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How Did We Get Here? Dissecting the Hedge Fund Conundrum Through an Institutional Theory Lens

*By Cary Martin Shelby**

This article dissects both the origins and resulting harms of what the author terms the "hedge fund conundrum," in which institutional investors, such as pension plans and endowments, have consistently increased hedge fund allocations over the past decade despite pervasive evidence of excessive fees and subpar returns. It then utilizes an historical institutionalist lens to examine how lawmakers may have enabled a conundrum of this magnitude. By and large, this phenomenon is a symptom of regulatory loopholes that have permitted the private hedge fund market to increase in "publicness" through its expanding access and subsequent harm to retail investors. Such investors are now indirectly exposed to hedge funds through pension plans and endowments, without receiving the investor protection guarantees under the federal securities laws. Subsets of historical institutionalism, such as "conversion" and "drift," provide useful rubrics in analyzing how the law has evolved in this regard. In terms of conversion, lawmakers initially converted concepts of publicness through administrative regulations and court rulings that expanded indirect retail investor access to private investments. With respect to drift, lawmakers then failed to update these amended definitions to accommodate evolving notions of publicness brought about by financial innovation and changing market conditions.

An examination of this nature is novel in this area of the law and it provides a useful guidepost for exploring well-tailored solutions that concede the unlikelihood of subjecting hedge funds to direct regulation. Such a solution would therefore rely on conversion to effectively create a regulated market for "hedge-fund-like" strategies. This would entail loosening (but not eliminating) the section 18 capital restrictions that currently apply to mutual funds. Loosening these restrictions would allow pension plans and other institutional investors to access essential opportunities for wealth maximization, particularly during declining

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markets, in a transparent market that is subject to extensive regulation. If, however, pension plans and other institutional investors continue to allocate to hedge funds in an inefficient manner, Congress should then consider more drastic measures, such as completely excluding such investors from accessing private investment funds by amending elite investor definitions provided under federal securities laws.

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Introduction

Warren Buffett famously won a bet where he predicted that a basket of hedge funds would underperform a passive S&P 500 index from 2007 to 2017.[1] The S&P 500 passive index earned an annual 7.1 percent gain, whereas the basket of hedge funds earned 2.2 percent.[2] While his bet was limited to a relatively small basket of hedge funds, several reports and studies similarly found that the hedge fund industry as a whole has failed to produce above-market returns for extended periods of time, particularly since the end of our most recent financial

1. Akin Oyedele, *Warren Buffett Has Won His $1 Million Bet Against the Hedge Fund Industry*, Bus. Insider (Jan. 2, 2018, 12:33 PM), https://www.businessinsider.com/warren-buffett-wins-million-dollar-bet-against-hedge-funds-2018-1.
2. *Id.*

crisis of 2007–2009.[3] One such study used a dollar-weighted return to evaluate the performance of nearly 11,000 hedge funds between 1980 to 2008.[4] Pursuant to this methodology, hedge fund returns were significantly "lower than the returns of broad-based [indices] like the S&P500 and only marginally higher than risk-free rates of return."[5] This study, among others, countered the commonly held notion that hedge funds provide superior returns due to their management by highly talented experts who possess exclusive access to innovative and exotic financial products.[6]

As background, hedge funds are private investment funds that are restricted to elite investors, such as wealthy individuals and institutional investors.[7] The disappointing returns of hedge funds would be of little concern if only elite investors were losing capital, with limited exposure to the investing public, which is generally comprised of retail investors. Such retail investors are not required to maintain a particular income level or hold a certain amount of net assets. After all, the federal securities laws are rooted in investor protection principles as they entitle retail investors to a panoply of protections, such as material disclosures, antifraud protections, and even restricted access to "risky" instruments.[8] These principles similarly presume that elite hedge fund investors should have the resources to protect themselves, and that regulators should not expend limited resources in protecting such wealthy individuals and prestigious institutions.

Nevertheless, various loopholes under federal securities laws categorize pension plans, endowments, and other institutional investors that manage pools of capital on behalf of retail investor beneficiaries (hereinafter, "Fiduciary Investors") as elite investors that are sufficiently capable of protecting themselves.[9] These Fiduciary Investors are therefore free to invest in hedge funds despite the indirect access passed along to underlying retail investors. Such access would likewise be of limited concern if Fiduciary Investors were consistently allocating to hedge funds that earned above-market returns without having to pay excessive and/or hidden fees. Yet, as further discussed in Part II of this article, Fiduciary Investors have consistently increased hedge fund allocations despite overwhelming evidence of subpar returns and excessive fees.[10] The author refers to this phenomenon as the hedge fund conundrum as it is not easily explained

3. *See infra* Part II.A (summarizing multiple studies that challenge the abilities of hedge funds to earn above-market returns under various market conditions).

4. Ilia D. Dichev & Gwen Yu, *Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn*, 100 J. Fin. Econ. 248, 252 (2011) (analyzing overall results as well as results during specific time periods within that timeframe).

5. *Id.* at 261.

6. *See infra* Part II.A.

7. These elite investors are legally defined as "accredited investors" and "qualified purchasers." *See infra* notes 254–66 and accompanying text (citing and defining those terms).

8. *The Laws That Govern the Securities Industry*, U.S. Sec. & Exchange Commission, https://www.sec.gov/answers/about-lawsshtml.html (last modified Oct. 1, 2013) (discussing the investor protection goals of the federal securities laws).

9. *See infra* Part I.B.

10. *See infra* Part II.D (providing evidence on increased hedge fund allocations despite excessive fees).

by basic notions of economic theory which would presume that investors allocate capital in a rational wealth-maximizing manner.

Furthermore, the reasons for such continued allocations seem to be enabled by the opacity of the hedge fund industry as pension plan trustees can mask conflicts of interest or larger problems of underfunded plans by allocating to an industry that merely "promises" to earn superior returns at some point in the future.[11] Trustee decisions to allocate to hedge funds are more politically feasible as such allocations are not easily scrutinized by policymakers or beneficiaries. Detailed information regarding hedge fund strategies and fees is largely deemed confidential and proprietary. In the midst of the political implications of these decisions, one commentator estimated that pension plans collectively lost $600 billion over an eight-year period by failing to invest in passive investments.[12] An additional study found that pension plans paid approximately $4 billion in unreported fees in 2014.[13] These misallocations can also perpetuate wealth inequality by creating opportunities for advisers to earn excessive fees that do not necessarily match their skillsets in producing superior returns.[14] Hedge fund advisers are likewise amongst the highest income earners in the country. An additional source noted that the "top 25 hedge fund managers earned more than all the CEOs of the S&P 500 *combined*."[15]

This article thus utilizes an historical institutionalist lens to examine how lawmakers may have enabled a conundrum of this nature. Overall, excessive hedge fund fees are a symptom of regulatory loopholes where the private hedge fund market has increased in "publicness" through its increasing access and subsequent harm to retail investors. This "retailization" of the industry warrants a deeper theoretical analysis as to how the definition of publicness has evolved under federal securities laws, and whether it should be recalibrated given the financial innovations and changing market conditions that have led to the harms discussed herein. Historical institutionalists provide novel approaches for examining institutional changes of this nature as they encourage scholars to "trace the processes behind the creation and persistence of institutions and policies."[16] Tracing such historical processes and patterns is helpful in understanding how current expectations have been molded by the past. Understanding the

11. *See id.* (explaining how reasons for continued hedge fund allocations are enabled by opacity of the industry).

12. Leland Faust, *Hedge Funds Are No Place for Public Pension Investments*, HUFFINGTON POST (June 26, 2017, 12:39 PM), https://www.huffingtonpost.com/entry/hedge-funds-are-no-place-for-public-pension-investments_us_59513200e4b0326c0a8d0a21.

13. PEW CHARITABLE TRUSTS, STATE PUBLIC PENSION FUNDS INCREASE USE OF COMPLEX INVESTMENTS 2, 18 (2017), https://www.pewtrusts.org/-/media/assets/2017/04/psrs_state_public_pension_funds_increase_use_of_complex_investments.pdf.

14. *See infra* Part II.C (summarizing the harms resulting from the hedge fund conundrum, such as billions of dollars in excessive and/or hidden fees and potentially contributing to the wealth gap).

15. BRINK LINDSEY & STEVEN M. TELES, THE CAPTURED ECONOMY: HOW THE POWERFUL ENRICH THEMSELVES, SLOW DOWN GROWTH, AND INCREASE INEQUALITY 35 (2017).

