-U.S. bonds that were purchased in the United States. This tax led to the market for these bonds migrating to Europe. Congress eventually eliminated the tax, but the market, now known as the Euro-Bond market, never returned to the United States and now is larger than the U.S. bond market. See MERTON H. MILLER, FINANCIAL INNOVATIONS AND MARKET VOLATILITY, at 7 (Wiley 1991).

240 Euronext Amsterdam has attracted a number of listings due to provisions in the Dutch Financial Markets Supervision Act and Euronext Amsterdam's listing rules which permit fast-track, light regime listing procedure for international investment companies that have their registered office in Guernsey, Ireland, Jersey, Luxembourg or the United States. See Financial Markets Supervision Act, § 2:66 ((Wft) Jan. 1, 2007). The LSE standards for close-ended domestic investment entities are under revision, but are currently set out in chapter 15 of the U.K. Listing Authority's listing rules. See UKLA Listings Rules 15 (Investment Entities), available at http://fsahandbook.info/FSA/html/handbook/LR.
Financial Services Authority ("FSA") in the United Kingdom limits the public marketing to retail investors of single strategy hedge funds and private equity.241 However, in October 2006, the FSA announced an initiative to consider permitting hedge funds of funds to be generally marketed to retail investors.242 Illustrating that black market capital is not limited to the United States, the FSA justified its review by stating that:

Retail investors can currently gain access to products with hedge-fund investment characteristics through a variety of means, including listed funds of hedge funds, [and] funds offered on the internet from European jurisdictions . . . . 243

In addition, the FSA is currently implementing revised LSE listing rules to further accommodate hedge funds and private equity listings.244 In anticipation of these rule revisions, on July 12, 2007 the LSE announced the establishment of a dedicated new market, the Specialist Fund Market, for institutional investors and issuers of single strategy hedge funds and private equity vehicles.245 This market, which is deliberately less regulated than the LSE's Main Market, was set up to better position the LSE to attract pri-

241 See generally Financial Services Authority, Wider-range Retail Investment Products Consumer protection in a rapidly changing world (June 2005) available at http://www.fsa.gov.uk/pubs/discussion/dp05_03.pdf (discussing the "nature of the UK regulatory regime that applies to retail investment products").


243 Id.


vate equity fund and hedge fund listings vis-à-vis Euronext.

These European stock markets are also acutely aware that one of the main appeals they offer funds is the ability to widely access public shareholders. For example, when the LSE announced its new Specialist Fund Market, it also noted that “[i]ssuers that wish to market funds to a wide audience, including retail investors, will continue to have access to the Main Market . . ..” Ultimately, though, this competition is defining the regulatory, logistical, and other parameters of an economically optimal market for regulation of publicly-traded hedge funds and private equity funds. This is a worthy experiment in the global competition for capital and listings, one with implications for the larger competition for listings of publicly traded companies. Yet, the U.S. markets are not even in this competition; they are currently and unwillingly forfeiting an entire market segment to foreign stock markets, a beach-head they may never recover even if they are later regulatorily permitted to enter this market.

VI. TOWARD RETAIL CAPITAL

Black market capital thus produces increased investment in seemingly less suitable hedge fund and private equity substitutes, engendering uneconomic distortion within the


247 See generally PRICEWATERHOUSECOOPERS, UNDER THE SPOTLIGHT: THE REGULATION, TAXATION AND DISTRIBUTION OF HEDGE FUNDS AROUND THE GLOBE (2007) (stating that non-U.S. “regulators appear to have accepted the fact that hedge funds will continue to penetrate the retail market . . .”), available at http://www.pwc.com/extweb/pwcpublications.nsf/docid/5D8AB75A01C274B9852572FA0073A6C0/$File/under_the_spotlite.pdf

248 Id.

249 For an analysis and description of this market, see Davidoff, supra note 186, at 145-52.
U.S. capital market. It also exposes the irrationality inherent in current regulation; public offerings of private equity and hedge fund investments are prohibited, yet riskier black market investments which attempt to mimic hedge fund and private equity characteristics are permitted. The SEC has yet to recognize these costs. Moreover, the SEC has not conducted any cost-benefit analysis of its current hedge fund and private equity regulation or its flip side, an open market solution.\textsuperscript{250}

This Part considers the costs and benefits of such an open market solution.\textsuperscript{251} In particular, it considers the countervailing arguments in favor of the regulatory status quo. I conclude that any SEC study is likely to find that the open market solution is more socially optimal than the current regime.

