BEYOND THE CRISIS: DODD-FRANK AND PRIVATE EQUITY

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The history of the U.S. financial markets is peppered with economic crises. A few scholars have argued that in the wake of these events, the combination of widespread media attention and a flurry of congressional action has led to the hurried creation of sweeping remedial legislation. Indeed, these scholars maintain that in seeking to put out the flames of panic and financial instability, such regulations have often been mismatched to the problems they intended to address. My Note enters the fore and argues that the Volcker Rule and the amendments to the Investment Advisers Act of 1940, promulgated in response to the Financial Crisis of 2008 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, are examples of financial market regulation that go beyond the concerns that led to their enactment. Specifically, this Note explores these regulations as they apply to private equity (PE) funds and contends that they each bring the PE industry within the purview of regulatory scrutiny in a way that may have negative implications for our economic recovery. While the need to be forward-looking remains present in any legislative scheme, this Note takes the position that we are currently facing uncertain economic times that require a response more closely tied to the conduct that led to the Crisis.

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Introduction

The history of the U.S. financial markets is peppered with economic crises. In the wake of these events, the combination of widespread media attention and a flurry of congressional action often has led to the hurried creation of sweeping remedial legislation.[1] In seeking to put out the flames of panic and financial instability, such regulations have, at times, been mismatched to the problems they were intended to address.[2] Perhaps due to the sophistication of the regulated entities, legislators feel as if rules must reach widely enough to encompass efforts to circumvent the law. Maybe the drafters believe that their only job is to provide supervisory agencies with broad statutory authority so that they may implement the rules fairly

[1] *See, e.g.*, Larry Bumgardner, *A Brief History of the 1930s Securities Laws in the United States—And the Potential Lesson for Today*, 4 J. Global Bus. Mgmt. 1, 2 (2008) (describing the political climate and sweeping financial regulations that emerged during the Great Depression); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1523 (2005) (describing the Sarbanes-Oxley Act of 2002 as a "considerable change in law" that was enacted in a "flurry of congressional activity" after the "spectacular failures" of Enron and WorldCom).

[2] *See* Romano, *supra* note 1, at 1592 (describing the Future Trading Act of 1921 passed in response to the agricultural crisis of the 1920s as "not a solution even remotely addressing the problem at hand"); *id.* at 1593 (explaining that the 1930s securities acts were not targeted toward remedying the economic turmoil of the Great Depression); *cf.* Milton Friedman & Anna Jacobson Schwartz, A Monetary History of the United States 1867-1960 at 299–407 (1963) (explaining that the economic problems that attended the Great Depression were caused by mistakes in monetary policy as opposed to fraud in the securities markets).

through regulations and selective enforcement. Whatever the case, it appears that—at least in the financial markets context—in the wake of a crisis, legislators sometimes regulate beyond pre-crisis conduct rather than calibrate legislation toward remedying the actual problem.

This Note explores two regulations that emerged in the wake of the Financial Crisis of 2008 (Crisis). Ultimately, it argues that the Volcker Rule and the amendments to the Investment Advisers Act of 1940 (IAA Amendments), promulgated as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), are examples of financial market regulation that go beyond the concerns that led to their enactment. That is, the Volcker Rule and the IAA Amendments, as they apply to private equity (PE) funds, do not represent a legislative response that is geared toward the way in which PE funds contributed to the Crisis—they go beyond the lengths necessary to address adequately the ills of PE funds' pre-Crisis conduct. This may indeed represent a reasoned policy choice by Congress, as legislators may have believed that this area of the financial markets requires increased transparency. However, this choice has created economic and social costs that will have to be borne by not only PE firms, but also the U.S. economy in general.

Because the United States is still recovering from the Crisis, legislation that unnecessarily curbs investment activity risks hindering our financial markets and pushing investors overseas in search of higher returns. The Volcker Rule's restrictions on U.S. banks' investment in PE funds unreasonably constrain these institutions from profitable, long-term investment opportunities. The IAA Amendments impose burdensome compliance costs on PE funds—as well as other private financial firms, like hedge funds or venture capital funds—by eliminating their exemption from Securities and Exchange Commission (SEC) registration. Each of these provisions brings the PE industry within the purview of regulatory scrutiny in a way that may have negative implications for our economic recovery. While the need to be forward-looking remains present in any regulatory scheme, this Note contends that we are facing uncertain economic times that require a legislative response more closely tied to the conduct that led to the Crisis.

This Note proceeds in three Parts: Part I provides an explanation of PE funds and their activities, including how PE fund activity did (and did not) contribute to the Crisis. Part II examines both the systemic-risk concerns that emerged during the Crisis and the congressional response to those concerns. It does this first by explaining systemic risk and investigating the propositions that engendered within Congress the sense that PE funds required regulation. It then details both the Volcker Rule and the IAA Amendments and demonstrates why these regulations go beyond addressing the ways in which PE funds actually contributed to the Crisis. Lastly, Part III provides theoretical support for more finely calibrated regulation and highlights the economic and social costs that have emerged from unnecessary regulation of PE funds.

I
Private Equity Funds and the Financial Crisis of 2008

In this Part, I explain PE funds and describe the ways in which they work in conjunction with other financial institutions. I then demonstrate that by creating a demand for inexpensive capital and providing a means through which banks could hide their infirmities from regulators, PE funds contributed to the Crisis by encouraging excessively risky bank activity.

A. *Private Equity Funds*

Private equity funds are "private investment vehicles that permit investors to combine their capital for investment"[3] in a way that greatly increases investors' purchasing power.[4] The managers of the PE funds are general partners (GPs)[5] and have discretion over all investment activity engaged in by the fund.[6] The fund's investors—usually pension funds, banks, insurance companies, or high

[3] Until recently, these "private" investment vehicles were able to avoid extensive SEC regulation by relying on exemptions from the Investment Company Act of 1940. 15 U.S.C. §§ 80a-1–64 (2006). Specifically, Sections 3(c)(1) and 3(c)(7) of the Act exempted PE funds from having to register as investment companies. Section 3(c)(1) generally specifies that to be exempt from registration, fund enrollment must be restricted to no more than 100 total investors. *Id.* § 80a-3(c)(1). Section 3(c)(7) allows for an unlimited number of investors as long as they fit the statutory definition of "qualified purchasers," which is defined as either a person or an entity that has more than $5 million or $25 million, respectively, in investments. *Id.* § 80a-2(a)(51)(A). Moreover, the general partners (GPs) of PE funds maintained exemption from registration with the SEC as investment advisers by relying on § 3(b)(3) of the Investment Advisers Act of 1940. 15 U.S.C. §§ 80b-1–21. Section 3(b)(3) exempts from registration:

> any investment adviser 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 registered under [the Investment Company Act of 1940].

Id. § 80b-3(b)(3). The IAA Amendments mandate registration with the SEC by removing the investment adviser exemption found in § 3(b)(3). *See infra* Part II.B.3 (discussing the IAA Amendments).

[4] Harry Cendrowski et al., Private Equity: History, Governance, and Operations 5 (2008).

[5] They may also be referred to as "sponsors" or merely "fund managers." *Id.*

[6] *See id.* (describing the framework of PE funds).

net-worth individuals—are limited partners (LPs).[7] This GP-LP structure provides investors the opportunity to benefit from the expertise of the fund manager and thereby achieve greater returns on capital than if they otherwise invested on their own.

By pooling investors' capital, the PE fund structure allows investors to achieve greater returns through direct investment in portfolio companies.[8] In becoming LPs, investors pledge to commit capital upon joining the fund; throughout the fund's life—usually between eight to twelve years—the GP makes specific requests for that capital, which is then drawn down from the LPs' accounts.[9] Once a GP identifies a viable portfolio company,[10] it will use the LPs' capital to "buy out" a controlling interest in that company, replacing most or all of the company's public stock interests with fund equity ownership.[11] The fund then uses its controlling interest in the company to expand the company's earnings[12] and to grow market share, both with an eye

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[7] This is due to their limited liability and lack of control in the day-to-day operations of the fund. *See id.* (explaining that limited liability means that "an investor can lose, at most, the sum of their total capital contributions").

[8] A "portfolio company" is a company in which a PE fund invests. CENDROWSKI ET AL., *supra* note 4, at 9. For the purposes of this Note, the term "portfolio company" refers to those companies that are publicly traded prior to the acquisition of a controlling interest by a PE fund.

[9] *Id.* at 5–6. Capital is usually drawn down from investors' accounts during the beginning stages of the fund's life. Once enough investors have pledged enough capital, the fund is said to have been raised. Once the fundraising stage closes, the GPs require time to search for viable portfolio companies before they make any investments. *Id.* Some funds provide a pre-specified schedule upon which they will draw down from investors' accounts, permitting the investor to budget for capital subscriptions with certainty. *Id.*

[10] GPs generally choose companies that they believe are undervalued, thus providing an opportunity to realize gains on the fund's investment once that value is corrected. However, portfolio company valuation is an extremely complicated quantitative endeavor which can differ among GPs. *See* Douglas Cumming & Uwe Walz, *Private Equity Returns and Disclosure Around the World*, 41 J. INT'L BUS. STUDS. 727, 727, 731 (2010) (noting the difficulties inherent in portfolio company valuation and explaining that PE firms use "many different methods, such as the price of recent investments, earnings multiples, discounted cash flows or earnings of underlying business, discounted cash flows from the investments, and industry valuation benchmarks"); *see also* CENDROWSKI ET AL., *supra* note 4, at 21 ("When searching for potential buyout targets, general partners look for firms with strong, stable cash flows, market leadership, a well-seasoned management team, and a low debt-to-equity ratio relative to industry peers (i.e., a conservative capital structure).").

[11] These are called "buyout" or "going-private" transactions. *See* Harry DeAngelo et al., *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367, 367, 370 (1984) (explaining "going-private" transactions).

[12] *See* ROBERT J. SHAPIRO & NAM D. PHAM, THE ROLE OF PRIVATE EQUITY IN U.S. CAPITAL MARKETS 7 (2008), *available at* http://www.sonecon.com/docs/studies/Role-ofPEinUSCapitalMarkets-FINAL.pdf ("The strategic objective of all private equity transactions and subsequent operations is to raise the value of the acquired company, which normally involves steps to raise its earnings.").

toward selling its controlling interest at a profit.[13] Once the portfolio company's value has increased sufficiently, the fund utilizes one of many common "exit strategies" in order to liquidize its investment and realize returns.[14] This process takes time, as such, the investments of PE funds are "rather long-term commitments."[15] The returns that are ultimately realized by the investors are directly correlated with the extent to which the fund can increase the value of its portfolio companies. Therefore the fund must generally commit its capital for as long as it takes to achieve that increase.

B. Banks' Involvement in Private Equity Funds: LPs and Lenders

In a typical PE transaction, when the fund initially buys out the portfolio company's public shareholders, it pays a premium of fifteen to fifty percent over the then-current share price.[16] This purchase is usually financed with anywhere between sixty and ninety percent debt and the remaining portion is financed with the equity commitments of the PE firm.[17] Because such a large portion of the fund's controlling interest in the company is paid for with debt, the fund realizes a greater return on its own equity investment when it liquidates that interest in the future.[18] To be sure, banks can participate in PE invest-

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[13] *See Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 188 (2009) (written testimony of Douglas Lowenstein, President & CEO, Private Equity Council) [hereinafter Lowenstein, Written Testimony] (testifying that "the goal of all PE investments is to increase the value of the business during the time that it is owned by a PE fund" and that "PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders").

[14] Cendrowski et al., *supra* note 4, at 6. The three most typical exit strategies are: "an outright sale (to a strategic or financial buyer), an initial public offering (IPO), and [a] merger." *Id.*

[15] *Id.*

[16] Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. Econ. Perspectives 121, 124 (2009). For explanations regarding the many reasons why a purchaser of a controlling interest in a company must—and is willing to—pay a premium over the market price, see William T. Allen et al., Commentaries and Cases on the Law of Business Organization 413 (3d ed., 2009).

[17] Kaplan & Strömberg, *supra* note 16, at 124–25. The firm's equity commitment could consist entirely of LP funds or a combination of LP and GP capital.