16. Edwin Amenta & Kelly M. Ramsey, *Institutional Theory*, *in* HANDBOOK OF POLITICS: STATE AND SOCIETY IN GLOBAL PERSPECTIVE 15, 16 (Kevin T. Leicht & J. Craig Jenkins eds., 2010).

historical context in which decisions are made can further guide actors in developing effective strategies for implementing desired institutional changes.

Professor Kathleen Thelen, a prominent historical institutionalist and Ford Professor of Political Science at MIT, further developed a subset of this theory which is commonly referred to as "conversion."[17] Conversion generally occurs when political actors redirect institutions to meet new goals, which diverge from the institution's original purposes.[18] Conversion is apt to occur when underlying rules or policies are ambiguous in nature.[19] In exploring how conversion contributed to the hedge fund conundrum identified in this article, lawmakers initially converted legislative concepts of "publicness" through administrative regulations that specifically carved out several categories of Fiduciary Investors as being sufficiently capable of protecting themselves in spite of potential retail investor exposure.[20] Professor Jacob S. Hacker, a political science expert at Yale University, identified an additional process through which the impact of a particular institutional framework weakens over time due to economic shifts or other societal changes.[21] In broad strokes, "drift" refers to "systematic, prolonged failures of government to respond to the shifting realities of a dynamic economy."[22] In exploring how drift further contributed to the hedge fund conundrum, lawmakers then failed to update such amended definitions to accommodate evolving notions of publicness brought about by increasing harms by indirect hedge fund exposure to retail investors.

Both conversion and drift provide useful approaches for examining how "hidden" changes in political outcomes occur even when their underlying institutions remain intact and relatively stable.[23] For instance, investor protection principles remain deeply embedded within federal securities laws despite eroding retail investor protections through indirect access to private fund investments.[24] These changes also occur during periods of stability, as opposed to being enacted in response to an exogenous shock or event that often triggers large-scale legislative

17. Kathleen Thelen, *How Institutions Evolve: Insights from Comparative Historical Analysis*, *in* COMPARATIVE HISTORICAL ANALYSIS IN THE SOCIAL SCIENCES 208, 225–26 (James Mahoney & Dietrich Rueschemeyer eds., 2003).

18. *Id.*; *see also* KATHLEEN THELEN, HOW INSTITUTIONS EVOLVE: THE POLITICAL ECONOMY OF SKILLS IN GERMANY, BRITAIN, THE UNITED STATES, AND JAPAN 36 (2004) (further describing institutional conversion as "the adoption of new goals or the incorporation of new groups into the coalitions on which institutions are founded").

19. Jacob S. Hacker, Paul Pierson & Kathleen Thelen, *Drift and Conversion: Hidden Faces of Institutional Change*, *in* ADVANCES IN COMPARATIVE-HISTORICAL ANALYSIS 180, 181 (James Mahoney & Kathleen Thelen eds., 2015).

20. *See infra* Part III.B (analyzing the extent to which political actors converted original notions of publicness through the passage of Regulation D in 1982).

21. Jacob S. Hacker, *Privatizing Risk Without Privatizing the Welfare State: The Hidden Politics of Social Policy Retrenchment in the United States*, 98 AM. POL. SCI. REV. 243, 246 (2004).

22. JACOB S. HACKER & PAUL PIERSON, WINNER-TAKE-ALL POLITICS: HOW WASHINGTON MADE THE RICH RICHER—AND TURNED ITS BACK ON THE MIDDLE CLASS 43 (2010).

23. Hacker, Pierson & Thelen, *supra* note 19, at 180–82.

24. *About the SEC*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/about.shtml (last modified Nov. 22, 2016) (providing that the SEC's mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation"); *see also infra* Part III.

amendments.[25] Many of the institutional shifts discussed in this article have occurred during times of economic stability where repeat player private interest groups have strategically leveraged opportunities to introduce preferred changes with little interference from the general populace.[26]

Applying this historical institutional framework is a novel approach for analyzing the evolution of publicness in the federal securities law space.[27] Scholars have relied on historical institutionalism to dissect hidden changes that have occurred in policies related to welfare benefits, social security, construction regulations, antitrust, and other significant policy shifts.[28] Historical institutionalism is a particularly helpful framework in this area of the law given the vast number of changes that have occurred through legislative and regulatory enactments that

25. *See* Hacker, Pierson & Thelen, *supra* note 19, at 180–82.

26. *See infra* Part III (analyzing the extent to which political actors enabled conversion and drift from original notions of publicness despite enduring notions of investor protection within the federal securities law space).

27. An emerging body of scholarship has explored the inconsistent definitions of "publicness" under federal securities laws, but limited attention has been dedicated to evaluating the evolution of publicness through an institutional theory lens. *See, e.g.*, Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 445 (2017) (providing commentary of how "the new public-private divide [is] centered on its information effects . . . [though] private companies are thriving in part by freeriding on the information contained in public company stock prices and disclosure"); Onnig H. Dombalagian, *Principles for Publicness*, 67 FLA. L. REV. 649, 653 (2015) (proposing to regulate evolving notions of publicness by "reframing the regulation of public companies under U.S. federal securities law around three well-worn regulatory principles: (1) suitability, (2) efficiency, and (3) representativeness"); Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339, 342–46 (2013) (highlighting inconsistent definitions of "publicness" under federal securities laws, acknowledging that the "public-private divide has long been an entirely undertheorized aspect of securities regulation," and further proposing new standards for evaluating publicness under the Securities Exchange Act of 1934); A.C. Pritchard, *Revisiting* "Truth in Securities" Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1001–02 (2013) (discussing Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966), and arguing that the inconsistent treatment of "publicness" under the Securities and Exchange Acts creates scenarios where the "transition from private to public will inevitably be awkward, abrupt, and fraught with problems for issuers, investors, and regulators"); Hillary A. Sale, *The New "Public" Corporation*, LAW & CONTEMP. PROBS., Winter 2011, at 137, 137–38 (proposing that many recent scandals result from the failures of public corporation fiduciaries in understanding their increasing notions of "publicness"); Cary Martin Shelby, *Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency*, 69 SMU L. REV. 405, 445 (2016) (arguing that the incoherent definition of publicness results from layering evolving notions onto ancillary regulation as opposed to amending primary legislation intended to holistically regulate the investment fund industry); Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1574–78 (2013) (focusing on the Securities Act of 1933 in addressing related issues).

28. *See, e.g.*, HACKER & PIERSON, *supra* note 22, at 42–47 (exploring how drift facilitated policies that have deepened the wealth gap in the United States); Daniel Béland, *Ideas and Institutional Change in Social Security: Conversion, Layering, and Policy Drift*, 88 SOC. SCI. Q. 20 (2007) (utilizing an historical institutionalist lens to examine how social security policy transformed from a family protection income maintenance program to a model that more closely resembles a privatized system); Hacker, *supra* note 21, at 246 (developing drift as a subset of historical institutionalism to explain the evolution of the welfare state); Jeroen van der Heijden, *Through Thelen's Lens: Layering, Conversion, Drift, Displacement and Exhaustion in the Development of Dutch Construction Regulation* 4 (Austl. Nat'l Univ., Reg. Insts. Network, Paper No. 46, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2497838 (applying an historical institutionalist lens to explore incremental institutional changes to construction regulation in the Netherlands).

have effectively altered the definition of "publicness" in the past decades. These changes have occurred despite enduring notions of investor protection that are still embedded in federal securities laws and enforced by administrative agencies. While tenets of rational choice theory can be helpful for evaluating a particular piece of legislation or regulation in this regard (and such analyses have indeed been helpful in identifying various limitations of regulatory agencies, such as the SEC and CFTC),[29] they have failed to provide a large-scale historical overview of how various processes may have impacted the evolving definition of "publicness" over time. Public choice theory fails to account for the complex array of justifications that human actors consider in adopting or reframing a particular institution in this area. Whereas self-interested economic factors may in fact be a motivating justification, other factors may play a role, such as reducing regulatory complexity or providing clarity and predictability in interpreting an ambiguous congressional mandate. An historical institutional lens can likewise be helpful in developing a well-tailored solution that is responsive to the historical context in which changes occur. Effective solutions could strategically utilize conversion as a means to restore certain protections to underlying retail investor beneficiaries.