A. The Open Market Solution's Benefits

An open market solution would permit public investors to invest in their desired investment opportunities. They could consequently access the directed benefits of hedge funds and private equity outlined \textit{supra} in Part I, including diversification opportunities and the potential for extraordinary returns.\textsuperscript{252} An open market solution would thus end many of

\textsuperscript{250} This is a need even the SEC has at times recognized, though without any formal follow-up through study or rule-making. \textit{See Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong. 16 (2003) (statement of William H. Donaldson, Chairman, Securities and Exchange Commission) ("I think there is a definite need to examine how hedge funds, properly run and properly disclosed, can be allowed to be purchased by retail investors.".).


\textsuperscript{252} This would comport with principles of shareholder equality sometimes cited by the SEC as a foundational principle for its regulation. \textit{See} Donald C. Langevoort, \textit{The SEC as a Bureaucracy: Public Choice, Institu-
the distortive investment practices engendered by black market capital. U.S. capital flows would be redirected from black market capital investments to primary hedge fund and private equity investments. These black market capital investments would still continue to exist at a diminished level, but demand for them would be lower and more particularized to those investors who specifically desire the investing characteristics of these securities. Instead, this capital would be redirected to hedge funds and private equity, economically incentivizing fund advisers to meet this demand and publicly offer these investments. Market equilibrium would be restored.

An open market solution and the consequent elimination of the primary impetus for black market capital would likely offer other significant benefits. First, an open market solution would enhance the U.S. competitive position in the global listings and offerings markets. U.S. stock markets could solicit these funds to offer securities and list in the United States. This would attract both domestic and foreign fund offerings and provide economic benefit not only to the U.S. stock markets but to the actors necessary to offer and maintain these investments publicly in the United States, including the investment bankers, accountants, and attorneys. The establishment and preservation of this "critical mass" of human capital would also maintain an important U.S. skill-set and presence in the global capital markets permitting the United States to better compete in the future.

The public offering and listing of hedge funds and private equity in the United States would also introduce greater transparency to this sometimes secretive and opaque investment community. Instead of existing privately and unmonitored in the shadow of U.S. securities markets and

253 This would likely be a much smaller pool of more sophisticated investors who appreciate the risks and opportunities associated with these specialized investments.
regulation, market forces would drive hedge funds and private equity funds to publicly offer securities. Hedge funds and private equity funds that did so would be required to disclose increased information concerning themselves to U.S. regulators and the public generally. This would permit greater scrutiny of the actual performance and characteristics of these funds by both investors as well as any investment analyst community arising to monitor these investments. It would also provide all investors with more fulsome information for comparison of returns among these funds. Both retail and sophisticated investors would therefore be placed in a superior position to assess these investments. Regulators would also benefit; they would be in a better position to monitor these funds for systemic risk as well as any of the fraudulent, manipulative, and deceptive practices that the SEC has cited as justifying its own attempts to regulate hedge funds.

If hedge funds and private equity were permitted to freely access the U.S. public markets, they could raise additional capital and enhance their growth prospects. This would likely strengthen the ability of these funds to influence and affect the U.S. capital market. The possible beneficial effects of these investments on U.S. capital markets, outlined supra in Part I, would thus likely be magnified. For example, an increase in private equity assets under management could further benefit public shareholders by engendering additional buy-outs, thereby providing these shareholders with a control share premium. For hedge funds, additional capital would produce increased trading and investing ability, adding further liquidity to markets, likely further increasing their shareholder activism and spurring these funds to con-

254 This would create an economic force towards a similar result that the SEC attempted to require with the proposed hedge funds adviser registration rule. See supra notes 136-140 and accompanying text. And while there would be only a confined number of funds who advantaged themselves of the public markets, with many remaining private, it is likely that the bigger funds with longer survivorship periods would tend towards the public markets. This is evidenced by the case of fund adviser initial public offerings which thus far have involved more prominent fund advisers. See supra notes 161-165 and accompanying text.
continue to create alternative financial products in search of extraordinary positive returns. These possible benefits must be set against the individualized and systemic risks raised by these investments and any enhanced negative effect to the U.S. capital markets generally if the presence and influence of hedge funds and private equity increased due to public investment in these funds. I discuss these possible negative effects infra.

B. The Open Market Solution's Costs

The effective elimination of black market capital through an open market regulatory solution would thus restore equilibrium to the U.S. capital market and eliminate seemingly irrational regulatory distinctions. Still, if the open market solution is to be implemented, it should be a utilitarian one: its benefits should prospectively offset any risks and other negative consequences arising from it. Many, including the SEC, have implicitly asserted that these benefits are so outweighed. Yet they have done so without any real examination or recognition of the costs associated with this regulation. This Part continues by examining the possible costs associated with and other objections to an open market solution; it finds the majority of these arguments to be unjustified, principally resting on a misperception of the possible negative systemic effects of these investments. Other objections raise more serious concerns but warrant further study. Ultimately, though further study of these objections is necessary, the open market solution at this time appears to be an economically more optimal system than the current scheme.