[18] This is due to the concept of financial leverage. Leverage is the strategy of using borrowed funds to increase the return on a particular investment. Assuming the return on the total value invested by the fund is higher than the interest the fund pays on the borrowed debt, leverage increases return on equity. This concept is bolstered by the fact that after the PE fund exits its position in a portfolio company, the debt that was used to purchase the PE fund's initial controlling interest ultimately remains on that company's balance sheet as a part of its capital structure. Much of the criticism of PE activity has been in relation to this aspect of the PE investment process. *See* Julie Creswell, *Profits for*

ments by investing as LPs.[19] But with PE funds, through the process of debt financing, banks have the opportunity to play a unique role as contrasted with other LPs, in that they can serve as both an LP and as a primary lender to the fund.

In many cases when a bank is a lead lender, the bank will also be the fund's parent company, whereas other PE funds, such as Apollo and Blackstone, are stand-alone entities.[20] These bank-affiliated PE funds provide banks with the opportunity to arrange the debt financing for the fund's transactions.[21] By becoming the lead lender among a syndicate of institutions, banks can utilize their superior positions as market intermediaries[22] in order to time the credit markets for favorable loan terms.[23] These favorable terms allow banks to generate additional revenue from lending fees above and beyond those generated from their underlying investments as LPs. Additionally, affiliation with a PE fund creates "significantly higher odds for the bank to win future investment banking mandates from the target firm, serving either as future lenders, equity underwriters, or M&A advisors . . . . These future revenues offer an additional rational[e] for banks to engage in private equity investments."[24]

Buyout Firms as Company Debt Soared, N.Y. TIMES, Oct. 5, 2009, at A1 (explaining that the Simmons Bedding Company had been driven into bankruptcy by PE firms that "were able to buy companies like Simmons with borrowed money and put down relatively little of their own cash"); Serena Ng, *Buyout Bonanza Compels Firms To Pile on Debt*, WALL ST. J., Dec. 27, 2006, at C1 ("Private-equity investors . . . are pushing companies further out on a limb . . . . In many cases, companies will need to devote at least half their yearly cash flow to meeting interest payments on their debt.").

19 *See supra* Part I.A (discussing the participation of LPs in PE investments).

20 *See* Lily Fang et al., Unstable Equity? Combining Banking with Private Equity Investing 2 (Feb. 15, 2011) (unpublished manuscript) (on file with *New York University Law Review*) (explaining that in bank-affiliated deals, PE sponsors often have bank holding company as a parent as opposed to a stand alone entity).

21 Since the 1980s, PE debt financing has primarily come in the form of syndicated loans. *Id.* at 2–3. A syndicated loan is a loan offered by a group of lenders (called a syndicate), usually consisting of mutual funds, hedge funds, banks, and other institutional investors, who work together to provide funds for a single borrower. *See* The Depository Trust and Clearing Corporation, *Transforming the Syndicated Loan Market* 1 (2008), *available at* http://www.dtcc.com/downloads/leadership/whitepapers/Transforming_Syndicated_Loan_Market.pdf ("A syndicated loan, by definition, is a loan provided by a group of lenders usually arranged and administered by a third-party banking agent whose responsibilities include the transmission of information and cash between the parties.").

22 Studies have suggested that banks have superior information about their institutional clients due to banks' screening and monitoring roles. *See* Fang et al., *supra* note 20, at 3 (citing studies).

23 This is because when a bank has "both an in-house private equity group and a loan syndication division, it has superior knowledge of both the private equity deal flow (demand for credit) and the syndicated-loan market conditions (supply of credit), and thus has a natural advantage in matching the demand for credit with supply." *Id.* at 3–4.

24 *Id.* at 7.

C. Private Equity's Contribution to the Crisis

1. Demand for Capital as a Catalyst for Shadow Banking

Once the structure and activity of PE funds are understood, one can begin to understand how PE funds contributed to the Crisis. PE funds invest by purchasing controlling interests in portfolio companies with an eye toward selling that interest at a profit in the future.[25] Because such a large percentage of that purchase is financed with debt, the more debt that a PE fund can secure—typically loans from banks—and the cheaper it is to procure that debt,[26] the less of its own money it will have to use to purchase the initial interest in the portfolio company. Thus, when the fund finally sells that interest, the investment will be more profitable because the fund will internalize more of the gains from the sale.[27]

This desire to borrow inexpensive capital from banks was the first—and by far the most substantial—way in which PE funds contributed to the Crisis.[28] Through an intense demand for loans,[29] PE

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[25] *See supra* Part I.A (describing PE funds' investment practices).

[26] If the fund is able to obtain a loan commitment that has a relatively small interest payment, the portfolio company will have to use less of its earnings to finance that debt. These decreased loan payments mean higher profitability for the company and thus a higher profit for the fund when it exits the investment.

[27] By way of an illustration, suppose a PE fund begins with $1,000,000 of its own money obtained through capital commitments from LPs. Then suppose that the PE fund can borrow $15,000,000 from a bank at an interest rate of 6%. Let us then say that the PE fund invests the entire $16,000,000 in a single investment, which the GP is confident will have a 15% return in a year. The PE fund plans to return the borrowed money plus interest at the end of the year. The value of the investment at the end of the year will be $18,400,000, and the PE fund will pay the bank back $15,900,000 (i.e., the $15,000,000 in principal plus the $900,000 interest payment). The PE fund would be thus left with a total of $2,500,000 and a net positive gain of $1,500,000 once it subtracts the initial $1,000,000 it invested. That amounts to a 150% return on an investment that had an unleveraged return of 15%. *See also supra* note 18 (explaining how debt increases profitability of PE investments).

[28] Indeed the impacts of the shadow banking industry, or alternative-source financing, were monumental in comparison to the effects of PE funds shielding capital infirmities from regulators. According to the International Monetary Fund, in 2009 U.S. banks were expected to *lose* approximately $1 trillion as a result of their shadow banking activities. *Factbox-U.S., European Bank Writedowns, Credit Losses*, REUTERS (Nov. 5, 2009), http://www.reuters.com/article/2009/11/05/banks-writedowns-losses-idCNL554155620091105?rpc=44. By contrast, the six largest U.S. banks only had about $45 billion in *exposure* to PE fund investments during 2009, which did not necessarily translate into losses. *Implications of the "Volcker Rules" for Financial Stability: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 56 (2010) (written testimony of Hal S. Scott, Professor, Harvard Law School) [hereinafter Scott, Written Testimony].

[29] According to a recent study by the Government Accountability Office (GAO), from 2005 to 2007, ten banks provided approximately $634 billion in syndicated, leveraged loans in order to finance 956 buyout transactions sponsored by PE funds. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-885, PRIVATE EQUITY: RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 46 (2008) [hereinafter GAO STUDY]. That $634 billion amounted to 56% of the total

funds took advantage of banks' desire to gain additional profits as lenders to those funds. They did this by implicitly pushing banks to lend extraordinarily high levels of capital. This is because the Federal Deposit Insurance Corporation (FDIC)—as well as other regulatory bodies like the U.S. Treasury and the Federal Reserve—regulates commercial banks; the amount of capital on the banks' balance sheets may not fall below a certain level.[30] To circumvent these restrictions, banks procured capital from non-traditional sources.[31] Instead of funding loans from customer deposits, banks sold "securitized mortgages and other asset-backed securities," allowing them to lend without increasing the liabilities on their balance sheets.[32] This alternative-source financing is called the "shadow banking" business.[33] Because shadow banking consisted of commercial banks speculating in highly complex securities,[34] many cite the practice as being

syndicated, leveraged loans issued for all fund-sponsored transactions, including the refinancing of portfolio companies. *Id.* Of the 956 deals that were financed, four U.S. commercial banks combined to provide 35.6% of the total deal value: JP Morgan Chase ($95.3 billion), Citigroup ($56.2 billion), Bank of America ($49.6 billion), and Wachovia ($24.4 billion). *Id.* at 47 tbl.4.

30 The FDIC is a U.S. government corporation created by the Banking Act of 1933, known as the Glass-Steagall Act. Pub. L. No. 73-66, 48 Stat. 162 (1933). It provides deposit insurance, among other things, which guarantees the safety of deposits in member banks, currently up to $250,000 per depositor per bank. In order to receive this insurance, member banks must follow certain capital reserve requirements set by the FDIC and can be subject to regulation if the bank becomes undercapitalized. Thus, banks must be mindful that they do not lend too much of their capital, otherwise they risk corrective action by the FDIC. For more information on the FDIC and federal deposit insurance, see *Who is the FDIC?*, FDIC, http://www.fdic.gov/about/learn/symbol/WhoistheFDIC.pdf (last visited Sept. 20, 2012) and Stephen A. Buser et al., *Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*, 36 J. FIN. 51, 51 (1981).

31 *See* DAVID SMITH, THE AGE OF INSTABILITY 91–92 (2010) (describing nontraditional sources of lending).

32 *Id.* at 93. According to Smith, "[s]ome argue that the driving force [behind this new style of lending] was a response by banks to tighter regulation . . . ." *Id.* Whether or not this was purely an effort to avoid banking regulations, by utilizing these securities, banks were able to provide PE funds with the cheap capital they craved. *See id.* at 100 ("The total market in derivatives was estimated to be more than $500 trillion."). "This was the evolution of a new style of banking, in which banks were no longer constrained in their lending by the customer deposits they could attract." *Id.* at 93.

33 *Id.* at 91.

34 The highly publicized "mortgage-backed security" is an example of this off-balance-sheet lending. *Id.* at 99. Banks sold securitized mortgages, which were simply "pool[s] of mortgages bundled together or securitised, the return on which would be provided by the regular payments of borrowers." *Id.* at 99–100. As the borrowers made their mortgage payments, that income would be used to pay a return to the holders of the securities. Banks would sell these instruments through separate legal entities known as structured investment vehicles (SIVs), which would allow them to parcel up and issue debt, without having to internalize the riskiness of the underlying mortgages on their own balance sheets. *Id.* at 100–01.

one of the most significant causes of the Crisis.[35]

2. *Shielding Capital Infirmities from Regulators*

Other PE fund activities—beyond contributing to shadow banking—helped perpetuate excessive risktaking by banks. Due to a combination of the nature of PE investment on the one hand and historical-cost accounting on the other, PE funds provided a way in which banks could hide capital infirmities from regulators simply by investing in PE funds. In a recent study regarding banks' investments in PE funds, Lily Fang, an Associate Professor of Finance at INSEAD, found that between 1978 and 2009, bank-affiliated PE groups—PE funds that have banks acting as significant LPs to the fund—accounted for thirty-one percent of all PE transactions.[36] This means that a sizeable portion of "buyout" transactions have involved banks committing their own capital, as LPs, to PE funds for anywhere between eight to ten years at a time (the typical life of a fund).[37] These banks would invest in multiple PE funds with staggered life cycles, and the historical returns of those funds' GPs was the only metric by which potential returns were gauged.[38] Moreover, by utilizing historical-cost accounting,[39] banks not only relied on past

[35] *Id.* at 91–102 (discussing the contributions of the shadow banking system to the Crisis); PETER J. WALLISON, DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION 3–4 (2011) (discussing "the shadow banking business" as one of the oft-cited causes of the Crisis); *see also supra* note 28 (describing the $1 trillion of losses resulting from the shadow banking industry).

[36] Fang et al., *supra* note 20, at 16.

[37] *See supra* note 9 and accompanying text (describing the typical PE fund process).

[38] Interview with Todd N. Dumas, Managing Dir., Bank of N.Y. Mellon Asset Management, in N.Y.C., N.Y. (Oct. 13, 2011). This account is consistent with the overall structure of the PE funds. A PE fund will typically go through four stages throughout its life cycle: fund raising, investment, management, and harvest. CENDROWSKI ET AL., *supra* note 4, at 10. During the fund-raising stage—approximately 0–1.5 years—PE funds will recruit investors, largely through "word-of-mouth" among LPs. *Id.* at 11 & tbl.1.3. As a result, "[i]t is the primary goal of the [PE] firm to cultivate long-term relationships with their investors" so that they can establish a readily accessible investor base. *Id.* at 11. PE firms tend to raise new funds approximately every three to four years, and investors must rely on past returns in order to evaluate these follow-on funds. *See id.* at 13 (noting that "[i]f a PE firm manages funds that repeatedly distribute subpar returns, the firm may be disbanded after such a fund is liquidated if they are unable to find investors for a future follow-on fund").