Part I begins with a broad overview of investment fund regulation to provide a foundational backdrop for understanding the public/private dichotomy in this niche area of the law. It then deconstructs core aspects of the hedge fund industry while highlighting emerging controversies related to systemic risk and retailization. Part II identifies and summarizes the multiple studies that have revealed the difficulties that hedge funds face in producing above-market returns over extended periods of time. This section further reveals the hidden fees that hedge funds often charge its investors, which total billions of dollars in lost capital. Fiduciary Investors have collectively increased hedge fund allocations in spite of these growing concerns. Part III delves into the historical institutionalist analysis summarized in the preceding paragraphs to explore how lawmakers contributed to a phenomenon of this nature. Part IV provides preliminary thoughts on a well-tailored solution that relies on conversion to essentially create a regulated market for "hedge-fund-like strategies." This would entail loosening the section 18 capital restrictions that currently apply to registered investment funds so that Fiduciary Investors can access essential opportunities for wealth maximization and diversification, particularly during declining markets. Such a solution would likewise create better mechanisms for more effectively weeding out low-performing

29. *See, e.g.*, Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. Rev. 745, 750–51 (2013) (applying a modified version of public choice theory to provide a possible rationale for the SEC's continued passage of regulation that expands private securities markets, while further highlighting that "regulators will in fact be willing to permit, or even facilitate, the expansion of the unregulated portion of their industry if, by doing so, they are able to avoid the risk of public scrutiny that accompanies their next best alternative regulatory strategy"); Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 Del. J. Corp. L. 151, 187 (2010) (arguing that "[s]ome combination of conservative political will fueled by Wall Street contributions and backroom lobbying, coupled with a possible misunderstanding of private placements, contributed to the . . . preemptive force [of the National Securities Markets Improvement Act of 1996]").

funds with excessive fees. If, however, Fiduciary Investors continue to allocate to hedge funds in an inefficient manner, even with the increased access to protectionist strategies briefly discussed above, then Congress should consider directly excluding Fiduciary Investors from accessing private investment funds altogether. By excluding Fiduciary Investors from certain exemptions of the federal securities laws, Congress would reinstitute standard investor protections provided by law.

I. Growing Prevalence of Hedge Funds

Part I.A discusses the primary characteristics of the investment fund industry, as well as the general registration requirements that apply to mutual funds and other registered investment company structures. Background material of this nature provides the foundational rubric for understanding how regulation serves to distinguish public and private investment funds. It also reveals the complexities that lawmakers face in updating notions of publicness in this industry. Part I.B deconstructs core characteristics of the hedge fund industry, which is one of the most popular choices within the realm of private investment funds. It similarly emphasizes its regulatory structure and proffered benefits. Part I.C explains how the exponential growth of the industry has led to various controversies related to the increasing "publicness" of hedge funds in that retail investors are increasingly exposed to these entities as underlying beneficiaries of Fiduciary Investors. While other notions of publicness have emerged, such as systemic risk, this article focuses on the retailization of the industry, which has been largely neglected by scholars and lawmakers as a loophole worth correcting.

A. Overview of Investment Fund Regulation

Investment funds can provide an ideal mechanism for average investors to produce meaningful, yet stable returns over extended periods of time. Countless households therefore rely on this industry to fund various long-term financial objectives. Such goals can include saving for retirement, paying for college expenses, or purchasing a home.[30] While the investment fund industry is comprised of other types of vehicles, such as exchange-traded funds and unit-investment trusts, mutual funds tend to be the most popular choice amongst investors.[31] According to the Investment Company Institute, "[a]n estimated 100 million individual Americans in 56.2 million households owned mutual funds in mid-2017."[32] With respect to retirement savings in particular, "[s]ixty-seven percent of 401(k) assets at year-end 2017 were invested in mutual

30. Inv. Co. Inst., 2018 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry 64 (58th ed. 2018), http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf.

31. *Id.*

32. *Id.* at 56.

funds."[33] The mutual fund industry, as a whole, manages a total of $18.7 trillion in total net assets.[34]

In terms of their structure, mutual funds are created and managed by investment adviser entities that effectively pool assets from large numbers of shareholders.[35] Mutual fund advisers then invest the resulting pool of assets into baskets of financial instruments, such as equities, bonds, and/or cash instruments.[36] A wide variety of mutual funds exist, some of which target a range of companies depending on their size and/or growth prospects. Mutual funds can also target fixed-income instruments, such as government securities or corporate bonds.[37] Most mutual funds are also sufficiently diversified in an array of issuers so that investors are not unduly exposed to a trivial number of investments.[38] Thus, instead of having to select amongst a myriad of companies for investment, mutual fund shareholders are provided with direct and immediate access to a diversified pool of assets. Investors similarly receive the benefit of relying on the expertise of the investment adviser in selecting such investments.[39] In exchange for continuously managing a particular fund, the investment adviser receives a management fee, which can span from 0.5 percent to 2 percent of the total value of its underlying pool of assets.[40]

The public/private dichotomy of the investment fund industry is primarily rooted in the status of shareholders that are permitted to invest in the pool.[41] More specifically, investment funds that are open for investment by retail investors (which generally encompasses the general public) must register under a complex rubric of federal legislation (also, "Registered Investment Companies" or "RICs").[42] Such retail investors are not required to maintain a particular income level or hold a certain amount of net assets. Because of their limited resources, these investors are entitled to the investor protection mechanisms guaranteed under the federal securities laws. In particular, once investment advisers open the door to retail investment, they must register their respective pool(s) under the Investment Company Act of 1940 ("1940 Act").[43] The 1940 Act is widely known as being the most restrictive and intricate of the federal securities laws, as it includes detailed disclosure mandates, convoluted restrictions on "riskier" investments, such as illiquid securities and derivatives, rigid prohibi-

33. *Id.* at 138.

34. *Id.* at 58 (reporting figure as of year-end 2017).

35. *See* 1 Thomas P. Lemke et al., Regulation of Investment Companies § 1.01 (Matthew Bender, rev. ed. 2018) (providing a description of investment company structures).

36. *Id.*

37. U.S. Sec. & Exch. Comm'n, Mutual Funds and ETFs: A Guide for Investors 13 (2016), http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [hereinafter Mutual Fund Guide].

38. *Id.* at 8.

39. *Id.*

40. Adam Hayes, *4. Mutual Funds: The Costs*, Investopedia, https://www.investopedia.com/university/mutualfunds/mutualfunds2.asp (last visited Mar. 15, 2019).

41. *See* Martin Shelby, *supra* note 27, at 423–29 (summarizing predominant indicators of publicness that primarily rely on status of investors).

42. *See id.* at 434–40.

43. 15 U.S.C. §§ 80a-1(b)(1), 80a-24 (2018).

tions on conflict of interest transactions, and other directives that extend beyond the "truth in securities"[44] framework provided under the inaugural Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act").[45]

Even still, because mutual fund investors receive "securities" via their ownership interest in the underlying vehicle, such funds must also register under the Securities Act, unless there is an available exclusion or exemption.[46] Registration under this law includes the completion of a detailed prospectus that is publicly available on the SEC's website, as well as exposure to private causes of action for any material misstatements and omissions that may appear on this lengthy document.[47] SEC rules attempt to eliminate redundant disclosure obligations that fall under both the Securities Act and 1940 Act.[48]

The Exchange Act encompasses additional regulations for "investment company principal underwriters and others that sell investment company shares, and requires them to register with the SEC."[49] RICs similarly fall within the definition of "public company" under the Exchange Act, triggering its periodic disclosure requirements, which extend beyond the initial filing of a prospectus.[50] The definition of public company under the Exchange Act includes: (1) issuers that have securities listed on an exchange;[51] (2) issuers with "total assets" exceeding $10 million and classes of equity securities held by at least 2,000 persons (or 500 persons who are not accredited investors);[52] and (3) any issuer that files a registration statement under the Securities Act.[53] Investment company structures could potentially fall under any of these categories of public company due to their size, number of holders, and/or registration status under the Securities Act. As a result, RICs must file the periodic reports mandated under the Exchange Act unless an available exclusion or exemption applies to the underlying entity.[54]

Interestingly enough, advisers of RICs must separately register under the Investment Advisers Act of 1940 (the "Advisers Act"). For the sake of clarity, in addition to the adviser registering itself, such advisers must still register their underlying pools under the 1940 Act, and the Securities and Exchange Acts, unless there are available exemptions. Moreover, such pools are overseen by a separate board of directors so as to mitigate any conflicts of interest that may arise

44. *See* U.S. Sec. & Exchange Commissionn, *supra* note 8.
45. *See* Martin Shelby, *supra* note 27, at 414–17 (explaining specific restrictions and mandates of the 1940 Act).
46. 15 U.S.C. §§ 77c, 77e (2018); *see id.* § 80a-24 (1940 Act).
47. *See id.* §§ 77j, 77*l*.
48. *See id.* § 78*l*(g)(2)(B).
49. Inv. Co. Inst., *supra* note 30, at 279.
50. *See* 15 U.S.C. § 78m (2018).
51. *Id.* § 78*l*(a).
52. *Id.* § 78*l*(g)(1).
53. *Id.* § 78o(d).
54. *See id.* § 78*l*(g)(2).