C. Investor Risk

A principal argument often put forth to justify the current ban on public investment in hedge funds and private equity is that these investments pose inordinate risk to investors. This is a primary argument made by the SEC to support its

\[\text{For more on these activities, see supra notes 82-85 and accompanying text.}\]
own heightened regulation of hedge funds. Yet, if hedge funds and private equity are too risky, then it would be logical to conclude that derivative, black market capital investments should also be prohibited. Moreover, these arguments typically conflate the systemic risk of hedge funds and private equity with their individual risk to investors. The investor's individualized risk is confined to the fund investment itself. While both systemic and individualized risk must be considered in the context of this Article's proposal, each is a different quantity and should be assessed separately.

I will address in the next sub-part issues of systemic risk, but with respect to individualized risk, hedge funds offer opportunities to reduce investor risk due to their low correlation with market factors compared to general mutual fund or public company equity investments. The following chart shows the $R^2$ of hedge fund and mutual fund returns versus eight classes of assets.

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256 See, e.g., ACCREDITED INVESTOR PROPOSING RELEASE, supra note 13, at 84,053 (stating that hedge funds "involve risks not generally associated with many other issuers of securities"); COX SENATE TESTIMONY, supra note 11 (stating hedge funds "are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors").

257 See supra notes 76-81 and accompanying text.

Chart 6A

Distribution of $R^2$ versus Eight Asset Classes

Source: CISDM, HFR, TASS, Morningstar, Datastream

$R^2$ is a statistical term which measures the dependent variability, or correlation, of one set of statistics (i.e., hedge fund returns) against another (i.e., a market asset class). Chart 6A reveals that in comparison to mutual funds, hedge fund returns are less correlated with general market indicators and therefore bear less market risk. In both instances, this is a source of the attractiveness of these investments: the addition of a portfolio of hedge funds to an investment portfolio provides an investor diversification against systemic risk and consequently produces idiosyncratic returns independent of the market itself. In short, hedge funds can potentially reduce an investor’s susceptibility to market-wide risk thereby lowering overall risk exposure.

Hedge funds still have their own individualized and unique risk properties. Hedge funds can invest in illiquid securities, making valuation difficult and posing liquidity is-

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259 This chart is taken from Fung & Hsieh, supra note 77, at 8. This chart also appears in Houman B. Shadab, Fending for Themselves: Regulatory Reform to Create a U.S. Hedge Fund Market for Retail Investors, 11 N.Y.U J. LEGIS. & PUB. POL’Y (forthcoming 2008).

260 This is also illustrated by Chart 1D, supra Part I.B., which shows that hedge funds can obtain positive returns even in times of declining public market returns.

261 See supra Part I.B. for a further discussion of these properties.
sues when they utilize short-term financing to make such purchases.® Hedge funds appear to have other adverse investing properties such as increased market correlation during market downturns, and the possibility of contagion—poor performance in certain hedge fund strategies affecting other classes of hedge fund.® There is also the possibility for increased risk-taking as additional hedge funds enter the market as well as cataclysmic loss events generally.264 But the risk of a singular hedge fund implosion appears to be popularly over-estimated, a possible product of the availability heuristic.265 Long-Term Capital Management collapsed in 1998 and Amaranth in 2004, and these are the two most often cited examples.266 Yet, in both cases investors received a measure of their capital back.267 Compare this with a public company failure where equity investors typically receive nothing. Moreover, even during the severe market distress of August 2007, the hedge fund failure rate due to cataclysmic loss events generally was very low.

262 See John Kambhu et al., Hedge Funds, Financial Intermediation, and Systemic Risk, FRBNY ECON. POL. REV. at 8 (Dec. 2007).
263 See inter alia Nicole M. Boyson et al., Is There Hedge Fund Contagion? (Mar. 13, 2007) (finding evidence that hedge fund styles can be subject to contagion), available at http://ssrn.com/abstract=884202; Andreas Signer & Laurent Favre, The Difficulties in Measuring the Benefits of Hedge Funds, 5(1) J. ALT. INV. (2002) (observing that the "return distributions of hedge funds frequently exhibit negative skewness and positive kurtosis," indicating a higher likelihood of extreme returns). For an excellent summary of these risks and a survey of the academic literature relating to them, see Shadab, supra note 259, at 9-10.
264 See Fung et al., supra note 74, at 4 ("Faced with a huge influx of capital, it is conceivable that hedge fund managers will attempt to generate returns by taking on more beta bets unless there is a change in the contract structure.").
265 The availability heuristic is a cognitive bias of individuals to premise the frequency of events based on recent or prominent occurrences.
266 See supra notes 87, 224.
267 See supra note 224. Investors in Long-Term Capital Management were returned ten percent of their invested capital. See NICHOLAS DUNBAR, INVENTING MONEY: THE STORY OF LONG-TERM CAPITAL MANAGEMENT AND THE LEGENDS BEHIND IT, 223 (2001).
mic events still appeared to be below the public company rate.