[39] Historical-cost accounting refers to the practice of recording the value of an asset based on the costs incurred to procure that asset as opposed to fair-value accounting, which values an asset by "the price that would be received to sell [that] asset or paid to transfer a liability in an orderly transaction between market participants at [a given] measurement date." Christian Laux & Christian Leuz, *The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate*, 34 ACCT. ORG. & SOC'Y 826, 827 (2009) (citing the Financial Accounting Standards Board); *cf.* Stephen A. Zeff, The SEC Rules Historical Cost Accounting: 1934 to the 1970s 1 (unpublished manuscript) (on file with *New York*

funds' returns to ascertain current values, but they also recorded the value of their then-current PE investments solely by the amount they invested at the start of each fund.[40] Thus, during the Crisis, when companies' stock prices plummeted and the value of PE investments fell accordingly, banks were still able to record the value of these investments by the amount that was initially paid at the start of the fund. This dressed up the banks' balance sheets in a way that seemed to minimize losses. As a result, regulators were unable to determine accurately the true value of banks' balance sheets and were thereby prevented from imposing restrictions on those banks to ensure adequate levels of capital were maintained.

It was not until the Fair Accounting Standards Board (FASB) ushered in the widespread use of fair-value accounting that banks had to mark their investments at current values.[41] The FASB is "the designated organization in the private sector for establishing standards of financial accounting . . . ."[42] In 2006, the FASB promulgated Fair Accounting Standard No. 157 (FAS 157) that required banks to mark balance-sheet assets at "fair value" beginning November 15, 2007.[43] As I argue in Part II.B.4 *infra*, this change in accounting standards phased out PE funds' ability to hide banks' capital infirmities from regulators.

Now, after having provided background on the role of PE funds' contribution to the Crisis, this Note examines the Crisis in more detail. The next Part explains Congress's response to concerns about sys-

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University Law Review) ("[T]he United States has long been a bastion of predominantly historical cost accounting . . . .").

[40] "For many years, historical cost was the primary basis by which assets and liabilities were accounted." JAN R. WILLIAMS ET AL., GAAP GUIDE, VOLUME I: RESTATEMENT AND ANALYSIS OF CURRENT FASB STANDARDS 16.03 (2010). "More recently, however, standards have been developed that require an assessment of the impairment of [an asset's] value where evidence suggests that [the asset's] current worth is less than its recorded amount." *Id.* at 16.04. By way of illustration, suppose in 2003 a bank were to invest $1 million in a new PE fund by the name of "NY Equity." Because this fund presumably has a ten-year life cycle, the bank would not realize any returns on this investment until 2013. Now suppose that three years later, the GP of NY Equity decides to raise another fund, "NY Equity II." Relying on both the reputation of the GP and the longstanding relationship between that GP and the bank, the bank would invest another $1 million into NY Equity II believing that it would receive returns in 2016 that would be comparable to the returns it expects to receive in 2013. This would mean that by 2008, during the time in which many companies' market values were reaching historic lows, the bank's investments in these funds would still be valued at $2 million when, in actuality, the then-current value would have been much lower.

[41] *See* FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157 (2006) [hereinafter FAS 157].

[42] *Facts About FASB*, FASB, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Sept. 20, 2012).

[43] FAS 157, *supra* note 41, at 4.

temic risk. In so doing, Part II demonstrates how regulating PE funds through the Volcker Rule and the IAA Amendments is not merely a response to the ways in which these funds contributed to the Crisis. Instead, these regulations target more than PE funds' pre-Crisis activities—they broadly aim to prevent unforeseen negative consequences.

II
Regulating Private Equity: The Congressional Response to the Crisis

In the fall of 2008, our nation was in the midst of "the worst financial crisis since the Great Depression."[44] Panic, uncertainty, and speculation spread as the economic system was on the verge of collapse. Three years later, even with the benefit of hindsight, scholars and practitioners still disagree on the true cause of the Crisis.[45] For regulators, however, nailing down the true cause seemed less important; they responded to the perceived risk created by systemically important financial institutions.[46]

"Too big to fail" is a colloquial term in popular discourse referring to large financial institutions so entrenched in the economy that their failure would result in disaster. This term became popular in the midst of the fall 2008 government bailouts—including Fannie Mae, Freddie Mac, AIG, and Bear Stearns.[47] The phrase "too big to fail" also refers to the moral hazards that are created when uninsured cred-

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[44] *Obama: U.S. in Worst Crisis Since Depression*, Reuters (Oct. 7, 2008), http://www.reuters.com/article/2008/10/08/usa-politics-debate-economy-idUSN0749084220081008.

[45] *Compare* Memorandum from Edward Pinto to the staff of the FCIC 1 (Mar. 15, 2010), *available at* http://www.aei.org/paper/100174 ("I believe that the financial crisis had a single major cause: the accumulation of an unprecedented number of weak mortgages in the U.S. financial system."), *with* Smith, *supra* note 31, at 5–6 (tracing the roots of the Financial Crisis of 2008 back to the early 1990s), *and* Richard N. Haass, *Foreward* to Benn Steil, Lessons of the Financial Crisis, at vii (2009) ("Any short list of what led to the current economic crisis would include an abundance of inexpensive capital, the issuance of mortgages to borrowers with a high risk of default, the securitization of these mortgages into complex assets, and the extensive use of leverage by financial institutions.").

[46] *See* S. Rep. No. 111-176, at 1 (2010) (describing the legislation that eventually became the Dodd-Frank Act as a bill "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' . . . [and] to protect consumers from abusive financial services practices . . .").

[47] *See, e.g.*, Tim Fernholz, *The Myth of Too Big To Fail*, The American Prospect (Oct. 21, 2009), http://prospect.org/cs/articles?article=the_myth_of_too_big_to_fail. In actuality, the "too big to fail" doctrine had been in use long before the crash. *See* Richard M. Salsman, *Banking Without the Too-Big-To-Fail Doctrine*, The Freeman Ideas on Liberty, (Nov. 1992) http://www.thefreemanonline.org/columns/banking-without-the-too-big-to-fail-doctrine/ (last visited Sept. 20, 2012) ("The 'too-big-to-fail' doctrine has arisen not simply because of the growing number of bank failures in the past decade, though indeed failures have increased. In fact, the doctrine's historical origins go back much further than a decade.").

itors of systemically important financial institutions expect government protection from financial or operational trouble.[48] As these uninsured creditors continue to expect special protection, they underprice the risktaking of these financial institutions, overfund them, and thus fail to provide effective market discipline.[49] Without market discipline, these financial institutions engage in excessive risktaking that squanders valuable economic resources and, because of their systemic importance, eventually leads to financial crises.[50] Regulators believed that this systemic risk caused the Crisis and necessitated the bank bailouts. It is this systemic risk that the Volcker Rule and the IAA Amendments aim to eliminate.[51]

The Volcker Rule targets this systemic risk in two ways: 1) it limits proprietary trading[52] and 2) it tries to eliminate excessive risktaking by restricting investment in private funds.[53] The IAA Amendments focus primarily on eliminating excessive risk through

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48 *Regulating and Resolving Institutions Whose Failure Would Pose a Risk to the Financial Sector and Underlying Economy in the United States: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 56 (2009) (prepared statement of Gary H. Stern, President & CEO, Federal Reserve Bank of Minneapolis) [hereinafter Stern, Written Testimony].

49 *Id.*

50 *Id.*

51 In his written testimony before the House Committee on Financial Services, Douglas Lowenstein explained:

> In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

Lowenstein, Written Testimony, *supra* note 13, at 189. According to Lowenstein, "[p]rivate equity presents none of these systemic risk factors and thus should pose little concern for policymakers seeking to develop a new regime to guard against catastrophic, cascading financial shocks." *Id.*

52 The rule does this by not only restricting banking entities from investing in hedge fund or PE funds, but also preventing them from otherwise sponsoring such funds as well. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 619(a)(1)(B), 619(d), 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. Recall that sponsoring a fund means serving as the fund's manager and thus the Act prevents banks from raising their own PE funds. This aspect of the Rule targets the "too big to fail" mentality by forcing banking entities to separate themselves from these non-traditional banking functions. *Cf.* Heath Tarbert & Alex Radetsky, *The Volcker Rule and the Future of Private Equity*, 27 REV. BANKING & FIN. SERVS. 43, 44 (2011) ("For the past decade, however, the banking sector and the private equity industry have become closely intertwined; some of the largest and most active private equity funds are sponsored by financial institutions.").

53 *See infra* Part II.B.1 (discussing the Volcker Rule's restriction of banks' investments in PE funds).

SEC oversight. While increased oversight may mitigate the systemic risk that led to the calamity and bailouts of the Crisis, these provisions—insofar as they apply to PE funds—go beyond that objective. Rather than restrict banks' investments in PE funds, Congress could have focused primarily on mandating stricter capital requirements. That would have prevented excessive risktaking by banks while still allowing them to engage in potentially profitable investments.[54] Instead of bringing PE funds under the purview of SEC regulation, regulators could have relied on then-recent accounting changes to provide the transparency necessary to monitor banks' investments.[55]

This Part begins by exploring the legislative history of the Volcker Rule and the IAA Amendments to ascertain the justifications behind the regulation of PE funds. That is, it seeks to answer the first-order question of why Congress even chose to regulate PE funds. It first considers the scant discussion of PE funds throughout these legislative accounts. It then highlights the minimal degree in which PE investments directly contributed to systemic risk. Through this examination, this Part posits that Congress likely was looking beyond PE funds' pre-Crisis conduct when it decided to bring them within the scope of these regulations.

Next, this Part describes the Volcker Rule and the IAA Amendments and demonstrates how they were not a response to PE funds' contribution to the Crisis. It does this by highlighting the ways in which PE funds' pre-Crisis conduct could have been adequately addressed by alternative regulations. In light of this demonstration, this Part finally concludes that the possibility of unforeseen transparency issues with regard to PE funds' future conduct was indeed the primary motivator behind Congress's choice to regulate them.

A. *Why Target Private Equity?*

Through parsing the legislative history of the Volcker Rule and the IAA Amendments, it appears that regulators were not directly focused on PE funds when they spoke out against the systemic risk concerns of private pools of capital.[56] For example, during the testimony of Neal S. Wolin, Deputy Secretary of the Treasury, given along-

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54 *See infra* Part II.B.2 (explaining the ways in which new capital requirement regulations could address the issues targeted by the Volcker Rule).

55 *See infra* Part II.B.4 (demonstrating how fair-value accounting addresses the transparency issues targeted by the IAA Amendments).

56 *See* Lowenstein, Written Testimony, *supra* note 13, at 189 (explaining that PE funds do not contribute to systemic risk in part because "PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships").

side Paul Volcker in favor of the Volcker Rule, Mr. Wolin speaks out about the need to curb systemically risky behaviors.[57] However, nowhere in Mr. Wolin's statement does he discuss the riskiness of PE fund activity. Indeed, he only mentions PE funds in passing after discussing, at length, the riskiness of hedge funds:

> The activities targeted by our proposal tend to be volatile and high risk. Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms "bailed out" their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised. . . . [Thus], we have concluded that proprietary trading, and the ownership or sponsorship o[f] hedge funds and private equity funds, should be separated, to the fullest extent practicable, from the business of banking—and from the safety net that benefits the business of banking.[58]

Similarly, the grouping of hedge funds, PE funds, and venture capital funds together as "private funds" or "private pools of capital" throughout the legislative hearings on the IAA Amendments suggests that PE funds were not of regulators' direct concern:

> The financial crisis that erupted in the fall of 2008 exposed numerous vulnerabilities in our present regulatory system for the financial services industry, including a lack of oversight of, and transparency with respect to, private pools of capital. These pools take many forms, including hedge funds, private equity funds, venture capital funds, and family offices, among others. While they offer the promise of increased market efficiency and job creation, these pools also pose potential dangers for systemic risk and investor abuse.[59]

In the very next sentence, the section goes on to discuss three intensifying trends in the hedge fund industry that justify greater regu-

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

[58] *Id.* at 54-55.

[59] H.R. Rep. No. 111-686, pt. 1, at 6 (2010). In this report, Representative Barney Frank never once discusses the dangerousness of PE fund strategies. He explains the growth in the *hedge fund* industry, the "retailization" of *hedge funds* that has led to the exposure of ordinary investors, and fraud actions that have been brought against *hedge funds* in recent years. *Id.* PE funds are only mentioned as an afterthought and while being lumped together with hedge funds.

lation. According to the report, "*[h]edge funds* and other private funds" are unregulated and "[b]ecause of minimal transparency in this sector of the financial markets, government authorities have limited ability to monitor and constrain systemic risks."[60]

Rather than focus on PE funds and their activity, these accounts seem to be more concerned with the riskiness of hedge funds.[61] While it may be true that private pools of capital can share similar characteristics, hedge funds and PE funds have different business models that create clear points of differentiation.[62] For example, hedge funds tend to employ more short-term investment strategies that seek to capitalize on price inefficiencies in the market.[63] Rather than making long-

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60 *Id.* (emphasis added).