between advisers and their respective pools.[55] The Advisers Act is distinctive in that it creates a mandatory fiduciary obligation for registered investment advisers ("RIAs") to act in the best interests of their clients when dispensing investment advice.[56] RIA clients are further protected by the disclosure requirements provided under the Advisers Act. RIAs must disclose material information relating to their business practices, fees, disciplinary history, certain conflicts of interest, and other material information related to their advisory business.[57] RIAs must also create and maintain compliance programs to prevent violations of the Advisers Act, and the SEC has the power to randomly inspect RIAs to ensure compliance with these various provisions.[58]

By and large, the investment fund industry is one of the most regulated industries in the nation. While the Securities and Exchange Acts create standard disclosure obligations for investment fund entities, the 1940 Act includes additional restrictions on the abilities of such funds to trade risky instruments and to engage in conflict of interest transactions. Regulatory bodies, such as the SEC, CFTC, and FINRA, implement additional rules that further apply to industry participants.[59] Researchers have posited multiple reasons for this regulatory complexity, including political maneuverings and limited expertise by regulators.[60] Although these reasons are largely outside the scope of this article, this complexity partly explains the hurdles that lawmakers face in updating existing notions of publicness within this framework, which is further discussed in subsequent sections of this article.

B. Hedge Funds Deconstructed

Investment funds can avoid the arduous registration requirements discussed above by complying with one of the many exclusions or exemptions incorporated into these laws.[61] Broadly speaking, restricting investments to elite investors, such as high net worth individuals or institutional investors, permits advisers to operate private investment funds, such as hedge funds, private equity funds, or venture capital funds ("Private Funds").[62] Such investors are generally

55. Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Protecting Investors: A Half Century of Investment Company Regulation 251–52 (1992), https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf [hereinafter Protecting Investors Study].

56. *See* 15 U.S.C. § 80b-6 (2018).

57. *See id.* § 80b-4(b).

58. *See id.*

59. Cary Martin Shelby, *Closing the Hedge Fund Loophole: The SEC as the Primary Regulator of Systemic Risk*, 58 B.C. L. Rev. 639, 666–67 (2017) (highlighting the fragmented nature of federal securities laws).

60. *See, e.g.*, Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. Cin. L. Rev. 537, 552–53 (2009) (exploring historical reasons for division of SEC and CFTC).

61. U.S. Sec. & Exch. Comm'n, Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission 23–32 (2003), https://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter Implications of the Growth of Hedge Funds] (summarizing multiple exemptions that hedge funds must adhere to in order to avoid registration requirements under federal securities laws).

62. *See infra* Parts IV.B–C.

not entitled to certain protections guaranteed under the federal securities laws.[63] Investors of this stature theoretically have the resources to sufficiently protect themselves from unscrupulous advisers and riskier investments.[64] This theoretical approach to the public/private divide was effectuated through a series of regulations and court rulings that developed over the course of several decades (the evolution of this regulatory divide will be further discussed through an institutional theory lens in Part III below).[65] With this division comes more limited disclosure obligations, permissive fee structures, greater access to "riskier" strategies, and looser governance requirements.[66] Because hedge funds are a popular choice amongst the several Private Fund options available to Fiduciary Investors, this article will primarily analyze the unique characteristics of the hedge fund industry.

With respect to transparency, hedge funds are not required to comply with the initial and periodic disclosure obligations that would accompany registration under the Securities Act, Exchange Act, or 1940 Act.[67] These transparency guarantees, which are among the primary goals of the federal securities laws, help to resolve the information asymmetries that may exist between investors and advisers. For instance, fund advisers may not be incentivized to voluntarily provide material information about their offered investments if the costs of doing so exceeds its benefits.[68] Mandated disclosures under the Securities and 1940 Acts therefore provide investors with a wealth of material information related to a fund's strategies, fees, and valuation procedures.[69] Even though hedge fund investors are not guaranteed to receive much of this information, they are free to negotiate for additional disclosures directly from advisers. Elite investors often perform extensive due diligence on an assortment of hedge funds before deciding on a particular allocation.[70] Many do in fact receive a private placement memorandum upon subscribing to a hedge fund, which provides comparable information that would appear in a registration statement.[71] Any such disclosures

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63. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 124–27 (1953) (holding that offerings that are restricted to investors who can fend for themselves are "private" in nature); 17 C.F.R. § 230.501(a) (2019) (defining "accredited investors" as individuals who surpass certain income thresholds or high net worth requirements, as well as a variety of institutions).

64. *Ralston Purina*, 346 U.S. at 124–27. Note, however, that antifraud protections generally apply. *See* 15 U.S.C. § 78j (2018).

65. *See infra* Parts III.B–C (analyzing how the definition of "publicness" evolved under federal securities laws).

66. *See id.*

67. Implications of the Growth of Hedge Funds, *supra* note 61, at 11–20, 46–52.

68. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 292 (1998).

69. *See* 1 Lemke et al., *supra* note 35, § 5.02 (summarizing the extensive initial disclosure requirements that apply to registered investment companies).

70. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. Ill. L. Rev. 975, 992 (noting that hedge fund investors, "particularly institutional investors, engage in active due diligence before investing, routinely retain advisory firms to evaluate options for them, and negotiate for more disclosure from hedge funds").

71. Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 Berkeley Bus. L.J. 240, 288 (2009) (contending that hedge fund investors have increasingly demanded enhanced transparency from prospective hedge fund investments).

are further subject to the general antifraud protections under the federal securities laws.[72] Nevertheless, the disclosures received by investors can vary across funds because they are not standardized.[73] This could make it difficult for even the most sophisticated of elite investors to optimize hedge fund selections.[74] Access to transparency likewise depends on the bargaining power of investors as hedge fund advisers are not obligated to provide any such information to investors.

Hedge funds are typically organized as pass-through tax entities, such as limited partnerships or limited liability companies, because they enjoy looser governance requirements under 1940 Act exemptions.[75] More specifically, they are not required to have a separate board of directors to oversee potential conflicts of interest between the investment adviser and its fund.[76] This provides hedge fund advisers with the freedom to select more favorable business association structures to operate their underlying funds.[77] Moreover, hedge funds are not subject to the standardized valuation requirements provided under the 1940 Act.[78] Even if fund disclosures provide detailed valuation procedures, advisers often grant themselves the ability to deviate from such procedures in their discretion.[79] These flexible valuation standards expand the categories of instruments that can be traded by hedge fund advisers on behalf of their funds.[80] They effectively enable advisers to trade illiquid instruments without facing the same liability risks as mutual fund boards.[81]

Even more importantly, hedge funds are unconstrained by the 1940 Act restrictions on trading "riskier" financial instruments and strategies. Consistent with the paternalistic nature of the federal securities laws, the 1940 Act severely restricts the extent to which RICs can trade in derivatives[82] or engage in leveraged transactions.[83] Because such transactions may expose retail investors to

72. Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 713–14 (2000) (synopsizing the antifraud protections that extend to private investment fund investors).

73. *See generally* Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87, 113–24 (2012) (highlighting how lack of standardization with respect to valuations and risk present unique investor protection concerns for hedge fund investors who subsequently face heightened challenges in optimizing hedge fund allocations given the thousands of available options).

74. *Id.* at 119.

75. THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE §§ 2:8, 2:9 (2018).

76. *Id.* § 2:8 ("A limited partnership has a general partner . . . which is responsible for overall management of the fund . . . , and numerous limited partners that are relatively passive investors."); *id.* § 2:9 ("Rather than having a general partner, an LLC typically has one or more managing members, which have limited liability.").

77. *Id.* §§ 2:8, 2:9.

78. *See* 17 C.F.R. § 270.2a-4 (2019); Ryan Sklar, Note, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3268 (2009).

79. *See* Sklar, *supra* note 78, at 3268–69.

80. *See* LEMKE ET AL., *supra* note 75, § 4:19.