Analysis of hedge fund failure has found that the majority occur due to operational difficulties similar to those of public companies rather than poor investment performance. The latter class of hedge funds have almost all terminated operations through a run-off of the fund in a natural closure process rather than because of cataclysmic investment failure. The former problem would likely be diminished through heightened regulatory supervision in an open market solution. Thus, the individualized risk benefits of hedge funds warrant more study but appear to offer promising and beneficial opportunities for individual investors. Moreover, studies have shown that hedge funds are improving their risk-monitoring and other self-regulatory criteria over time. This is particularly true for hedge funds of funds which mitigate much of the individualized risk of hedge fund failure but still offer many of the benefits of hedge fund investing.

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268 See infra notes 292-295 and accompanying text.

269 See Stuart Feffer & Christopher Kundro, Understanding and Mitigating Operational Risk in Hedge Fund Investments, CAPITAL MARKETS COMPANY LTD. (2003) (“54% of failed funds had identifiable operational issues and half of all failures could be attributed to operational risk alone.”).

270 The rate is uncertain with one study finding it at 0.16% per year and another at 7.7% per year. The majority of studies have found this rate to be in the two to four percent range per year. See C. Ackermann et al., The Performance of Hedge Funds: Risk, Return and Incentives, 54 J. FIN. 833 (1999); Malkiel & Saha, supra note 70; see also Mila Getmansky et al., Sifting Through the Wreckage: Lessons from Recent Hedge Fund Liquidations, 2 J. INVESTMENT MGMT. 6 (2004); Fabrice D. Rouah, Fabrice Douglas, Competing Risks for Hedge Fund Survival, at 5 (Nov. 1, 2005), available at http://ssrn.com/abstract=840505.

271 See Shadab, supra note 259.

272 See Emily Dervir & Elaine Hutson, The Performance and Diversification Benefits of Funds of Hedge Funds, 16 J. INT’L FIN. MARKETS 4 (2006) (finding funds of hedge funds to be lower correlated to equity markets than hedge fund indexes). But see Steven J. Brown et al., Fees on Fees in Funds of Funds, 2 J. INVESTMENT MGMT. 39 (2004) (arguing that fund of fund fees can result in over-compensation). Additionally, larger hedge funds, the more likely candidates for public offerings, have been found to have higher survival rates. See Naohiko Baba & Hiromichi Goko, Survival Analysis of Hedge Funds, at 27 (Mar. 2006) (finding that hedge funds “with higher re-
Moreover, certain hedge fund strategies appear to offer the ability to earn extraordinary returns with less volatility. For example, the hedge fund adviser Och-Ziff's primary $17.6 billion fund returned seventeen percent over an approximate thirteen year period, a return greater than the 12.2% return of S&P 500 during this time while pursuing and achieving sixty-five percent less volatility. Thus, although further study is needed, certain hedge funds appear to offer opportunities to reduce volatility when compared to equity investments generally.

Studies have shown that private equity funds have similar beneficial risk-reduction properties. Private equity funds have also generally been found to have reduced correlation to market benchmarks than public debt and equity investments, again providing diversification and reducing exposure to market risk. Furthermore, private equity offers a less pronounced risk profile than a singular levered investment in a private company while providing the possibility for enhanced returns. Also, analogous to certain hedge funds, private equity has been generally found to be a less volatile investment than one in the market benchmark, the S&P 500. Moreover, no major private equity fund has ever
collapsed due to cataclysmic failure, and funds of funds have been found to bear low risk of implosion.\(^{280}\) Thus, while further study on the individualized risk profile of private equity is warranted, like hedge funds, private equity funds appear to offer beneficial risk-reducing opportunities for public investment.

Finally, the SEC has itself put forth the argument that hedge funds are too "complex" for the average investor to assess the risks associated with investment in these vehicles.\(^{281}\) Private equity has not been specifically cited, but is grouped into this prohibition by association. Here, the irrationality of black market capital investments must be highlighted. If investment in fund advisers is permitted, how can the underlying investment be too risky for public investment? Moreover, the SEC does not, as a regulatory principle, assess the riskiness of equity investments or determine their "complexity" or "appropriateness" for public investing.\(^{282}\) Many equity investments, such as General Electric Co. or Goldman Sachs & Co., are as complex or more complex than hedge funds and private equity, the parameters of their operation beyond the grasp of retail investors.\(^{283}\) Assuming that correct disclosure is made of the risks and other material information concerning these investments as it is done with black market capital and other public investments, the SEC has not sustained its burden of proving that these funds should be treated differently. Moreover, with respect to hedge funds, their use of complex derivatives to hedge risk and increased internal risk-management practices have led some to assert that they have become more stable investments.\(^{284}\) Instead, the regula-

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10.36% and 11.45% compared to 11.61%, 15.06% and 18.17% for the S&P 500, respectively).