61 In addition to the numerous references to hedge funds, this contention is also consistent with a general understanding of hedge funds and their volatile short-selling strategies. Indeed there are myriad hedge fund strategies that yield different annualized returns and contain different annualized volatilities. As a result, volatility across different fund types is a largely contested area in finance. However, despite the difficulties associated with ascertaining return/volatility statistics for any private fund, short-selling strategies have been known to have high volatilities in relation to the market. *See* ISABELLE BORELLO & HANSPETER BADER, ALTASSETS.NET, HEDGE FUNDS: A THREAT TO PRIVATE EQUITY?, http://unigestion.com/DocsContainer/00067573.pdf (demonstrating that short-seller strategies had an annualized volatility of approximately twenty-four percent compared to an approximately eighteen percent annualized volatility for the S&P 500 index from July 1999 to December 2003); *cf. Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/. . ./EC*, at 2–3, COM (2009) 207 final (Apr. 30, 2009) (finding that hedge funds contributed to global systemic risk whereas PE funds did not); Ann-Kristin Achleitner & Christoph Kaserer, *Private Equity Funds and Hedge Funds: A Primer* 1 (Ctr. for Entrepreneurial and Fin. Studs., Working Paper No. 2005-03, 2005) (explaining that with respect to instability in the financial markets, "regulators are focused on behavior that could potentially destabilize the financial system" and in the case of hedge funds, "the use of derivatives, and, especially, short selling" calls for attention); Press Release, U.S. Sec. & Exch. Comm'n, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-211.htm ("At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation.").

62 *See* FRANÇOIS-SERGE LHABITANT, HEDGE FUNDS: QUANTITATIVE INSIGHTS 5 (2004) (explaining the diverse investment styles associated with hedge funds). Thus, regulators arguably could differentiate between these two funds by targeting the investment strategies. Indeed as Paul Volcker testified in support of the Volcker Rule, creating "the functional definition of hedge funds and private equity funds that commercial banks would be forbidden to own or sponsor is not difficult." *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the Committee on Banking, Housing, and Urban Affairs*, 111th Cong. 50 (2010) (prepared statement of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board).

63 To be sure, there exists a myriad of hedge fund investment styles with very different strategies and objectives that make it difficult to take a one-size-fits-all approach in characterizing these types of investment vehicles. However, in *Hedge Funds: A Resource for Investors*, Simone Borla and Denis Masetti make a helpful attempt at dividing the universe of hedge fund styles into three investment classes. One of which, "opportunistic strategies," describes an investment class that has variable levels of correlation with equity

term investments in portfolio companies, a hedge fund manager "may concentrate its portfolio in a handful of investments, use leverage, short selling and/or derivatives."[64] Because of these differences, the lack of specific instances in which PE funds engendered systemic risk concerns tends to suggest that there was nothing uniquely culpable about such funds that warranted their inclusion within these regulations. Instead, the legislative history indicates a concern for the overall lack of transparency in the private funds sector. Indeed it seems that for Congress, these regulations were seen as provisions that will "close loopholes and provide the SEC with long-overdue authority to examine and collect data on the industry."[65] Because PE funds lacked transparency prior to the Crisis—in the way that they shielded banks' infirmities from regulators and encouraged banks to engage in off-balance-sheet transactions—Congress reasonably believed that such opacity could also be problematic in the future.[66]

The possibility must also be considered that PE investments are in fact excessively risky as an asset class, thereby justifying congressional regulation. To be sure, experts disagree on the risks involved in banks' PE investments.[67] Congress could have simply determined that PE investments are excessively risky because they lock investors into

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markets. These include short selling and long/short equity investments. SIMONE BORLA & DENIS MASETTI, HEDGE FUNDS: A RESOURCE FOR INVESTORS 17–32 (2003).

64 LHABITANT, *supra* note 62, at 5. *Contra* Lowenstein, Written Testimony, *supra* note 13, at 2 (explaining that PE funds do not contribute to systemic risk in part because "PE firms are not deeply interconnected with other financial market participants through *derivatives positions*, counterparty exposures or prime brokerage relationships") (emphasis added).

65 Amy Or, *Buyout Shops Move To Kill Registration Requirement*, WALL ST. J. (Apr. 11, 2011 5:47 PM), http://online.wsj.com/article/SB100014240527487046626045762570217 68314248.html. According to Senator Jack Reed, a Democratic Senator from Rhode Island who proposed regulation of PE funds, PE funds "played an important role in providing liquidity to our financial system and improving the efficiency of capital markets," but proponents of regulation feel as if their role has grown and so has the potential risks they pose. *Id.*

66 This Note does not argue that Congress was necessarily wrong for making the policy judgment to regulate PE funds in anticipation of future problems. Rather, it contends that in light of the current economic circumstances and the costs associated with such a judgment, Congress should have chosen to regulate in a way that was more finely calibrated to the problems that led to the Crisis.

67 *See* SUSAN E. WOODWARD, SANDHILL ECONOMETRICS, MEASURING RISK AND PERFORMANCE FOR PRIVATE EQUITY 3–5 (2004) (explaining that "approaches to measuring risk and performance for private equity are diverse" and providing explanations of some of these approaches). As Woodward notes, based on data by Cambridge Associates, the simple correlation between PE quarterly returns and returns on broad market indices such as the S&P 500 or Wilshire5000 are low enough to suggest that private equity is less risky than plain vanilla stock market exposure. *Id.* at 2. However, Woodward articulates an approach that compensates for "stale valuations" and shows that the risk of private equity is considerably higher than is generally believed. *Id.* at 1.

specific investments for long periods of time. However, this position is undermined by the limited degree to which banks were actually exposed to PE investments during the Crisis. Recall that the Volcker Rule and the IAA Amendments stem from fears of banks engaging in excessively risky activity such that the threat of their failure may create the need for future bailouts.[68] For most banks, however, a relatively small amount of their total assets were at risk in the PE business during the midst of the Crisis.[69] Also, according to a study of more than 3200 private equity-backed companies, "during the 'Great Recession' of 2008-2009 private equity-backed businesses defaulted at less than one-half the rate of comparable companies: 2.84 [percent] versus 6.17 [percent]."[70] Additionally, while both hedge funds and PE funds experienced losses during the Crisis, research indicates that PE funds have actually performed more than 5% better than hedge funds since 2007.[71] Thus, to the extent that regulators did view PE investments as excessively risky, it seems unlikely that Congress was concerned with that riskiness in light of the economic developments that emerged during the Crisis. This is because, unlike the "troubled hedge funds" in need of bailouts discussed in Mr. Wolin's testimony,[72] PE investments did not pose a unique threat to the economy.[73]

Notwithstanding the lack of a direct nexus between PE investments and the systemic risk concerns underlying the enactment of the Volcker Rule and the IAA Amendments, legislators likely still believed that PE funds' lack of transparency warranted attention. Recall that the Volcker Rule restricts U.S. banks' investments in PE funds and the IAA Amendments eliminate such funds' exemption

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68 *See supra* notes 44–51 and accompanying text (describing the systemic risk concerns resulting from the Crisis).

69 *See* Scott, Written Testimony, *supra* note 28, at 59 (stating that as of September 2009, investment in private equity accounted for less than 3% of the aggregate total assets of the six largest U.S. banks).

70 JASON M. THOMAS, THE CREDIT PERFORMANCE OF PRIVATE EQUITY-BACKED COMPANIES IN THE 'GREAT RECESSION' OF 2008–2009, at 1 (2010), *available at* http://www.nvp.nl/data_files/credit_performance.pdf.

71 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-324, DEFINED BENEFIT PENSION PLANS: RECENT DEVELOPMENTS HIGHLIGHT CHALLENGES OF HEDGE FUND AND PRIVATE EQUITY INVESTING 9 tbl.1 (2012), *available at* http://www.gao.gov/assets/590/588623.pdf.

72 Wolin Testimony, *supra* note 57, at 54. To be sure, Mr. Wolin was referring to the $3.2 billion bailout of Bear Stearns's hedge fund. Jody Shenn & Yalman Onaran, *Bear Stearns Plans $3.2 Billion Hedge Fund Bailout*, BLOOMBERG (June 22, 2007, 5:17 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=amZ.IeL2pJHo.

73 As Federal Reserve Board Chairman Ben Bernanke stated in his testimony in front of the House Committee on Financial Services, he "would not think that any . . . private equity fund would become a systemically-critical firm individually" but rather it remains important for regulators to monitor systemic risk in the financial industry as a whole. Lowenstein, Written Testimony, *supra* note 13, at 189–90.

from SEC registration. Congress could have chosen to update the IAA to reflect the rising prominence of private equity as an asset class.[74] Under this line of thinking, the IAA Amendments provide the SEC with essential visibility into an investment class that could one day make up a very large portion of investments. Additionally, the fact that the IAA Amendments apply to all private funds—not just to bank holdings—supports the notion that they were put in place not only as a way to deal with risk taken on by banks, but also to remove an asymmetry in the previous regulatory scheme that allowed PE firms to report far less about their investment activities than other types of investors. Such conclusions suggest that a regulatory response would not need to be limited to addressing the ways in which these funds actually contributed to the Crisis. Indeed it seems more likely that Congress made the policy judgment to look beyond PE funds' pre-Crisis conduct in order to abate any unforeseen issues that these funds may cause in the future.

The next Subpart confirms this hypothesis. It accomplishes this through a detailed examination of the way in which Congress actually chose to regulate PE funds. It first explains the Volcker Rule and the ways in which that rule restricts banks from investing in PE funds. Then it demonstrates that this attempt at restricting banks' PE investments is unnecessary in light of capital requirement regulations that force banks to insure themselves for their own investment activities and the accounting changes that allow regulators to gauge the amount of insurance required. Next, it describes the IAA Amendments and the ways they affect PE fund registration. It then illustrates that the transparency issues of PE funds that contributed to the Crisis had already been adequately addressed through the implementation of FAS 157. In this way I both describe the regulations and demonstrate how they do not address the ways in which PE funds actually contributed to the Crisis. Once this is understood, it becomes clear how the choice to include PE funds within these regulations represents a legislative judgment to look beyond these funds' pre-Crisis culpability.

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[74] *See* Diana Farrell, *Private Equity Isn't Fading Away*, BLOOMBERG BUSINESSWEEK (Nov. 20, 2007, 12:37 PM), http://www.businessweek.com/globalbiz/content/nov2007/gb20071120_276791.htm (explaining that though "private equity remains a relatively small player in the corporate world," analysts at McKinsey & Company project that "the industry's assets under management may double by 2012").

B. *How Congress Chose To Regulate Private Equity*

1. *The Volcker Rule*

The Volcker Rule restricts banking entities[75] from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring any hedge fund or PE fund, subject to certain exceptions.[76] That is, "the Rule operates to separate private equity sponsorship and investment activities from the traditional business of banking."[77] In prohibiting these activities, the Volcker Rule aims to prevent excessively risky investment activities by banks and other financial institutions.[78] Though there are exceptions and carve-outs for organizing and offering PE funds,[79] "[w]ithout a doubt, [because of this rule] banking entities will be constrained in their ability to participate as limited partners and to sponsor their own [PE] funds on a substantial scale."[80]

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75 The Act defines "banking entity" as including any depository institution insured by the FDIC, along with any of the institution's parents, affiliates, or subsidiaries. Dodd-Frank Act § 619(h)(1).

76 *Id.* § 619(a)(1)(B). To be clear, it is section 619 in its entirety that is most commonly known as the Volcker Rule. The Volcker Rule contains two basic restrictions: (1) a prohibition on proprietary trading, and (2) a ban on certain hedge fund and PE activities. *Id.* § 619(a)(1)(A)–(B). The restrictions on proprietary trading, while arguably the most controversial prohibitions, are outside the scope of this Note.

77 Tarbert & Radetsky, *supra* note 52, at 44.

78 *See* Financial Stability Oversight Council, U.S. Dep't of Treasury, Study & Recommendations on Prohibitions of Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds 52–55 (2011) [hereinafter FSOC Study] (explaining how the Volcker Rule reduces risk and relates to other pending and related regulations).