81. *Id.*

82. *Id.*

83. *Id.*; THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12 (1999), https://www.treasury.gov/resource-center/fin-mkts/

excessive losses, mutual fund strategies are mostly limited to equities, bonds, and cash instruments.[84] Hedge funds on the other hand can trade a wide range of exotic derivatives, illiquid instruments, and non-U.S. investments in an effort to chase "alpha," which refers to above-average returns that exceed a predetermined benchmark, such as the S&P500 index.[85] These flexibilities also grant hedge funds the unfettered ability to utilize derivatives to protect underlying portfolios against declining markets.[86] For example, a hedge fund adviser could simultaneously take long and short positions on behalf of its funds, within the same class of instruments, without having to comply with the 1940 Act restrictions briefly discussed above.[87] A strategy of this nature enables such advisers to guarantee "absolute returns" irrespective of market performance.[88] Hedge funds have relied on these flexibilities to create an entire universe of strategies that are simply unavailable to their mutual fund counterparts. Common hedge fund strategies include market neutral, global macro, opportunistic, emerging markets, and distressed securities, to name a few.[89]

Hedge fund advisers also have greater latitude in charging additional layers of fees in comparison to registered funds. Under an exemption provided under the Advisers Act, hedge fund advisers are permitted to charge a performance fee, which is a percentage of the actual profits earned by a particular pool.[90] Performance fees, which can frequently constitute 20 to 50 percent of a fund's profits, are also commonly known as incentive fees or carried interest.[91] Such advisers receive this fee in addition to the management fee, which is a fixed percentage of the pool's net assets.[92] While performance fees can incentivize hedge fund advisers to produce absolute returns, they can similarly induce advisers to pursue excessively risky strategies.[93] An additional controversy, which is largely outside the scope of this article, relates to the favorable tax treatment that such fees re-

Documents/hedgfund.pdf. The amount of leverage employed by a particular hedge fund is only limited to the extent requested by its actual counterparties. *See id.* at 13. *Compare* 15 U.S.C. § 80a-18 (2018) (imposing capital structure requirements on issuances by registered closed-end companies).

84. Mutual Fund Guide, *supra* note 37, at 4.

85. *See* Lemke et al., *supra* note 75, § 4:19.

86. Joseph G. Nicholas, Investing in Hedge Funds: Strategies for the New Marketplace 15–16, 62–67 (1999).

87. *See id.* at 65.

88. Implications of the Growth of Hedge Funds, *supra* note 61, at 33–36.

89. Dion Friedland, *Synopsis of Hedge Fund Strategies*, Magnum Funds, http://www.magnum.com/hedgefunds/strategies.asp (last visited Mar. 18, 2019).

90. 15 U.S.C. § 80b-5(a)(1) (2018) (generally prohibiting registered investment advisers from charging performance based fees); 17 C.F.R. § 275.205-3(a), (d)(1) (2019) (providing that advisers who restrict investments to "qualified clients" are permitted to charge performance-based fees, and defining "qualified clients" to include a "natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser").

91. Lemke et al., *supra* note 75, §§ 1:1, 3:30, 13:21.

92. *Id.* § 1:1.

93. *See* U.S. Sec. & Exch. Comm'n, Investor Bulletin: Hedge Funds 3 (2013), https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf; *see also* Nicholas, *supra* note 86, at 165.

ceive under the U.S. Tax Code.[94] The research regarding the extent to which these fees are excessive is discussed at length in Part II of this article.

C. Exorbitant Growth and Emerging Controversies

The expansive investment liberties afforded to hedge funds caused the industry to grow exponentially over the past decades. Elite investors would often flock to this industry as these investment freedoms created a gateway for advisers to earn astronomical returns while accessing innovative strategies. One of the first hedge funds, which was created by Alfred Winslow Jones in the late 1940s, "gained 670% [over a 10-year period], compared with a 358% gain for the leading mutual fund of the [same] period."[95] Mr. Winslow utilized a "hedging" strategy where he short traded stocks that he predicted would decline in value, while engaging in offsetting long positions for stocks that he predicted would increase in value.[96] He would frequently rely on leverage to fund many of his short trades as a mechanism to magnify returns.[97] Mutual funds are restricted from using a comparable strategy as shorting a high level of stocks would run afoul of the 1940 Act restrictions on leverage.

In 1968, there were approximately 200 hedge funds in existence in the United States, most of which utilized a strategy similar to the one founded by Mr. Jones.[98] While the industry's growth was volatile due to several market fluctuations in subsequent decades, it experienced a significant expansion in the 1990s.[99] This likely resulted from a number of factors such as an overall increase in wealth, innovative developments with respect to financial instruments and strategies, and the creation of additional regulatory loopholes (which is further discussed in Part III below).[100] As of the end of 2017, over 8,335 hedge funds existed, and they utilize a heterogenous blend of strategies.[101] Around the same time period, the industry's total assets under management in the United States grew to $3.211 trillion.[102] This figure represents "the sixth consecutive quarterly peak of assets under management" according to data published by Hedge Fund Research.[103]

94. *See infra* notes 181–84 and accompanying text (summarizing favorable tax treatment that applies to performance fees, also referred to as "carried interest").

95. Rachael Levy, *The Amazing Story Behind the World's First Hedge Fund*, Bus. Insider (Aug. 22, 2016, 11:38 AM), https://www.businessinsider.com/alfred-winslow-jones-started-the-first-hedge-fund-2016-8.

96. *Id.*

97. *Id.*

98. *Hedge Fund Basics: History*, Managed Funds Ass'n, https://www.managedfunds.org/hedge-fund-investors/history/ (last visited Mar. 18, 2019).

99. *Id.*

100. *Id.*; *see infra* Part III (discussing political and economic climate that facilitated the passage of additional registration loopholes under the 1940 Act).

101. Christine Williamson, *Hedge Fund Assets End 2017 at Record $3.2 Trillion—HFR*, Pensions & Invs. (Jan. 19, 2018, 6:09 PM), http://www.pionline.com/article/20180119/ONLINE/180119827/hedge-fund-assets-end-2017-at-record-32-trillion-8211-hfr.

102. *Id.*

103. *Id.*

Amid this exorbitant growth, hedge funds started to increase in "publicness" as the impact of hedge fund activities started to overflow into the public sphere.[104] One aspect of this public encroachment involves the possibility of hedge funds creating negative externalities that could cripple the broader economy. Such externalities generally occur when unrelated third parties, or the economy as a whole, have to pay the cost for an economic decision for which they were not a direct party.[105] These kinds of scenarios create glaring market inefficiencies that should be corrected by regulatory action. Private entities, along with their investors, should presumably have the capacity to absorb any losses that result from underlying trading decisions gone awry. However, with the near failure of Long-Term Capital Management ("LTCM") in 1998, regulators quickly discovered that hedge funds could potentially fall into the "too big to fail" category of financial institutions.[106] More specifically, because hedge funds are unconstrained by regulatory limits on leverage and derivatives trading, their underlying activities can generate and transmit systemic risk to the broader financial system.[107] In fact, LTCM was so heavily leveraged that it was set to default on over $1 trillion of contracts with its investment banking counterparties.[108] If LTCM did in fact default on these contracts, then its investment banking counterparties would have likely gone into liquidation. The Federal Reserve was then forced to orchestrate a deal amongst these banks to prevent the cascading failures of these multiple banking entities.[109] Allowing them to fail would have surely toppled the global economy.

However, regulators refrained from imposing any additional regulation on hedge funds. The general public was therefore left to rely on the markets in mitigating this growing systemic risk threat by perhaps implementing privately enforced limits on leverage. This regulatory inaction paved the way for yet an additional systemic risk event to occur in the coming years. On the eve of the 2007–2009 financial crisis, "Bear Sterns Companies, the investment bank, pledged up to $3.2 billion in loans . . . to bail out one of its hedge funds that

104. *See* Martin Shelby, *supra* note 27, at 430–34 (evaluating the extent to which hedge funds increased in publicness due to systemic risk and retailization).

105. Thomas Helbling, *Externalities: Prices Do Not Capture All Costs*, INT'L MONETARY FUND (Dec. 18, 2018), www.imf.org/external/pubs/ft/fandd/basics/external.htm.

106. THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 83, at 12; *see* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) (documenting the events that led to the near failure of Long-Term Capital Management, which had a staggering debt-to-equity ratio of over twenty-five to one).