\(^{280}\) See Weidig & Mathonet, supra note 228, at 4.

\(^{281}\) See supra Part III.

\(^{282}\) See supra note 152 and accompanying text.

\(^{283}\) See generally Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. ILL. L. REV. 1 (highlighting the increasing complexity of public disclosure and concomitant inability of investors, even sophisticated ones, to properly comprehend and analyze this information).

\(^{284}\) Shadab, supra note 259, at 10.
tory "risk" promoted by the SEC as justifying its regulation appears to be more a product of popular fears than logical cost-benefit analysis.\footnote{285}

It is for these reasons also that the SEC should not, before further study, take the approach regulators traditionally adopt towards a black market: regulate, enforce, and attempt to hamper that black market itself. Rather, before it does this, the SEC should proffer distinct reasons for prohibiting black market capital investments over and above other equity type investments.\footnote{286} Although these investments may have heightened risk over and above the hedge fund and private equity investments they attempt to mimic, this does not mean that this risk is qualitatively and quantitatively different from or higher than all other publicly traded securities such that their prohibition is warranted. If it wants to take this approach, the SEC should again justify it for each of these investment types through regulatory consideration of these factors, a consideration which should include cost-benefit analysis. Ultimately, SEC treatment of black market investments is a divorced question from whether hedge funds or private equity funds should themselves be publicly offered and traded. Each should be assessed individually on their merits.\footnote{287}

D. Systemic Risk

Distinct from the risk of individual investment in hedge funds and private equity is the risk these investments pose to the capital market system. This risk is often highlighted by regulators, particularly the SEC with respect to hedge

\footnote{285} This disconnect is discussed further supra Part III.

\footnote{286} Even when the SEC has publicly looked at black market capital investments they have tended to view these investments through the same regulatory perspective as hedge funds. See, e.g., Donohue Speech, supra note 24 (stating that hedged mutual funds "while providing retail investors exposure to hedge fund investment strategies, may, like hedge funds themselves, raise certain regulatory and investor protection concerns").

\footnote{287} Although in assessing black market capital investments, it may be necessary to take into account the effect public investment in hedge funds and private equity would have on retail investor demand for each of them.
funds, to justify prohibitions on public investment. But hedge funds and private equity funds exist and will likely continue to thrive and grow whether or not public investment is permitted. The consequent risks and other issues posed by the presence of these investments, increased or otherwise, is divorced from the issue of public investment; the systemic risk of these investments is a separate matter to be addressed whether or not public investment is permitted.

Public investment is only problematic on system-wide grounds if this investment increases systemic risk. This is currently unclear. The additional capital supplied to these investments by an open market solution may indeed enhance systemic risk by providing these hedge funds and private equity with additional capital, exacerbating any adverse impact they may already have or potentially have on the U.S. capital markets. If this is true, regulators should confront these issues directly, regulating these investments for their systemic adverse effects rather than addressing these problems derivatively through mediating the public's ability to invest in them. Moreover, any increased systemic risk would need to be assessed against the benefit of eliminating black market capital, restoring equilibrium to the U.S. capital market and stemming any excess risk that this effect itself has engendered. Yet, the SEC has not performed this analysis.

288 See, e.g., Cox Senate Testimony, supra note 11 (statement by Chairman Cox that hedge funds "rais[e] questions such as systemic risk and investor protection . . . ").

E. Cyclicality and the Relevance of Investment Performance

A third possible issue with an open market solution is that the black market capital investments such a system would eliminate are the product of cyclicality or "bubbles" in the private equity and hedge fund markets. These investments will therefore disappear once these bubbles "pop," making regulatory reform unnecessary: the social cost of black market capital is a transitory one. This argument belies the fundamental staying power of these investments. Both hedge funds and private equity have been on an upward course for the last three decades, and appear to be a secular trend that will persist on some level due to their unique investing benefits.