79 For example, section 619(d) explicitly allows for a banking entity to organize and to offer a "de minimis" PE fund—provided certain requirements are satisfied. Dodd-Frank Act § 619(d)(1)(G)(i)–(viii). Apart from this de minimis exception, the Volcker Rule also permits banking entities to sponsor or invest in a PE fund outside the United States, so long as "no ownership interest in such . . . fund is offered for sale or sold to a resident of the United States" and "the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States." *Id.* § 619(d)(1)(I).

80 Tarbert & Radetsky, *supra* note 52, at 52. At the time of this writing, the Volcker Rule has not yet been fully implemented. The Rule became effective on July 21, 2012, and all entities that fall within its purview were given two years to conform their activities to the Rule's prohibitions. *See* Press Release, Volcker Rule Conformance Period Clarified, Apr. 19, 2012, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20120419a.htm. However, section 619 requires that the SEC and other regulators draft implementing regulations on all aspects of the Rule (including the definitions of covered funds) which will provide the covered entities with guidance on how to comply with the Rule. Regulators have yet to complete the final regulations and as a result, there still exists much uncertainty regarding the final contents of the Rule. *See Final Volcker Rule Expected by Year-End—Treasury Official*, Reuters (Aug. 21, 2012, 9:20 PM), http://in.reuters.com/article/2012/08/21/volcker-timeline-idINL2E8JL4CB20120821 ("The [Volcker Rule's] implementation is now a month past its initial deadline. The delay stems from differences in how regulators want the rule to be implemented, as well as an overwhelming volume of feedback from industry groups and the public."); Ben Protess & Peter Eavis, *Progress is*

Because PE funds fall within the Volcker Rule's restrictions, banks will lose out on any returns that could have been generated from their PE assets.[81] For example, JPMorgan manages $8 billion of these investments.[82] Goldman Sachs will be forced to remove approximately $14–15 billion in PE assets from its balance sheet.[83] Though this amount is only a small percentage of the firm's total assets, three quarters of these investments are illiquid and will be difficult for the company to divest.[84] As Lattman elucidates, the company could presumably just revoke its banking license, thus avoiding the Act's prohibitions by removing itself from within the ambit of the Act.[85] Though this may be an option for Goldman, for other banks—those that do not have the benefit of Goldman Sachs's $849 billion balance

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Seen in Advancing a Final Volcker Rule, N.Y. TIMES DEALBOOK (May 2, 2012, 8:44 PM), http://dealbook.nytimes.com/2012/05/02/progress-is-seen-in-advancing-a-final-volcker-rule/ ("As Wall Street sees it, the Volcker Rule threatens the health of the financial industry and the broader economy."); Ben Protess, *Volcker Rule Divides Regulators*, N.Y. TIMES DEALBOOK (Oct. 16, 2011, 9:48 PM), http://dealbook.nytimes.com/2011/10/16/volcker-rule-divides-regulators/. ("Both the rule's critics and supporters fear that an escalating turf war could sidetrack regulators as they shape a final version of the overhaul . . . . While Wall Street opposes the proposal, it worries that the regulatory fracture will generate additional uncertainty over how to comply."). However, despite the delayed implementation, there have been periodic releases that have provided guidance to regulators—and practitioners—as the final rules are being drafted. For example, the Financial Stability Oversight Council (FSOC) has issued guidance on the Rule and the Federal Reserve has set conformance periods for compliance. *See* FSOC STUDY, *supra* note 78. Throughout these releases, PE funds have consistently fallen within the ambit of the Volcker Rule's prohibitions and as a result, in the most recent official draft of the final implementing regulations, "[t]he proposed rule's definition of covered fund generally parallels the statutory definition of 'hedge fund' and 'private equity fund.'" Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,852 (Nov. 7, 2011).

81 According to Hal Scott, a Professor of International Financial Systems at Harvard Law School and Director of the Committee on Capital Markets Regulation, as of 2010 banks and investment banks accounted for $115 billion of investments by limited partners in PE buyout transactions worldwide. Scott, Written Testimony, *supra* note 28, at 55.

82 *See* Megan Davies, *Banks May Shed Private Equity Assets in Obama Plan*, REUTERS (Jan. 22, 2010, 9:25 AM), http://www.reuters.com/article/2010/01/22/us-privateequity-obama-idUSTRE60L17720100122 ("A number of banks have sizeable private equity interests, for example, JPMorgan's One Equity Partners, manages $8 billion of investments and commitments for the bank . . . .").

83 *See* Peter Lattman & Kate Kelly, *Hitting Goldman Where it Hurts*, WALL ST. J., Feb. 9, 2010, at C1–C2 (discussing the potential impact of the Volcker Rule on Goldman Sachs's PE investments).

84 *Id.*

85 This is because the Volcker Rule's prohibitions only apply to banking entities, and "banking entity" is defined as "any insured depository institution . . . , any company that controls an insured depository institution, or that is treated as a bank holding company . . . , and any affiliate or subsidiary of any such entity." Dodd-Frank Act § 619(h)(1). By revoking its banking license, Goldman would no longer qualify as a bank holding company for the purposes of the Act.

sheet—such a restriction limits investment opportunities[86] "at a time when growth is most needed."[87]

2. The Volcker Rule Is Not a Response to PE's Pre-Crisis Conduct

By restricting banks' investments in PE funds in this way, the Volcker Rule is not calibrated toward addressing the ways PE funds contributed to the Crisis. Rather than pushing banks into insolvency through volatile, high-risk investment opportunities, PE funds encouraged banks to engage in such investments so that the banks could provide these funds with cheap capital for their "buyout" transactions.[88] If regulators were concerned with how PE affected the Crisis, they could have addressed this by mandating stricter capital requirements that would prevent banks from indulging in shadow banking activities.

Indeed, sections 165 and 616 of the Dodd-Frank Act already provide the means to achieve this goal. Section 165 allows the Board of Governors to establish prudential standards, such as risk-based capital requirements, for banks and other systemically important financial institutions.[89] The Dodd-Frank Act allows the Board to differentiate these standards among institutions by taking into account various considerations.[90] Section 616 of the Dodd-Frank Act goes further by mandating a countercyclical approach to the establishment of banks' capital requirements. That is, the minimum capital requirement

86 *See* Lattman & Kelly, *supra* note 83, at C2 (discussing Goldman's $849 billion balance sheet, of which only $14 billion is in PE holdings).

87 Letter from David T. Hirschmann, Pres. & CEO, Ctr. for Capital Markets Competitiveness of the U.S. Chamber of Comm., to the Fin. Stability Oversight Council, at 5 (Nov. 5, 2010) (on file with *New York University Law Review*) [hereinafter Hirschmann Letter]; *see also* David Wessel, *Desperately Seeking Blueprint for Growth*, WALL ST. J., Aug. 4, 2011, at A4 (arguing that the U.S. presently needs a plan for improving economic growth); Barack Obama, *A Firewall To Stop Europe's Crisis Spreading*, FT.COM (Oct. 27, 2011, 11:00 PM), http://www.ft.com/intl/cms/s/0/8bea546a-ffc5-11e0-8441-00144feabdc0.html (explaining that the United States "must stay focused on the strong, sustainable and balanced growth that boosts global demand" and that as the world's largest economy, "[t]he single most effective thing [that the United States] can do to get the global economy growing faster is to get the US economy growing faster"); John B. Taylor, *The Two-Year Anniversary of the Non-recovery*, ECONOMICS ONE (June 21, 2011, 8:21 PM), http://johnbtaylorsblog.blogspot.com/2011/06/two-year-anniversary-of-non-recovery.html (explaining that in his view, as the Chair of the Hoover Institute's Working Group on Economic Policy, the current U.S. economic recovery is "a recovery in name only, so weak as to be nonexistent").

88 *See supra* Part I.C.1 (explaining the shadow banking industry).

89 Dodd-Frank Act § 165(a).

90 These considerations include an institution's "capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate." *Id.* § 165(a)(2)(A).

increases in times of economic expansion and decreases in times of economic contraction.[91] This encourages banks to build up capital during growth periods so that it is available to absorb losses during economic contractions, thereby "limit[ing] the risk of large-scale strains in the banking system by strengthening its resilience against shocks."[92]

These requirements address the risks of shadow banking by providing a buffer to protect against unexpected losses. Bank loans to PE funds are self-insured: The Dodd-Frank Act's capital requirements are pinned to the riskiness of the PE fund activity.[93] Further, if Congress determines that PE investments are an excessively risky asset class, it now can force a bank to reserve the necessary capital to cover its positions in such investments. Such an approach should also abate concerns that accounting for the riskiness of PE investments can be difficult.[94] This is because regulators could factor those difficulties into the capital requirement determination, ratcheting up the reserve levels to the point of mandating dollar-for-dollar insurance.[95] One could take the position that this approach leads to the same negative implications as the Volcker Rule in that it restricts banks from freely engaging in potentially profitable investments, thus stifling economic benefits.[96] However, this position overlooks the potential flexibility inherent in the use of capital requirements. That is, capital requirements set a floor that can vary from institution to institution.[97] Contrary to the restrictions imposed by the Volcker Rule, once this floor is established the bank will have adequately insured itself and

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91 *Id.* §§ 616(a)(2), 616(b)(2), 616(c). This is accomplished through amendments to the Bank Holding Company Act, 12 U.S.C. § 1844(b) (2006), the Home Owners' Loan Act, 12 U.S.C. § 1467a(g)(1) (2006), and the International Lending Supervision Act of 1983, 12 U.S.C. § 3907(a)(1) (2006). Dodd-Frank Act §§ 616(a)(2), 616(b)(2), 616(c).

92 Mathias Drehmann et al., *Countercyclical Capital Buffers: Exploring Options* 1 (Bank for Int'l Settlements, Working Paper No. 317, 2010), *available at* http://www.bis.org/publ/work317.pdf.

93 *See supra* note 90 (discussing the factors regulators consider in determining capital requirements). With regard to shadow banking in mortgage-backed securities investments discussed in note 34 *supra*, had these requirements been put in place before the Crisis, regulators would have taken into account the riskiness of those assets in determining how much capital those banks had to keep in reserves. As to PE investments, the accounting changes in FAS 157 provide regulators with at least some method of valuation to gauge how much insurance might be required.

94 *See infra* note 122 and accompanying text (noting critics of fair-value accounting's position that PE investments are difficult to value).

95 *See supra* note 90 (discussing the factors regulators consider in determining capital requirements).

96 *See infra* Part III.B.1 (discussing the economic implications of the Volcker Rule's restrictions on PE investment).

97 *See* Dodd-Frank Act § 165(a)(1) (enabling the Board of Governors to establish different prudential standards for banks with varying total consolidated assets).

presumably will be free to engage in more PE investments as it increases in profitability.[98]

In addition to these leverage and capital requirements, section 165(k) of the Act requires that off-balance-sheet risks also be included in the calculations of banks' exposure.[99] This requirement directly addresses the hidden vulnerabilities of shadow banking by forcing banks to account for, and insure themselves against, potential losses that result from off-balance-sheet activities.[100] Section 165(k) effectively eliminates the "shadow" of the shadow banking industry. The systemic-risk concerns engendered by pressures from PE funds are therefore abated as banks must now decide whether engaging in "off-balance-sheet" activity is worth the additional capital that would have to be reserved as insurance against unexpected losses.

3. *The IAA Amendments*

Title IV of the Dodd-Frank Act addresses investment adviser registration under the Investment Advisers Act of 1940.[101] Among other things, the IAA Amendments (1) alter the SEC registration criteria applicable to PE fund managers and other investment advisers[102] and (2) significantly increase the record-keeping and reporting obligations applicable to registered and unregistered advisers to hedge funds and PE funds.[103] Recall that PE fund managers were previously

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[98] I use the word presumably to acknowledge the reality that various considerations go into setting capital requirements. To the extent a bank becomes bigger, more profitable, and thus more systemically important, regulators might decide that these factors dictate higher levels of capital beyond dollar-for-dollar increments.

[99] Dodd-Frank Act § 165(k).

[100] *See id.* § 165(k)(1) ("[T]he computation of capital for purposes of meeting capital requirements shall take into account any off-balance-sheet activities of the company.").

[101] 15 U.S.C. § 80b-1 to -21 (2006).