107. Systemic risk is not defined under the federal securities laws, but scholars have offered various definitions. For instance, Professor Steven Schwarcz, Duke University School of Law, defines systemic risk, in his often cited piece, as "the risk that (i) an economic shock such as market or institutional failure triggers (through panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market volatility." Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

108. THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 83, at 12–14, 29.

109. *Id.* at 13–14.

was collapsing because of bad bets on subprime mortgages."[110] Shortly following this hedge fund bailout, Bear Sterns Companies failed and was subsequently purchased by JPMorgan Chase.[111] Although the causes of the 2007–2009 financial crisis are extremely complex and multi-faceted, the failure of Bear Sterns Companies precipitated a severe loss of investor confidence that reverberated throughout the economy. This massive decline in investor confidence likely contributed to the debilitating credit freeze, which was one of the most insidious characteristics of the 2007–2009 financial crisis. Moreover, the financial crisis revealed the heightened risk of contagion as seemingly uncorrelated strategies and financial institutions experienced concurrent losses.[112]

Another means through which hedge funds have increased in publicness is through "retailization" where a mounting number of retail investors are indirectly exposed to hedge funds through institutional investments.[113] Pension plans and endowments, for example, are the primary drivers of the growth of the hedge fund industry, even though their ultimate beneficiaries are mostly comprised of retail investors. One source estimated that, "[m]ore than half of the $3 trillion held in hedge funds nationwide is pension fund and retirement plan investments."[114] With respect to other categories of investors, an additional survey found that, in 2017, "[e]ighty-three percent of endowments and 66% of foundations invest[ed] in hedge funds."[115] This phenomenon does not constitute a negative externality because retail investors are indirectly in contractual privity with the institutional investors making such hedge fund allocations. Yet, because the public/private dichotomy under our federal securities laws is primarily rooted in the status of investors, the growing access by retail investors to such private entities entails a heightened degree of publicness from a regulatory perspective. In applying this framework to retailization, one could equally assume that Fiduciary Investors have the institutional and financial resources to sufficiently protect underlying retail investor beneficiaries from excessive risks because such investors are considered "elite investors" under federal securities laws. Nevertheless, reports have surfaced that reveal the difficulties that pension plan trustees and other Fiduciary Investors face in understanding the complexities of hedge fund strategies or fee structures.[116] As will be discussed

110. Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES (June 23, 2007), https://www.nytimes.com/2007/06/23/business/23bond.html.

111. Andrew Ross Sorkin, *JP Morgan Pays $2 a Share for Bear Stearns*, N.Y. TIMES (Mar. 17, 2008), https://www.nytimes.com/2008/03/17/business/17bear.html.

112. *See, e.g.*, Amir E. Khandani & Andrew W. Lo, *What Happened to the Quants in August 2007? Evidence from Factors and Transactions Data*, 14 J. FIN. MKTS. 1, 2–3 (2011) (providing evidence that hedge funds experienced concurrent losses even though underlying strategies were seemingly uncorrelated, demonstrating increasing contagion within the industry).

113. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 61, at 80–83.

114. Barry Ritholtz, *Hedge-Fund Mediocrity Is the Best Magic Trick*, BLOOMBERG (Feb. 15, 2018, 6:00 AM), https://www.bloomberg.com/view/articles/2018-02-15/hedge-funds-underperform-yet-keep-attracting-pension-fund-money (quoting Leland Faust, CSI Capital Management).

115. Press Release, Prequin, Largest Hedge Fund Investors Hold Outsize Influence (Mar. 28, 2018), http://docs.preqin.com/press/HF-Investors-Mar-18.pdf.

116. *See infra* Part II.D.

in Part II below, pension plans are also increasingly investing in hedge fund entities in spite of growing evidence of their excessive fees and subpar returns.

II. Dissecting the Hedge Fund Conundrum

One of the most prevalent harms that has resulted from retailization is the hedge fund conundrum. This article loosely defines this conundrum as a phenomenon where Fiduciary Investors continue to increase allocations to hedge funds, despite overwhelming evidence that hedge fund fees are excessive in comparison to lower cost alternatives, at least since the financial crisis of 2007–2009. Part II.A summarizes multiple studies that have examined the extent to which hedge fund fees are indeed excessive in comparison to lower cost substitutes, such as index funds, actively traded mutual funds, and even treasury bills. Part II.B investigates the extent to which hedge funds are charging hidden fees which further reduces returns. While at least some Fiduciary Investors have attempted to negotiate fee reductions via contract, these protections are limited due to varying degrees of bargaining power amongst institutional investors as well as a lack of standardization regarding the mechanisms through which such fees are calculated. Part II.C then illuminates the harms that result from the hedge fund conundrum, such as the loss of billions of dollars resulting from the misallocation of limited retail investor capital into excessively expensive vehicles, and the possibility that this conundrum has perpetuated wealth inequality within the investment advisory industry. Part II.D concludes by identifying the possible reasons for continued hedge fund allocations by pension plan trustees, the predominant category of Fiduciary Investors. Such justifications include the growing pressure to produce alpha, the complications related to pension plan trustees complying with elusive fiduciary duties under state law, and potential conflict of interest transactions between plan trustees and hedge fund advisers. It then explains how each of these reasons is enabled by the pervasive opacity of the hedge fund industry. With respect to seeking returns that exceed market performance, for example, trustees may view hedge fund allocations as the more politically feasible approach because their proprietary nature makes it more difficult for policymakers to scrutinize such decisions.

A. Inability to Beat the Markets

Scholars mainly rely on hedge fund indices to evaluate the profitability of the industry which in itself poses several limitations. For one, these indices rely on hedge funds that are "self-reporting" because these entities are not required to disclose returns pursuant to any regulatory mandate.[117] This creates self-selection biases in that hedge funds with superior performance may be incentivized to report returns to indices, as compared to funds with subpar performance

117. Salvatore Bruno & Robert Whitelaw, *Selecting a Hedge Fund Replication Approach: Some Factors to Consider*, J. Indexes, May–June 2012, at 40, 43, pages.stern.nyu.edu/~rwhitela/papers/HF%20Replication%20JoI%202012.pdf.

that may refrain from doing so.[118] Thus, widely used hedge fund indices are not likely to provide a wholistic snapshot of the industry in its entirety.[119] The ways in which valuations and fees are measured are also not subject to standardized methodologies, making it difficult to effectively compare a range of funds.[120] Alternative valuation methodologies available to hedge fund advisers could effectively skew the comparisons of funds even if such funds are employing comparable strategies and reporting identical returns. Hedge fund strategies that rely on complex derivatives and/or other illiquid instruments may further produce returns that are non-linear, making the use of an index to report such returns less than ideal.[121]

Scholars have attempted to control for these limitations as studies have become more sophisticated over time. In applying these more sophisticated analyses, a sizable body of research concluded that hedge funds could in fact exceed market and/or mutual fund returns, particularly prior to the financial crisis of 2007–2009.[122] After surveying the existing literature around this time period, one such study concluded that hedge fund performance exceeded that of mutual funds in part due to innovative trading strategies.[123] This author did however predict that hedge fund and mutual fund performance would begin converging as the hedge fund industry became more saturated, making the prospect of producing alpha increasingly competitive.[124]

Additional studies began to emerge which challenged these empirical conclusions regarding the superiority of hedge funds as an asset class.[125] One such

118. William Fung & David A. Hsieh, *Hedge-Fund Benchmarks: Information Content and Biases*, Fin. Analysts J., Jan.–Feb. 2002, at 22, 24 ("[P]resumably, only those funds that have 'good' performance and are looking to attract new investors want to be included in a database. Therefore, hedge funds in a database tend to have better performance than those that were excluded.").

119. *Id.*

120. William Fung & David A. Hsieh, *Hedge Fund Benchmarks: A Risk Based Approach*, Fin. Analysts J., Sept.–Oct. 2004, at 65, 65 ("The opaqueness of hedge fund operations . . . and a lack of performance-reporting standards make it hard to formulate expectations for hedge fund performance that reflect the current economic outlook.").

121. *See* Dichev & Yu, *supra* note 4, at 249.

122. *See, e.g.*, Carl Ackermann, Richard McEnally & David Ravenscraft, *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. Fin. 833, 870 (1999) ("[The] combination of incentive alignment and investment flexibility gives hedge funds a clear performance advantage over mutual funds."); Martin Eling & Roger Faust, *The Performance of Hedge Funds and Mutual Funds in Emerging Markets*, 34 J. Banking & Fin. 1993, 1994 (2010) ("[Emerging market h]edge fund returns and alphas are much higher than those of traditional mutual funds[, and s]ome hedge funds outperform traditional benchmarks, whereas most mutual funds tend to underperform traditional benchmarks."). *See generally* Vikas Agarwal, Kevin A. Mullally & Narayan Y. Naik, *The Economics and Finance of Hedge Funds: A Review of the Academic Literature*, 10 Found. & Trends Fin. 1 (2015) (summarizing a number of studies on this topic which have generally concluded that hedge funds have outperformed mutual funds, even after accounting for fees and biases in hedge fund indices).

123. René M. Stulz, *Hedge Funds: Past, Present, and Future*, J. Econ. Persp., Spring 2007, at 175, 180–81, 187 (discussing regulations that limit certain trading strategies by mutual funds, which regulations are inapplicable to hedge funds).

124. *Id.* at 190–92.