Moreover, the cyclicality of private equity is similar to other assets classes such as the real estate, takeover, and equity markets generally. To the extent private equity has recently experienced a cyclical upward swing and may be entering into a downward one, it will continue to exist even in a downward cycle, at some point returning to an upward slope. Black market capital private equity investments will similarly mimic this pattern. Moreover, hedge funds, as an investment and not an asset class, lack the overall cyclicality of private equity. Hedge funds have a variety of investment strategies and attempt for absolute returns which often aim to be anti-cyclical. These strategies are often dissimilar and often are specifically designed to damper volatility while returning an absolute positive return. Other hedge funds aim for counter-cyclical performance. For example, this Article was first drafted in August 2007, a time of heightened market volatility and crisis, yet many hedge funds are profiting from this market stress. It even appears that hedge

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290 See Cheffins & Armour, supra note 32, at 38.
292 Additionally, private equity and hedge funds continue to exist as a significant force in U.S. capital markets, and so long as that is true, black market capital and its adverse effects will also persist. For example, in 1999, private equity funds raised $41 billion compared to $171 billion by
funds may have profited on an aggregate level. The Credit/Suisse Tremont Index of Hedge Funds which measures total hedge fund performance was down 0.75% during June through August compared to a decline of 3.8% for the S&P 500 market index. In either the case of private equity or hedge funds, cyclicality, to the extent it exists, does not appear to justify or forestall regulatory reform.

F. SEC Imprimatur and Distraction

Finally, there is the argument that an SEC imprimatur would be placed upon these investments if they are publicly available. Investors would now be misled to think them

the end of 2006, while hedge funds have experienced similar exponential growth in assets under management during this time period. Even if these current figures were cut in half by the effects of the market crisis, they would still be significantly above 1999 levels. See Charts I.B. & I.C. supra at Part I.

See, e.g., Alistair Macdonald, Jabre Hedge Fund Thrives Amid Turmoil, WALL ST. J., Aug. 4, 2007, at B3 ("The hedge fund that trader Philippe Jabre set . . . is making money during the current market turmoil, underscoring how some hedge funds have avoided losses or even made hay during the same woes that have closed some of their peers.").

Bloomberg Data Terminal (search data on file with author). I discuss the relevance of the Credit Suisse/Tremont Index for tracking hedge fund performance supra at notes 71-73 and accompanying text. See also Nadia Van Dalen, Hedge Funds Outperform in the Third Quarter, Oct. 16, 2007, available at http://news.morningstar.com/articlenet/article.aspx?id=209677&_qsbspa=y ("Hedge funds in Morningstar's database returned an average of 2.44% over the third quarter of 2007, outperforming the S&P 500 and the MSCI World in U.S. dollars. September gains of 3.7% overcame poor performance in July and August of 0.42% and negative 1.63%, respectively.").

Certainly the August 2007 market volatility and the extreme negative returns experienced by particular types of hedge funds, such as quantitative market neutral hedge funds, warrant further study of and concern over the systemic risk impact of hedge funds. Yet again, any analysis should divorce the system-wide risk from the individualized risk in order to assess the benefits of public shareholder investment in hedge funds and private equity.

This was one argument put forth by SEC Commissioners Cynthia A. Glassman and Paul S. Atkins in their dissent from the SEC's hedge
appropriate investments merely because they are publicly offered and listed. This is a truism which can be said of all U.S. public investing. Here lies the objection's tension point. If all other investments are permitted, then why should this investment be excluded from the purview of investor choice? Certainly these investments may not be appropriate for all investors, but they can prove beneficial for many. Moreover, the SEC supervision of public hedge funds and private equity funds would be equivalent to what investors currently have when making black market capital investments but without the particularized regulation an open market solution would provide. It would also permit the SEC to focus its regulatory gaze more specifically on these investments in a manner that addresses their particularized issues while at the same time eliminating black market capital and its distortion and irrationality.

There is also the question of whether the SEC is up to this administrative task. However, an open market solution would likely engender this specialization. And an open market solution is unlikely to bring thousands of hedge funds and private equity funds into the public sphere. A 2006 study estimated that eighty percent of hedge fund assets under management are held by the top 200 funds.\(^{297}\) Private equity funds appear to be even more concentrated. It is these larger funds that are best qualified to undertake a public offering and therefore most likely to do so. Public offerings are therefore likely to be largely confined to these funds, limiting the number of issuers subject to SEC review while beneficially placing a large portion of fund assets under public scrutiny.\(^{298}\)

G. The Open Market Solution's Structure

An open market solution would require several key revisions to both the Investment Company Act and the Advisers fund adviser registration rule. See Adviser Registration Dissent, supra note 136, at 81,539.

\(^{297}\) See Barton Biggs, Hedgehogging, at 10 (2006).