[102] Dodd-Frank Act § 403. The IAA Amendments bring PE fund managers within the purview of SEC regulation by removing the commonly relied upon exemption found at § 203(b)(3) of the IAA. *Id.* Particularly, the amendment replaces the language of § 203(b) to only exempt from registration "any investment adviser that is a foreign private fund adviser." *Id.*; *see also* KENNETH MULLER & SETH CHERTOK, BLOOMBERG LAW REPORTS, THE IMPACT OF TITLE IV OF THE DODD-FRANK ACT ON INVESTMENT ADVISERS (2011), *available at* http://www.mofo.com/files/Uploads/Images/110124-Title-IV-Bloomberg.pdf ("Section 203(b)(3) is the most frequently relied upon Advisers Act exemption and exempts from registration investment advisers that advise fewer than 15 clients and meet certain other conditions. Revised Section 203(b)(3) will only provide an exemption with respect to 'foreign private advisers.'").

[103] *See* Dodd-Frank Act § 404 (detailing the new recordkeeping requirements). The records and reports that must be maintained under this rule include descriptions of: (i) "the amount of assets under management and use of leverage, including off-balance-sheet leverage"; (ii) "counterparty credit risk exposure"; (iii) "trading and investment positions"; (iv) "valuation policies and practices of the fund"; (v) "types of assets held"; (vi) "side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors"; (vii) "trading practices"; and (viii) "such other

exempt from registration as investment companies due to the IAA's section 3(b)(3) exemption.[104] The IAA Amendments simply remove these exemptions in furtherance of providing transparency and preventing potential "dangers for systemic risk and investor abuse."[105] Accordingly, the Act sets forth registration and reporting requirements for advisers to PE funds in order to "fill the gaps" in the regulation of these private pools of capital.[106]

Notwithstanding these registration and reporting requirements, pursuant to section 408 of the Act, an investment adviser to a private fund with assets under management of less than $150 million will be excluded from the aforementioned requirements.[107] However, the SEC is still empowered to require advisers to private funds "to maintain such records and provide to the [SEC] such annual . . . report[ing] as the [SEC] determines necessary or appropriate in the public interest or for the protection of investors."[108] According to industry professionals, the flexibility inherent in the "may deem necessary or appropriate" language suggests that the SEC will require registration and reporting despite the section 408 exemptions.[109]

4. The IAA Amendments Go Beyond Addressing PE's Pre-Crisis Conduct

By bringing PE funds within the purview of SEC regulation, the IAA Amendments go beyond remedying the transparency issues these funds engendered during the Crisis. This is because the ability to

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information as the Commission . . . determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk . . . ." *Id.* § 404(3)(A)–(H).

104 *See supra* note 102 (discussing the private funds exemption under the IAA). The IAA Amendments remove the commonly relied upon exemption for investment advisers with fewer than fifteen clients (during the preceding twelve-month period), that do not hold themselves out to the public as investment advisers, and that do not act as investment advisers to a registered investment company. However, the Act does still provide a few exemptions. While some of these exemptions will apply to certain PE funds that previously relied on the private adviser exemption, by and large, a majority of such PE funds will have to register under the new regime. For more on these exemptions, see WILLIAM E. KELLY, NIXON PEABODY LLP, IMPACT OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT ON PRIVATE EQUITY FUNDS AND OTHER PRIVATE POOLS OF CAPITAL (Aug. 19, 2010), *available at* http://www.nixonpeabody.com/linked_media/publications/Private_Equity_Alert_08_19_2010.pdf.

105 H.R. REP. NO. 111-686, pt. 1, at 6 (2010).

106 *Id.* at 7 (quoting DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 37 (2009)).

107 Dodd-Frank Act § 408(1).

108 *Id.* § 408(2).

109 Interview with Todd N. Dumas, *supra* note 38.

hide the infirmities of banks' balance sheets[110] had already been addressed through the FASB's implementation of FAS 157.[111] Particularly, the shift from historical-cost accounting to fair-value accounting provided a means through which regulators could monitor and track banks' investments in PE funds.

Fair-value accounting is simply a way to measure assets (and liabilities) that appear on a bank's balance sheet. FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[112] When quoted prices in active markets for identical assets are available, they have to be used as the measurement for fair value.[113] If identical assets are unavailable to be used for measurement purposes, observable inputs (including quoted prices for similar assets or liabilities in active markets), quoted prices from identical or similar assets in inactive markets, and other relevant market data, should be used. Lastly, unobservable inputs—like model assumptions—should be used to derive a fair value if observable inputs are not available.[114]

Recall that during the time leading up to the Crisis, banks could record the value of their PE investments according to the amount that was invested at the start of the fund.[115] This prevented regulators from monitoring accurately the value of these investments—and thus the value of those banks' balance sheets. However, on January 1, 2008, FAS 157 became effective for all companies whose fiscal years coincide with the end of the calendar year.[116] Through fair-value accounting, banks' assets now reflect current market conditions, thus providing timely information to regulators. This accounting practice directly addresses the concern that banks' PE investments hide infirmities in their balance sheets because it forces banks to record the value of their assets in real time. According to Stephen G. Ryan, an

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110 *See supra* Part I.C.2 (discussing how PE funds shielded banks' infirmities from regulators).

111 *See supra* note 41 and accompanying text (discussing the FASB's implementation of FAS 157).

112 FAS 157, *supra* note 41, at 8.

113 Laux & Leuz, *supra* note 39, at 827.

114 *See id.* (explaining other inputs for measurement if identical assets are unavailable). This is known as the "'mark-to-model' approach." *Id.*

115 *See supra* notes 38–40 and accompanying text (discussing banks' use of historical-cost accounting).

116 U.S. SEC. & EXCH. COMM'N, OFFICE OF THE CHIEF ACCOUNTANT, DIVISION OF CORPORATE FINANCE, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: STUDY ON MARK-TO-MARKET ACCOUNTING 44 (2008). Despite the January 1 effective date, only thirty-one percent of total bank assets were reported at fair value as of first quarter end 2008. *Id.* at 50.

accounting Professor at the New York University Stern School of Business, these real-time valuations allow comparability among different investment positions; this is particularly important in assessing the value and risks of financial institutions' portfolios.[117] As Professor Ryan notes, fair-value accounting is therefore the "best platform for mandatory and voluntary disclosure" because it increases transparency and encourages scrutiny from investors.[118]

It is important to understand that by the time FAS 157 became effective, banks had already valued a significant amount of PE investments using the historical-cost method. For example, global PE fundraising exceeded $100 billion in the fourth quarter of 2007 compared with less than $10 billion during the same period in 2009.[119] Therefore, because the switch to fair value accounting occurred in 2008, banks were forced to mark the value of their PE investments down from the amounts invested pre-2007 to the amount those investments were worth in the midst of the Crisis.[120] Needless to say, balance sheets plummeted.[121]

Critics of the fair value approach therefore claim that such an approach is potentially misleading for assets—such as PE fund investments—that are held for long periods until maturity. Under the fair value approach, prices can be distorted by market inefficiencies, investor irrationality, or liquidity problems.[122] This concern was par-

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117 STEPHEN G. RYAN, COUNCIL OF INSTITUTIONAL INVESTORS, FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH 17 (2008).

118 *Id.* at 18.

119 Scott, Written Testimony, *supra* note 28, at 55.

120 *See supra* text accompanying footnotes 115–17 (explaining FAS 157's effect on the valuation of PE fund investments).

121 *See* Ian Katz, *Behind Schwarzman Spat with Wasserstein Lies Rule 115*, BLOOMBERG (Dec. 8, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGLHt9Kw7JNo&refer=home ("Private-equity executives, including [Stephen] Schwarzman, [Chairman of Blackstone Group LP,] say mark-to-market accounting unfairly forces them to value holdings even if they have no intention of selling them at that time, hindering the business model of fixing up companies and disposing of them years later for a profit."). According to former FDIC Chairman William Isaac, the implementation of fair value accounting led to a loss of approximately $500 billion in banks' reported capital and, as a result, it has not been well received by the financial services industry. *See Mark-to-Market Accounting: Practices and Implications: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 117th Cong. 199 (2009) (prepared statement of William M. Isaac, Former Chairman, Federal Deposit Insurance Corporation) *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48865/pdf/CHRG-111hhrg48865.pdf.

122 *See* RYAN, *supra* note 117, at 11 ("The financial economics literature . . . contains considerable theory and empirical evidence that markets sometimes exhibit 'bubble prices' that either are inflated by market optimism and excess liquidity or are depressed by market pessimism and illiquidity compared to fundamental values."); *see also supra* notes 41–43 and accompanying text (discussing the fair value approach).

ticularly relevant when FAS 157 became effective due to the market distortion that occurred during the Crisis.[123] But, going forward, it is important to realize that the level of illiquidity in the financial markets that emerged during the midst of the Crisis was quite unique in comparison to past crises.[124]

To the extent that market distortion does become an issue for valuing PE investments, it is important to keep in mind that there are "many contexts in accounting where measurements are difficult to make . . . . In these contexts, accounting measurements often involve hypothetical transactions."[125] Also, if regulators believe that market distortions prevent them from using hypothetical models to accurately value a bank's PE investments, they can consider this uncertainty when determining that bank's capital requirements.[126] Because section 165 gives regulators the flexibility to consider "any other risk-related factors" that they deem appropriate, they could require a bank to insure itself dollar-for-dollar with regard to any PE investments that cannot be properly valued.[127] While not perfect,[128] such an approach would still alleviate the transparency concerns surrounding banks' PE investments and would do so through the accountability mechanisms inherent in the existing regulatory regime.

As this Part demonstrates, the Volcker Rule and the IAA Amendments are not direct responses to PE funds' problematic pre-Crisis activity. This is because the problems that arise from both shadow banking and opaque bank balance sheets have been addressed through existing regulatory changes. It therefore becomes clear that including PE funds within the ambit of the Volcker Rule and the IAA Amendments represents a policy choice by Congress to take a more broad and systematic approach toward such funds by regulating them

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123 *See* Brooke Sopelsa, *Former FDIC Chair Blames SEC for Credit Crunch*, CNBC.COM (Oct. 9, 2008, 12:49 PM), http://www.cnbc.com/id/27100454 ("The SEC has destroyed $500 billion of bank capital by its senseless marking to market of these assets . . . .").

124 *See* Nada Mora, *Can Banks Provide Liquidity in a Financial Crisis?*, ECON. REV. 3d Quarter 2010, at 31, 31, *available at* http://www.kansascityfed.org/publicat/econrev/pdf/10q3Mora.pdf (explaining how commercial banks' unprecedented exposure during 2007-2009 prevented them from providing market liquidity).

125 RYAN, *supra* note 117, at 19; *see supra* note 114 and accompanying text (describing the mark-to-model approach).

126 *See supra* Part II.B.2 (discussing the use of capital requirements as a buffer for banks' investments).

127 Dodd-Frank Act § 165(a)(2)(A); *see supra* notes 89–90 and accompanying text (discussing § 165); *supra* text accompanying note 91 (discussing regulators' power to require dollar-for-dollar insurance).

128 *See supra* text accompanying notes 94–96 (discussing the difficulties inherent in relying on capital requirements as a method of dollar-for-dollar insurance).

beyond their pre-Crisis conduct. This policy choice is well within the purview of the regulators—but it is not without costs.

It is in light of these costs that this Note takes the position that after the Crisis, financial regulators should have considered the changing circumstances amongst not only PE funds, but also the financial markets more generally. Part III examines why legislation should not regulate financial institutions beyond their problematic pre-Crisis conduct.

III
THE HARMS OF REGULATING BEYOND THE CRISIS

A. Theoretical Support for a Limited Response

A decade before the Crisis, a financial analyst by the name of Michael Taylor articulated an approach to reforming financial markets regulation.[129] Taylor defined his "regulatory paradigm" as a combination of (1) broad public policy objectives set for the regulatory system, (2) institutional arrangements for administering the requirements that stem from those policy objectives, and (3) specific regulatory techniques used by the agencies entrusted with the task of implementing the regulation.[130] To Taylor, such an approach is effective not only because it recognizes the need to effectuate public policy objectives, but also because it reflects the changes in the underlying structure of the modern financial industry.[131]

Although Taylor's approach was not directly articulated in response to the current debate over financial market regulation, his argument highlights an important consideration within the financial regulation context generally. Regulation must be designed with enough flexibility to deal with developments in financial markets. Indeed, as the U.S. Government Accountability Office (GAO) recognized in its January 2009 report, the ineffectiveness of the pre-Crisis financial regulatory system stemmed from its reliance on a fragmented and complex regime "that ha[d] not kept pace with major developments that have occurred in financial markets and products in recent decades."[132] The report makes clear that the increasing prevalence of new and more complex investment products had presented a difficult

[129] *See generally* Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 MERCER L. REV. 793 (1998).