125. *See, e.g.*, Juha Joenväärä et al., Hedge Fund Performance: What Do We Know? 30 (Dec. 18, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1989410 (Utilizing "a novel and replicable methodology to aggregate hedge fund databases [and concluding that] . . . hedge fund average returns are upward biased if a researcher uses only one of the commer-

study utilized a dollar-weighted return for evaluating returns, as opposed to the buy-and-hold assumption that was implicit in many hedge fund indices.[126] The buy-and-hold methodology assumes that investors simply maintain a particular hedge fund allocation for the duration of time being reported to the index.[127] In reality, investors tend to invest more money later in the fund's life while often increasing contributions during periods in which hedge funds are reporting higher returns.[128] As such, the dollar-weighted return methodology is "value-weighted *over time* by the amount of invested capital[,] thus . . . properly re-flect[ing] the effect of the timing and magnitude of fund flows on investor returns."[129] After applying this dollar-weighted methodology to close to 11,000 hedge funds during the time periods between 1980 to 2008, this study concluded as follows:

> [T]he main finding is that dollar-weighted investor returns are about 3% to 7% lower than fund returns, depending on specification and time period examined. This difference is economically large, and it is enough to reverse the conclusions of existing studies which show outperformance in hedge fund returns. In addition, the estimated dollar-weighted returns are rather modest in absolute magnitude; for example, they are reliably lower than the returns of broad-based indexes like the S&P 500 and only marginally higher than risk-free rates of return. . . . [A]lso . . . dollar-weighted returns are more variable than buy-and-hold returns although the magnitude of this effect is economically modest. Thus, the risk-return profile of hedge fund investors seems much worse than previously thought.[130]

Reconciling these findings with the growing popularity of hedge funds amongst institutional investors, such as pension plans and endowments, was indeed troubling given the sheer magnitude of potential losses passed along to retail investor beneficiaries.

Simon Lack used a comparable methodology to further scrutinize hedge fund returns in his book titled *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True*.[131] Lack relied on the Hedge Fund Research Global Hedge Fund Index ("HFRX") to evaluate returns from 1998 to 2010.[132] During this time period, the HFRX index reported an annual return of 7.3 percent for the industry, while the S&P500 yielded a 5.9 percent return, Treasury bills earned 3.0 percent, and blue chip corporate bonds earned 7.2 percent on an annual basis.[133] However, Lack notes that the returns documented by HFRX "are

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cial databases, because databases differ in their coverage of under-performing funds . . . [and] after correcting for data biases—including the aforementioned positive database selection bias—a typical hedge fund or the industry as a whole delivers significant abnormal returns before fees but not after fees, suggesting that fund managers extract the majority of the rents.").

126. *See* Dichev & Yu, *supra* note 4, at 250.

127. *Id.* at 249–50.

128. *Id.* at 249.

129. *Id.*

130. *Id.* at 261.

131. *See* SIMON LACK, THE HEDGE FUND MIRAGE: THE ILLUSION OF BIG MONEY AND WHY IT'S TOO GOOD TO BE TRUE (2012).

132. *Id.* at 6–7.

133. *Id.* at 7.

all based on the simple average return each year [and that the] hedge fund industry routinely calculates returns based on the value of $1 invested at inception."[134] This is problematic because hedge funds tend to perform better in their earlier years, when assets can be more easily deployed by advisers in response to varying market conditions. As a whole, the industry performed better during its earlier years while leveling off in later years. Investors who increased allocations during these later years likely suffered individual losses that are not easily reflected in the average returns that are reported to indices.

As such, Lack adjusted the HFRX figures to incorporate asset-weighted returns which more accurately reflect the amount of money invested during each reported time period.[135] When Lack adjusted the HFRX in this manner, the annual return for the hedge fund industry plummeted to 2.1 percent.[136] In applying this same methodology to other benchmarks, the S&P500 would have declined to 1.1 percent, corporate bonds would have yielded 6.3 percent, and Treasury bills would have dipped to 2.3 percent.[137] While Lack's adjusted hedge fund returns would have still exceeded the S&P500 by a slim margin, they were well below the risk-free rate provided by Treasury bills. As he emphasized at the outset of his book, "[i]f all the money that's ever been invested in hedge funds had been put in treasury bills instead, the results would have been twice as good."[138] He further noted that any combination of equities and bonds would have likely exceeded the performance of hedge funds.[139]

Some commentators disagreed with various nuances of these findings and aggressively defended the industry's ability to earn above-market returns. One study in particular criticized Lack's selection of the HFRX because it was created in 2000 and thus input historic returns that could be "suspect."[140] This study further noted that HFRX provided "a low estimate of the actual hedge fund average returns relative to those reported by most traditionally used hedge fund indices," while simultaneously acknowledging the limitations of selecting any such index for measuring hedge fund performance.[141] In applying Lack's method of incorporating asset-weighted returns to these more traditional indices (such as Barclays and CSFB), the authors concluded that, "the hedge fund index IRR . . . would have been at least twice the approximately 3% risk free return benchmark . . . and more than three times greater than the IRR return of the HFRX Global Hedge Index . . . reported by Lack."[142] The authors additionally remind readers that the hedge fund industry is extremely heterogeneous and

134. *Id.*
135. *Id.* at 10–12.
136. *Id.* at 7.
137. *Id.* at 12–13.
138. *Id.* at 1.
139. *Id.* at 12.
140. Thomas Schneeweis & Hossein Kazemi, An Academic Response to the "Hedge Fund Mirage" 7 (Sept. 30, 2012) (unpublished manuscript), http://ssrn.com/abstract=2228851 (criticizing the methodologies utilized by the author of *The Hedge Fund Mirage*).
141. *Id.* at 8.
142. *Id.*

encompasses an entire universe of distinctive strategies. Some strategies offer protection in declining equity/bond markets, due to their access to derivatives and other exotic instruments, while others permit participation in such markets when they are increasing in value.[143] Reviewing the returns of the entire industry also poses limitations in effectively evaluating whether to invest in a particular fund given the possibility of fluctuating market conditions that may occur in the future, such as changing interest rates or volatility in the stock market.[144]

Nevertheless, as the United States entered into an extended bull market that has lasted close to a decade, the hedge fund industry has encountered heightened challenges in earning above-market returns during this time period.[145] As the *New York Times* recently summarized, "[f]or eight consecutive years, hedge funds have disappointed, underperforming a roaring stock market."[146] CEM Benchmarking published an extensive study that "aggregated institutional portfolios with a hedge fund allocation history longer than five years and compared it to a custom equity/debt portfolio constructed from each plan's specific allocation."[147] It concluded that, between 2000 and 2016, "net of costs, the asset class fail[ed] to add value over a traditional equity/bond portfolio."[148] An additional academic study examined the extent to which a comprehensive set of twenty-six performance predictors, such as predictors related to managerial skill and timing, could be used to forecast superior hedge fund performance between 1997 and 2016.[149] The study further consolidated data from six available hedge fund indices and concluded that none of its identified predictors could select a 20 percent allocation to hedge funds that significantly improved the performance of a standard stock/bond portfolio during the 2008–2016 period.[150] Even certain hedge fund industry participants acknowledge that this period has been difficult for the industry. Daniel S. Loeb referenced this period as being "catastrophic" after managers lost billions of dollars resulting from unanticipated market swings.[151] Toward the end of 2018, the industry suffered additional challenges as "[h]edge-fund aggregate performance was down 2%

143. *See id.* at 3.

144. *Id.* at 4–5.

145. Roger Aitken, *Why Invest in Hedge Funds If They Don't Outperform the Market?*, FORBES (Jan. 21, 2015, 12:32 PM), https://www.forbes.com/sites/rogeraitken/2015/01/21/why-invest-in-hedge-funds-if-they-dont-outperform-the-market ("The S&P 500 total return index in fact outperformed almost every hedge fund out there in the three years through June 2014.").

146. Alexandra Stevenson, *Hedge Fund Managers Don't Always Beat the Market, but They Still Make Billions*, N.Y. TIMES (May 16, 2017), https://www.nytimes.com/2017/05/16/business/dealbook/best-paid-hedge-fund-managers.html.

147. Charles McGrath, *Costs Mute Hedge Fund Value Added*, PENSIONS & INVS. (May 21, 2018, 12:26 PM), http://www.pionline.com/article/20180521/INTERACTIVE/180529990/costs-mute-hedge-fund-value-added.

148. *Id.*

149. Nicolas P.B. Bollen, Juha Joenväärä & Mikko Kauppila, *Picking Winners? Selecting Hedge Funds for a Diversified Portfolio* 2–3 (Vanderbilt Owen Graduate Sch. of Mgmt., Paper No. 3034283, 2018), https://ssrn.com/abstract=3034283.

150. *Id.* at 29–30.