\(^{298}\) See supra note 254.
Act. These changes could be effected by the SEC itself without the need for congressional action due to the fulsome exemptive capacity Congress has provided the SEC under each of these Acts. These reforms would permit private equity and hedge funds to offer and sell investment securities to the general public while maintaining their current structural form. There are many potential structures for such a regulatory solution. And there is ample regulatory precedent: Australia, Hong Kong, Ireland, Luxembourg, Netherlands, and Singapore have all erected regulatory schemes that permit significant public investment in hedge funds. One possibility is for the SEC to create a specialized regulation, an Alternative Investment Part, for hedge funds. This regula-

299 See 15 U.S.C § 80a-6(c) (2007) (providing the SEC authority to exempt any corporate entity from the Investment Company Act as “necessary or appropriate in the public interest or for the protection of investors”); id., § 80b-6a (2007) (providing the SEC authority to exempt any person or transaction from the Advisers Act to the extent “that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title”).

300 See PRICEWATERHOUSECOOPERS: THE REGULATION, TAXATION AND DISTRIBUTION OF HEDGE FUNDS IN EUROPE: CHANGES AND CHALLENGES 14-30 (2006), available at http://www.pwc.com/Extweb/pwcpublications.net/docid/B0AD57236E4A91B18525702200521C2E/$File/18037Hedgefundsfinal.pdf (surveying the regulatory restrictions on public investment in hedge funds in Europe); Janine Canham & Manoj Ramachandran, Hedge Funds, Asia Leads the Retail Market, ASIALAW (Dec. 2003), available at http://www.asialaw.com/?ISS=64368PUBID=488Page=14&SId=281930&S M=&SearchStr= (surveying the regulation of public investment in hedge funds in Hong Kong and Singapore); see also Christopher Faills, Hong Kong Regulator Sees Value in Hedge Funds, HEDGEWORLD DAILY NEWS, Jan. 26, 2007 (reporting on the widespread adoption and marketing of hedge funds in Hong Kong); Australian Hedge Funds: Big Hitters, ECONOMIST, Dec. 16, 2006, at 16 (reporting that “in Australia individual investors account for two-thirds of the $60 billion invested in hedge funds, compared with just 44% globally”).

301 For an alternative proposal which calls for the amendment of the Investment Company Act to permit registered investment advisers with significant co-investment in a fund to offer hedge funds or funds to sophisticated investors under Rule 506 of Regulation D and for the SEC to amend Rule 144A to permit trading of these investments on private securities markets, see Shadab, supra note 259.
tion would permit hedge funds and private equity funds to elect to exempt themselves from certain provisions of the Investment Company Act and Advisers Act and alternatively be covered by the particular requirements of an Alternative Investment Part.

Hedge funds and private equity funds opting to be regulated under the Alternative Investment Part would be subject to the following exemptions from the Investment Company Act and Advisers Act:

**Compensation.** The Advisers Act and FINRA restrictions on the payment of performance fees would no longer apply. In particular, funds electing to be covered by the Alternative Investment Part would have no limitation on the amount of fee they could charge provided full disclosure was made in advance of any investment.

**Leverage.** Investment Company Act limitations on leverage and borrowing would be eliminated. Federal Reserve and margin regulation with respect to leverage and borrowing that are generally applicable to both private and public funds would still apply in their current form.

**Hedging.** Investment Company Act limitations on shorting and margin investing would be eliminated. Qualifying hedge funds and private equity would thus be permitted to freely hedge investments and engage in derivative securities transactions.

**Diversification.** Investment Company Act limitations on diversification and suitable investments would be eliminated. Qualifying hedge funds and private equity funds would still be required to disclose an investment plan and any revisions to it as well as materially comply with such a plan. Hedging, leveraging, and other material investment practices would also need to be in accordance with this plan.

**Redemptions.** The Investment Company Act and FINRA requirements that open investment companies permit investors to daily redeem their investment would be suspended. Instead, qualifying hedge funds and private equity funds could set their own time periods for redemptions. In cases of liquidity crisis, the funds would be permitted to suspend redemptions in accordance with pre-disclosed procedures. Spe-
cial procedures would be considered to accommodate private equity’s practice of maintaining capital commitments rather than receiving investment funds up-front.

The full scope of changes would be left to the regulatory process, but would be expected to encompass the above proposed fundamental changes and any other revisions necessary to make the public offering of hedge funds and private equity an economic possibility. Here, the primary regulatory principle would be for the SEC to disregard its uneconomic fears of hedge funds and, implicitly, private equity, and develop a system that treats these investments as any other one: a permitted public investment regulated on an economical basis to account for the risks and investor rights associated with it.