[130] *Id.* at 794.

[131] *See id.* at 793 (arguing that a new regulatory paradigm should take into account new public policy objectives and should be modernized to reflect modern financial industry practices).

[132] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED

challenge for regulators, and thus created the need for "significant reform."[133] However, despite the flexibility that can be provided through a broad systematic approach, it is important to realize that at times, the developments that a regulation should address are not only those that pertain specifically to the entities that regulation targets. Rather, this Note posits that an effective framework for financial regulation also must account for broader economic developments that may emerge in the post-Crisis context.[134]

It is here that the follies of regulating actors beyond their pre-Crisis conduct begin to emerge. As Professors Saule Omarova and Adam Feibelman note, a large "[i]nstitutional and regulatory structure can promote effective regulation, but it is unlikely to do so unless the goals and tools of a regulatory regime are carefully defined."[135] By focusing this large regulatory structure only on anticipating changes amongst the regulated entities, its effectiveness can be undermined by unforeseen external developments.[136] Also, because it is impossible to know exactly how the financial markets will be structured after recovering from the Crisis, failing to limit the legislative response to the actual causes of the Crisis risks the development of a regulatory system that is "weak where it should be strong and strong where it should be weak."[137] The Crisis arguably provides a unique opportunity to make substantial reforms to our financial regulatory system. This opportunity should be seized because there may be insufficient political will to override special interests after the Crisis subsides.[138]

U.S. FINANCIAL REGULATORY SYSTEM 1 (2009), *available at* http://www.gao.gov/new.items/d09216.pdf.

133 *Id.*

134 For the proposal of an even broader approach that highlights how the "entwining of markets give[s] the international financial system characteristics of a living organism or ecosystem," see Ted Harding, *Under the "Volcker Rule" in the United States, It Is Proposed that Banks Will No Longer Be Allowed To Own, Invest in, or Sponsor Hedge Funds, Private Equity Funds, or Proprietary Trading Operations for Their Own Profit, Unrelated to Serving Their Customers. Can This Be an Effective Regulatory Response to Risk Issues Exposed During the Financial Crisis that Commenced in the Autumn of 2008?*, at 7 (University College Dublin Working Papers in Law, Criminology, and Social Legal Studies, Research Paper No. 37, 2010).

135 Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881, 882 (2009) (discussing the risks of a broad regulatory response to the current financial crisis).

136 *See infra* note 148 and accompanying text (discussing unforeseen economic developments that have emerged since the Crisis).

137 Omarova & Feibelman, *supra* note 135, at 884.

138 It is generally understood that between bicameralism and interest group lobbying, there can be significant obstacles to the passage of legislation. *See* DANIEL M. BERMAN, A BILL BECOMES LAW 10–11 (1962) (explaining that disagreement among congressmen was a serious potential obstacle to the enactment of the Civil Rights Act of 1960); Thomas Stratmann, *Can Special Interests Buy Congressional Votes? Evidence from Financial*

With respect to unforeseen developments outside of the regulated entities, failure to regulate carefully in the wake of a crisis may result in a missed opportunity to shape the re-emergent markets through regulation.

However, to approach such comprehensive regulation "with particular structural and substantive reforms already in mind may increase the chances that policymakers will make consequential mistakes at a crucial juncture."[139] Further, the "sense of urgency" that often accompanies the perceived "need to make significant reforms in the near-term greatly increases the chance that policymakers will make such mistakes."[140] To be clear, limiting a legislative response to the direct remediation of pre-Crisis conduct—thus leaving flexibility for the emergence of broader external developments—does not mean that regulators will lose the ability to prevent financial calamity by reigning in undesired activity. A continuous, fine-grained examination of the financial sector will allow regulators to make incremental adjustments to the regulatory framework to address the most salient concerns and give existing regulatory actors time to assess the need for future reforms.[141] A more narrow response suggests, however, that effective financial regulation should be carefully calibrated "with reference to the actual, on-going nature of the firms and the activities to be regulated."[142] This way, the unintended consequences of locking private actors into broad regulatory regimes can be mitigated and the

Services Legislation, 45 J.L. & ECON. 345, 350–51 (2002) ("In 1995 the House Banking Committee had passed a banking reform bill, but it never reached the floor in either chamber because security, investment, and banking interests did not favor the proposed legislation."). These institutional bulwarks often block even the most thoughtful and well-calibrated legislation from becoming law. Therefore, it is sometimes necessary for public opinion to inject itself into the legislative process as an external force that breaks these walls down. *See* Paul Burstein, *The Impact of Public Opinion on Public Policy: A Review and an Agenda*, 56 POL. RES. Q. 29, 29 (2003) ("The major findings [of this Article] include: the impact of public opinion is substantial; salience enhances the impact of public opinion; the impact of opinion remains strong even when the activities of political organizations and elites are taken into account . . . ."); Benjamin I. Page & Robert Y. Shapiro, *Effects of Public Opinion on Policy*, 77 AM. POL. SCI. REV. 175, 175 (1983) ("We present evidence that public opinion is often a proximate cause of policy . . . ."). It is important to realize then, that a broad, comprehensive regulatory regime can be the result of a Congress that seeks to take advantage of opportunities presented by public outcry. Given that legislators have relatively few bites at the apple, dovetailing sweeping reforms with surges in public opinion seems quite reasonable.

139 Omarova & Feibelman, *supra* note 135, at 902.

140 *Id.*

141 As Omarova and Feibelman note, "[i]t is entirely reasonable to expect that market actors will adjust their behavior in light of the recent crisis." *Id.*

142 *Id.*

allocation of political capital toward scaling back broad legislation will be lessened.[143]

Following Omarova and Feibelman, this Note takes the position that a regulation's need to address unforeseen developments among regulated entities should not always subsume the need to adapt to the changed domestic and international financial markets that will emerge after the Crisis. In taking this view, this Note concludes that the current state of the U.S. financial market is one that necessitates a regulatory response that is more closely tied toward pre-Crisis conduct and that allows for post-Crisis economic growth.[144] As the next Subparts argue, in choosing to regulate broadly in anticipation of regulatory gaps with respect to PE funds, Congress failed to address other post-Crisis developments that have occurred in the U.S. economy. Further, Congress may have actually undermined the effectiveness of the laws by delegitimizing them in the eyes of those sought to be regulated. The next Subpart clarifies these contentions by first explaining the ways in which the Volcker Rule and the IAA Amendments have threatened economic growth and U.S. financial market competitiveness. It then illustrates that, in addition to economic costs, both legislative actions have also generated social costs by undermining the legitimacy of the Dodd-Frank Act.

B. The Economic and Social Costs of Regulating Beyond the Crisis

It is indeed plausible Congress considered that overregulation may increase unexpected post-Crisis economic and social costs, before choosing to proceed more broadly. As Professors Omarova and Feibelman explain, it is also possible that the "sense of urgency" that often accompanies "the need to make significant reforms in the near-term" caused the regulators to overlook these potential implications.[145] Whichever the case, it seems clear at this point that the costs generated by Congress's approach may have to be borne by the economy at large.[146] This Subpart explores those costs. In the hope

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143 Indeed, the Dodd-Frank Act, which has "ballooned in size and scope" in relation to its original stated goals, has been subject to "two dozen bills in Congress" seeking to restrain the Act's reach. Ron Pechtimaldjian, *Dodd-Frank Anniversary: Big Reform Followed by Mixed Progress—Slideshow*, AdvisorOne (July 20, 2011), http://www.advisorone.com/2011/07/20/dodd-frank-anniversary-big-reform-followed-by-mixe.

144 *See infra* Part III.B.1 (discussing current U.S. financial market conditions).

145 Omarova & Feibelman, *supra* note 135, at 902.

146 Due to the contemporaneousness of these issues and the pendency of the regulations discussed in this Note, there currently exists scant academic and empirical research on the effects that the Dodd-Frank Act will have on the financial markets. As a result, many of my contentions in this area are supported by forward-looking arguments advanced by fund managers and financial services professionals.

that future legislators might draft provisions that are more closely tied to pre-crisis conduct, it answers the question of why it now matters if we unnecessarily regulate the PE industry.

1. The Economic Costs

The Volcker Rule's restrictions on banks' PE fund investments prevents banks from engaging in potentially profitable investments at a time when economic growth is needed most.[147] America is facing a sluggish economic recovery as the continued "upset[s] to [financial market] confidence [are] likely to dampen economic growth over the next several quarters."[148] PE funds promote economic growth because such funds are "potentially lucrative" investments for banks "and can be used to subsidize fees"—which in turn attracts additional depositors, and thus increases lending activity.[149] Also, in many cases, PE investments provide opportunities for increased diversity of risk and earnings that can help make a bank's overall balance sheet healthier in the long run.[150] PE investment should be encouraged during these times because such funds have the potential to be an "important financing source for the U.S. economy" as they provide "needed investment to undercapitalized . . . U.S. industries."[151]

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147 As of this writing, business leaders are routinely downgrading the U.S. Economic Outlook well into the next two years. *See, e.g.*, The Associated Press, *IMF Sharply Downgrades U.S. Economic Outlook*, DAILYFINANCE (Sept. 20, 2011, 9:54 AM), http://www.dailyfinance.com/2011/09/20/imf-sharply-downgrades-u-s-economic-outlook/ ("The International Monetary Fund has sharply downgraded its outlook for the U.S. economy through 2012 because of *weak growth* and concern that Europe won't be able to solve its debt crisis.") (emphasis added); The Associated Press, *Moody's Lowers US Economic Outlook Through 2012*, BLOOMBERG BUSINESSWEEK, (Aug. 15, 2011, 5:30 PM), http://www.businessweek.com/ap/financialnews/D9P4OVNO0.htm ("Moody's Analytics . . . lowered its outlook for growth in the U.S. economy this year and next, saying it sees 'significantly weaker' prospects for the economy than just a month ago as the country struggles to avoid another recession.").

148 *TD Economics: U.S. Economy Stuck in Neutral*, PR NEWSWIRE (Sept. 13, 2011), http://www.prnewswire.com/news-releases/td-economics-us-economy-stuck-in-neutral-129722768.html.

149 Philip Gibbs, *Jupiter's Gibbs on Obama's Banking Reforms*, INVESTMENTWEEK (Feb. 8, 2010, 10:36 AM), http://www.investmentweek.co.uk/investment-week/opinion/1590832/jupiter-gibbs-obama-banking-reforms; *see also* Fang et al., *supra* note 20, at 7 (explaining that in addition to the benefits received from their equity investments in PE funds, "[a]ffiliation with the private equity sponsor leads to significantly higher odds for . . . bank[s] to win future investment banking mandates from the target firm, serving either as future lenders, equity underwriters, or M&A advis[e]rs" and that "[t]hese future revenues offer a rational [sic] for banks to engage in private equity investments").

150 *See* Letter from E. William Parsley III, Treasurer and Chief Inv. Officer, PNC Fin. Servs. Grp., to the Fin. Stability Oversight Council 7 (Nov. 5, 2010) (on file with the *New York University Law Review*) ("As a general matter, we note that we do not believe that investing in private funds necessarily represents undue risk to banks, particularly at relatively modest levels of investment.").

151 Scott, Written Testimony, *supra* note 28, at 55.

To be sure, these economic costs likely will not be substantial, as PE still remains a "relatively small player in the corporate world."[152] While PE fund investments do carry the potential for high returns and economic benefits, some banks that experienced losses from their stakes in PE fund investments during the Crisis have voluntarily begun exiting these investments even though the Volcker Rule is still pending.[153] Still, though some banks may have moved away from private equity, banks have long been significant contributors to the private equity industry,[154] and the Volcker Rule's restrictions prevent a return to PE investments when market conditions become more favorable.

In addition to stifling growth, because the Volcker Rule's prohibitions would not extend to emerging market banks or most European banks outside of the United Kingdom, U.S. banks could become less competitive in the global marketplace.[155] Competition in the financial sector is important because it impacts the "efficiency of the production of financial services, the quality of financial products, and the degree of innovation in the sector."[156] These issues can potentially "matter for the access of firms and households to financial services and external financing, in turn affecting overall economic growth . . . ."[157] According to Alan Greenspan, former Chairman of the Federal Reserve, many of the Dodd-Frank Act's rules on proprietary trading, including the Volcker Rule, apply to U.S. banks globally, but competing U.S. offices of foreign institutions can readily switch their proprietary transactions to European, Asian, and even Canadian banks. To Greenspan, the Dodd-Frank Act may create "the largest

152 Farrell, *supra* note 74. In 2006, "private equity accounted for just 11% of overall corporate borrowing in the U.S. and Europe." *Id.* Furthermore, "[p]rivate equity-owned companies are worth just 5% of the value of companies listed on U.S. stock markets and 3% of those in Europe." *Id.*

153 *See* Sharlene Goff, *Lloyds Sells BoS Private Equity Unit Stake*, FT.COM (July 5, 2010, 6:16 PM), http://www.ft.com/intl/cms/s/0/eacd1732-87fe-11df-a4e7-00144feabdc0.html ("The government-backed bank decided to offload the private equity business after it incurred heavy losses; many of the stakes were purchased at the top of the market shortly before values plummeted."); *see also* Davies, *supra* note 82 (noting that bank exits from private equity are expected to accelerate in the next two to three years).

154 *See supra* text accompanying notes 36–37 (discussing banks' contribution to the PE industry); *see also supra* note 74 (explaining that PE is still a growing industry).

155 *See* Scott, Written Testimony, *supra* note 28, at 57 ("Banks that sponsor or invest in private equity funds . . . are better positioned to serve their global clients, who increasingly look to banks for 'one-stop shopping' in financial products and services.").

156 Stijn Claessens & Luc Laeven, *What Drives Bank Competition? Some International Evidence*, 36 J. MONEY CREDIT & BANKING 563, 563 (2004).

157 *Id.* at 563–64.

regulatory-induced market distortion since America's ill-fated imposition of wage and price controls in 1971."[158]

While the potential economic costs imposed by the IAA Amendments are not as sweeping as those engendered by the Volcker Rule, PE firms are now subject to newfound regulatory compliance costs.[159] For example, according to Todd Dumas, Managing Director at Bank of New York Mellon Asset Management and former Senior Vice-President at Citi Alternative Investments, the IAA Amendments have necessitated that PE firms create Chief Compliance Officers.[160] The purpose of this position is to serve as a watchdog within the firm by ensuring the maintenance of records and monitoring compliance with the Act.[161] Although it is too early for PE firms to determine the exact costs of these administrative changes, such firms are viewing these outlays as "one-time costs."[162] This is because within the industry, PE professionals—who understand that PE funds did not directly contribute to the Crisis—perceive the targeting of PE funds as misguided and as evidence that the Dodd-Frank Act is merely "reactionary legislation that won't mean anything after the next election."[163]

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158 Alan Greenspan, *Dodd-Frank Fails To Meet Test of Our Times*, FT.COM (Mar. 29, 2011, 6:31 PM), http://www.ft.com/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html#axzz1bzu6Cxce. Notwithstanding the potential to impinge competitiveness, there are still many who see the Rule's restrictions as welcomed legislation. *See* W. Michael Blumenthal et al., *Letter to the Editor: Congress Should Implement the Volcker Rule for Banks*, WALL ST. J., Feb. 22, 2010, at A18 ("[T]he restriction of proprietary activity by banks is . . . a key element in protecting our financial system and will assure that banks will give priority to their essential lending and depository responsibilities."); John B. Taylor & Jennifer Schonberger, *How To Feed a Recovery*, HOOVER DIGEST, July 2, 2010, http://www.hoover.org/publications/hoover-digest/article/34956 (explaining Taylor's view that "[t]here is definitely a reason to restrict the amount of risk-taking [by banks]" and that "increasing the capital requirements generally for those institutions, to the extent that works, is worthwhile").

159 According to Dumas, the additional compliance costs are borne by the fund managers rather than passed on to those who invest in the funds. This is because the fees that PE funds charge are based on standard industry practices. Any attempts to pass on the compliance costs to investors through higher fees will be met with a decline in customer base. Therefore, one response has been for PE firms to require larger capital commitments on the funds that the firm already plans to raise. This means that investors must pledge more capital in order to participate in the larger funds, but it also helps ensure that the firm will generate additional revenue from fees as a result of an increase in assets under management. Interview with Todd N. Dumas, *supra* note 38.

160 *Id.*; *see also* Lowenstein, Written Testimony, *supra* note 13, at 190 (stating that firms will have to keep records "reflecting asset, liability, reserve, capital income and expense accounts; all written communications . . . personal securities transactions; client referrals; and various other documents" and that "firms will typically have to hire . . . perhaps a dozen or more persons to handle the compliance burden").

161 Interview with Todd N. Dumas, *supra* note 38.

162 *See id.* (explaining that firms anticipate these regulations "will gradually become loosened over time").

163 *Id.*

2. *The Social Costs*

It is generally understood—from a normative perspective—that if people believe they should comply with a law "because of their attitudes about how they should behave, they will voluntarily assume the obligation to follow legal rules."[164] Therefore, legal authorities, knowing that a key to their effectiveness is their ability to make laws that will be followed by the public, should regulate in ways that promote public compliance with the law. Voluntary compliance is much less costly to society because in its absence, officers, judges, and even lawmakers must expend additional resources in order to shape public behavior.[165] In the financial markets context, such resources translate into additional time and energy that must be spent on enforcement by an already-overburdened SEC.[166] That PE professionals perceive the targeting of PE funds through the IAA Amendments as a meaningless, "reactionary response" illustrates that there are social costs resulting from Congress's choice.[167]

The Volcker Rule also engenders social costs. Immediately following the Crisis, the Volcker Rule's restriction on PE investment could have been celebrated as a welcomed restraint on our nation's financial institutions. Amidst the turmoil, uncertainty, and public outcry that attended the Crisis, jilted investors likely viewed favorably *any* legislation that sought to reign in the activities of financial institutions. Similarly, professionals in the financial services industry were aware of the excessively risky behaviors in which their peers were engaged and knew that regulation was needed.[168] Fast forward three years and those same investors, now facing the slow pace of economic

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164 TOM R. TYLER, WHY PEOPLE OBEY THE LAW 3 (2006).

165 *See id.* at 4 (noting that sizeable resources will be expended if compliance is not voluntary and must be compelled by authorities).

166 *See* Melanie Waddell, *SEC Is Woefully Understaffed To Fulfill Dodd-Frank, Review Reportedly Finds*, ADVISORONE (Mar. 7, 2011), http://www.advisorone.com/2011/03/07/sec-is-woefully-understaffed-to-fulfill-doddfrank (noting that a recent report found that the SEC required 400 more employees than it had on staff in order to fulfill its heightened workload created by Dodd-Frank).

167 As mentioned above, professionals within the PE industry believe that the post-Crisis compliance regime will be made meaningless after a change in the administration, and they adhere to the amendments' requirements only in a mere "check-box" fashion; in this way, the IAA Amendments' effectiveness is undermined because their applicability to PE funds delegitimizes them in the eyes of those whose behavior they are meant to address. *See* Interview with Todd N. Dumas, *supra* note 38 (explaining that because the legislation is viewed as reactionary, "people will just find a way to get around it").

168 According to Philip Gibbs, manager of Jupiter's Absolute Return, Financial Opportunities and Global Financials funds, "[t]here is little doubt that reform is required after the credit crisis of 2007-08." Gibbs, *supra* note 149.

recovery,[169] high unemployment rates,[170] and the downgrade of the United States' credit rating,[171] likely prefer narrow regulations that address corrupt and unnecessarily risky conduct but do not hamper economic recovery.[172] Professionals, who once understood the need for intervention, now see the Volcker Rule's restriction as applied to PE funds as proof that the Dodd-Frank Act is reactionary.[173] Because the Volker Rule actually hinders activity that would lead to economic growth, it exceeds contemporary notions of what is socially desirable.[174] For both investors and professionals, the broad scope of the Volcker Rule undermines its legitimacy because it stifles recovery from the same Crisis that led to its enactment.

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169 *See* Neil Irwin, *E.U. Crisis Touches Wallets in U.S.*, WASH. POST, Oct. 1, 2011, at A13 (noting that as of "the spring of 2010 . . . the U.S. economy was finally starting to emerge from recession").

170 *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, THE EMPLOYMENT SITUATION—SEPTEMBER 2011, at 1 tbl.1, (Oct. 7, 2011), *available at* http://www.bls.gov/news.release/archives/empsit_10072011.pdf (illustrating that the U.S. unemployment rate has hovered between approximately nine and ten percent between September 2009 and September 2011); BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, THE EMPLOYMENT SITUATION—JULY 2012, at 1 chart 1, (Aug. 3, 2012), *available at* http://www.bls.gov/news.release/pdf/empsit.pdf (illustrating that the U.S. unemployment rate was just over eight percent as of July 2012).

171 *See* Walter Brandimart & Daniel Bases, *United States Loses Prized AAA Credit Rating from S&P*, REUTERS, Aug. 6, 2011, http://www.reuters.com/article/2011/08/06/us-usa-debt-downgrade-idUSTRE7746VF20110806 ("The United States lost its top-tier AAA credit rating from Standard & Poor's on Friday in an unprecedented blow to the world's largest economy in the wake of a political battle that took the country to the brink of default.").

172 *Stock Markets Plummet Again Amid Investor Uncertainty*, ONEFINANCIALMARKETS.COM (Aug. 10, 2011), http://www.onefinancialmarkets.com/market-news/2011/08/10/stock-markets-plummet-again-amid-investor-uncertainty/ ("[I]nvestors are worried about a global slowdown in growth and 'how Europe and the US are going to work their way out of a high debt burden.'"). It is important to note that:

> The main factor holding back the recovery of investment and consumption is the large uncertainty about the environment in which firms would invest and households would spend. . . . Significant changes and prospective changes to business and especially financial regulations will take several years to clarify. Until they do, it will not be possible to estimate their cost on businesses (and thus consumers) with any accuracy.

Warren Coats, *Uncertainty Causes Faltering U.S. Economic Recovery*, HUMAN EVENTS (Sept. 2, 2011, 3:01 AM), http://www.humanevents.com/article.php?id=45938.

173 *See* Interview with Todd N. Dumas, *supra* note 38.

174 *See* Scott, Written Testimony, *supra* note 28, at 4 ("The objective embodied in the Volcker Rules is to restrict banks . . . from participating in nontraditional risky investment activity, thus minimizing the chance they might fail . . . . This might have been the concern in the past but it misses the mark today.").

Conclusion

For at least a century, financial markets regulation has been characterized by periods of comprehensive regulatory reform in the wake of economic crises. Perhaps because of the sophistication of the regulated institutions or the difficulties that arise in passing legislation during tumultuous times, legislation in this area has often gone beyond the bounds necessary to address the ills that led to its enactment. Indeed, if financial legislation is to be effective, it will undoubtedly prevent the regulated from achieving their preferred goals, often by lowering their profitability and their return on investment. However, if these constraints are too onerous, or are not finely calibrated to the circumstances that led to the enactment of the legislation, the regulated will seek to circumvent the law. This circumvention, in turn, may cause the regulated to shift operations into non-regulated sectors in innovative ways that are beyond the purview of U.S. regulators.

This Note explores this trend during a time in which the U.S. economy is still struggling to recover from a crisis so severe that it has often been referred to as "The Great Recession." Indeed, Congress could have considered that its approach might have social and economic implications, but still decided that the potential ramifications of not regulating PE funds in this way weighed more heavily. However, in light of the aforementioned costs, the minimal impact that PE investment has on systemic risk, and the extent to which PE funds' contributions to the Crisis were addressed through alternative regulations, this Note contends that a more limited response was warranted.

At present, it is impossible to know for certain whether Congress made the right choice. Because the Volcker Rule's conformance period may stretch for up to a decade as regulators develop final rules and grant extensions, and because monetizing the costs of compliance with the IAA Amendments is untenable at this point, the ultimate effects of these regulations are difficult to predict. Unfortunately, what can be predicted is that at the very least, the costs generated by the uncertainty of these regulations will have to be borne by the economy at large. As recovery from the Crisis is increasingly forestalled, perhaps future legislators will draft provisions that are more finely calibrated to meet contemporary perils.