During this process, technical issues of differentiating open versus closed funds, the valuation parameters for redemptions in the case of these funds, the parameters of investment position disclosure, partnership governance, and other issues unique to hedge funds and private equity would be addressed. The creation of an Alternative Investment Part within the Investment Company and Advisers Act would thus allow for more particularized regulation geared towards the individualized needs of these funds. This would ultimately permit the SEC to differentiate between these funds and mutual funds in promulgating securities regulation and allow the determination of separate or uniform regulation for these differing investment companies as economically and socially necessary. Moreover, individualized treatment of hedge fund and private equity would spur the specialization of the SEC staff in this area to account for the particularized needs of hedge funds and private equity. This should result in regulation more attuned to the needs of these investments accounting for their material differences from mutual funds and other investments.\footnote{The creation of an Alternative Investment Part would not render the Investment Company Act and Advisers Act wholly inapplicable to hedge funds and private equity. Many of the Investment Company Act rules, such as limits on marketing and administrative fees and mandatory independent director requirements or their equivalent should arguably...}
VII. CONCLUSION

Professor Troy Paredes has ably analyzed in two recent companion articles the forces driving recent SEC attempts to regulate hedge funds.\(^{303}\) He highlights the “weak” case for additional SEC regulation in this area and notes that the SEC “paid relatively short shrift to the cost of regulating hedge funds,” with its adviser registration rule.\(^{304}\) Instead, he attributes the SEC's rule-making to factors such as the political economy of public demand, a precautionary principle and cognitive psychology. Professor Paredes in particular cites the recent noted work of Professor Cass Sunstein to highlight that “precautionary steps with respect to one risk inevitably leads to another,”\(^{305}\) and can lead to SEC overregulation or misregulation.

Black market capital provides important support for the observations of Professor Paredes. Historical investment company regulation has effectively prohibited private equity and hedge funds from accessing the public markets. This regulatory bar has been one the SEC has preserved and is now attempting to strengthen by further limiting the ability of investors to invest in these funds. The result is black market capital, a consequence with arguably greater adverse effects to the U.S. capital markets. Moreover, the SEC's...
failure to undertake a proper cost-benefit analysis of an open market regulatory regime has deprived investors of access to potentially beneficial investment opportunities. Black market capital thus also highlights the importance of such economic analysis in regulation. It also underlines the costs inherent in any regulation; here black market capital is a previously unrecognized cost of the SEC's current regulatory scheme for hedge funds and private equity.

Black market capital also exposes the dilemma of market regulators in a time of global capital markets and market proliferation. The simple prohibition or confining regulation of a financial product is no longer a panacea if demand for the security continues. In such a paradigm, prohibitory or restrictive regulation of this nature will simply cause trading and investing in this security to migrate to foreign or private markets. Alternatively, creative finance professionals will attempt to offer substitute financial products which mimic the prohibited or restricted investment. Black market capital thus teaches a lesson in unintended regulatory consequences beyond the precautionary principle; regulators must account for market proliferation and investment substitution in their rule-making and assess these matters in their regulatory cost/benefit analysis. Failure to do so can result in adverse distortion to the capital markets and uneconomical results in the U.S. economy generally.

This failure, unfortunately, has occurred in the case of hedge fund and private equity regulation.\(^{306}\) The per se effective regulatory prohibition on the public offer and listing of

hedge funds and private equity has created black market capital. This Article has documented this effect in a number of capital market phenomena, including fund adviser initial public offerings, special purpose acquisition companies, business development companies, hedged and synthetic mutual funds, and specialized exchange traded funds, all of which attempt to mimic private equity or hedge fund returns and have been marketed to public investors on that basis. Black market capital has not only altered the structure of the U.S. capital market but has shifted capital flows to non-U.S. markets and engendered the creation of U.S.-based private markets such as Portal Alliance.

Black market capital reveals irrational distinctions in the U.S. securities markets; less-suited hedge fund and private equity derivative investments are regulatorily permitted, but direct investment in underlying hedge funds and private equity is prohibited. Black market capital also has arguably adverse effects and imposes its own costs upon the U.S. capital market. It encourages potentially suboptimal and uneconomic investing, engenders increased risk on an individualized basis, and results in economic loss to the U.S. capital market as capital flows are reduced and shifted abroad. The SEC should accordingly reassess its refusal to countenance public investment in hedge funds and private equity, and begin the hard work of analytically assessing the perceived social benefits of, and objections to, public investing in hedge funds and private equity.

In this Article I have set forth the beginnings and structure of such an analysis. Based on these preliminary observations, I believe that if the SEC undertakes a similar project it will conclude that the optimal solution is to eliminate black market capital and restore market equilibrium by permitting the free public offering of and investment in hedge funds and private equity as part of a recommended diversified investment portfolio. The benefits of such a system appear substantial and superior to the current regime.

Until then, black market capital and its potentially adverse effects and unrecognized costs will continue to persist in the U.S. capital market. While I may ultimately prove incorrect upon further study, the SEC has yet to even begin the analysis to make such a judgment.