151. *See* Stevenson, *supra* note 146.

through the end of November [2018], thanks in part to a decline of 3.1% in October [2018] alone."[152]

In summary, most would agree that hedge funds have encountered significant difficulties in earning superior returns during the historic bull market that has characterized the markets over the past decade or so. However, scholars and commentators are slightly more divided with respect to whether hedge funds can earn superior returns in declining markets. These private entities are known for outperforming the markets during economic downturns given their increased freedoms to engage in short-trading and other "hedging" strategies. As one source noted, "[d]islocated markets, bear markets, inefficient markets are where hedge funds tend to do best, and these have not been the overall conditions during the slow and fragile recovery starting in 2009."[153] In terms of how hedge funds performed in the midst of our last financial crisis, one source estimated that, in 2008, "global equities lost 42 percent of their value while hedge funds worldwide lost a comparatively smaller 19 percent for their investors and with lower monthly volatility."[154] Professor Houman Shadab further noted that, "[h]edge funds use short sales and derivatives to manage risk and reduce losses when the overall market is performing poorly. This practice is difficult for mutual funds because of the legal restrictions on their investment activities."[155] Evidence has nonetheless emerged that institutional investors have encountered difficulties in selecting high performing hedge fund managers.[156] To the extent that hedge funds can provide additional protections during declining markets, additional transparency guarantees under the federal securities laws would greatly assist Fiduciary Investors in optimizing hedge fund selections during these time periods.

B. Hidden Fees and Limited Impact of Contractual Protections

Irrespective of this ongoing debate regarding when and how hedge funds can earn superior returns, legitimate concerns have also arisen regarding the costs of selecting hedge funds as well as the extent to which hedge funds charge hidden

152. Bradley Saacks, *A Surge in Shutdowns, Lagging Performance, and Slashed Fees: Hedge Funds Have Had a Brutal 6 Months*, Bus. Insider (Jan. 3, 2019, 9:30 AM), https://www.businessinsider.com/surge-shutdown-bad-performance-slashed-fees-2018-brutal-hedge-fund-2018-12.

153. Brian Robinson, *How Pension Plans Can Build the Case for Hedge Funds*, Pensions & Invs. (Nov. 30, 2016, 2:01 PM), http://www.pionline.com/article/20161130/ONLINE/161139991/how-pension-plans-can-build-the-case-for-hedge-funds.

154. Shadab, *supra* note 71, at 243–44 (citing Credit Suisse Tremont, One for the Record Books: Hedge Fund Performance in 2008 1 (2009)).

155. Houman B. Shadab, *Hedge Funds and the Financial Crisis* 2 (N.Y. Law Sch. Legal Studies, Paper No. 9/10 #31, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1564847.

156. *See, e.g.*, *The Hedge-Fund Delusion that Grips Pension-Fund Managers*, Economist (Jan. 18, 2018), https://www.economist.com/finance-and-economics/2018/01/18/the-hedge-fund-delusion-that-grips-pension-fund-managers ("Clients may think they will be able to pick the best hedge-fund managers, not the average ones. But one group of professionals—fund-of-fund managers—tries to do just that. They did manage to pip the average asset-weighted return of hedge funds in 2017, but failed to do so in any of the previous four years. If the experts cannot manage to pick the winners, why should a pension fund or endowment be able to manage the feat?").

fees which may not be reflected in reported returns. Most reputable indices admittedly require its listed hedge funds to report performance figures net of fees. This means that reported figures should at least exclude the fixed management fee and any variable incentive fees.[157] Anti-fraud provisions under the Advisers Act also require both registered and exempt advisers to deduct "advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid" from any actual performance figures that are disclosed to investors.[158] Even with these requirements, the costs of performing adequate due diligence on potential and ongoing hedge fund allocations is quite significant given the complexities involved in understanding strategies, fee structures, and corresponding risks. As Lack notes:

> Deciding which treasury bill to buy is not a particularly taxing job, but selecting hedge funds requires either a significant investment in a team of hedge fund analysts, risk management, due diligence, and financial experts, or the use of a hedge fund of funds that employs the same expertise. Either way, it costs an additional 0.5 to 1.0 percent annually for an investor to be in hedge funds, whether through fees paid to the hedge fund or funds manager or increased overhead of an investment team.[159]

Retaining sufficient expertise to select and monitor hedge funds is ultimately an expensive enterprise. Hedge funds can trade exotic and complex financial instruments that could yield inconsistent valuations. Deciphering hedge fund fees presents additional hurdles as there is no mandated standardized format for reporting these often intricate layers of fees.

Numerous reports have also emerged of institutional investors having to unexpectedly pay for unreported fees, such as accruals of performance fees, costs associated with monitoring hedge fund investments, or portfolio company fees.[160] In April 2017, a report published by PEW Charitable Trusts measured the average unreported fees for the seventy-three largest state-sponsored pension plans in the United States.[161] It shockingly found that these pension plans are paying approximately $4 billion in such unreported fees on an annual basis.[162] Thus, even if pension plans can successfully select high-performing hedge funds, returns may be adversely impacted by potential unaccounted-for fees. Although pension plans can potentially sue hedge funds for charging hid-

157. *HFRI Index Methodology*, Hedge Fund Res., Inc., https://www.hedgefundresearch.com/hfri-index-methodology (last visited Mar. 18, 2019).

158. Clover Capital Mgmt., Inc., SEC Staff No-Action Letter, File No. 801-27041 (Oct. 28, 1986), https://www.sec.gov/divisions/investment/noaction/clovercapital102886.htm; *see* 15 U.S.C. § 80b-6(4) (2018); 17 C.F.R. § 275.206(4)-1 (2019).

159. Lack, *supra* note 131, at 13.

160. Edward Siedle, *Pensions Unaware Hidden Real Estate Fees Dwarf Those Disclosed*, Forbes (June 16, 2016, 10:17 AM), https://www.forbes.com/sites/edwardsiedle/2016/06/16/pensions-unaware-hidden-real-estate-fund-fees-dwarf-disclosed-fees/#410140071961; Yves Smith, *SEC: More than Half the Private Equity Firms Gouge on Fees*, Naked Capitalism (Apr. 8, 2014), https://www.nakedcapitalism.com/2014/04/sec-half-private-equity-firms-gouge-fees.html.

161. *See* Pew Charitable Trusts, *supra* note 13, at 2.

162. *See id.* at 27.

den fees, such litigation can be difficult to prove because institutional investors are supposed to be well positioned to sufficiently protect themselves under federal securities laws. Litigation can further lead to additional costs in administering the pension plan that adversely affect underlying beneficiaries.

Several institutional investors have indeed responded to these subpar returns by negotiating for lower hedge fund fees directly with underlying advisers. One source estimated that hedge fund management fees have collectively fallen 13 basis points with average incentive fees declining 78 basis points since 2014.[163] A recent Goldman Sachs survey similarly found that hedge funds, on average, charge a 1.5 percent management fee and a 17 percent incentive fee.[164] Moreover, Fiduciary Investors can negotiate that such incentive fees only be paid after the hedge fund exceeds a certain benchmark, such as the S&P500. Hedge fund advisers have frequently agreed to such modifications. After all, sophisticated investors of this nature should be well-positioned to sufficiently protect themselves given their access to innumerable financial and institutional resources.

Yet, these collective declines in fees are perhaps insufficient given the lower-costs alternatives of allocating to passive index funds, which can have expense ratios as low as 0.05 percent.[165] Numerous hedge fund investors have also agreed to historic fee models as one survey revealed that "[a]round one in 10 investors paid a management fee of 2 per cent or more while almost a quarter (23 percent) stumped up a 20 per cent performance fee [in 2017]."[166] Perhaps some hedge fund advisers are deserving of this higher fee structure given particularized abilities to earn superior returns. The more likely scenario is that the ability to negotiate lower fees depends on the bargaining power of institutional investors. In a similar vein, many institutional investors may not have the sufficient expertise and/or foresight to negotiate for fees that are more reflective of risk/return profile that hedge funds produce across varying market conditions. The constrained transparency with respect to hedge fund fees likewise presents challenges in negotiating for lower fees as they are not universally reported or calculated in a standardized format.

C. Resulting Harms

The resulting costs of potential misallocations to excessively expensive vehicles by pension plans and other institutional investors are significant. These costs ultimately get passed down to underlying retail investors in the form of reduced retirement benefits or possible taxpayer bailouts of pension plans that are unduly reliant on these vehicles. Such retail investors are supposed to be entitled

163. Chris Flood, *Hedge Funds Forced to Cut Fees to Lure Investors*, Fin. Times (Feb. 18, 2018), https://www.ft.com/content/b889c3b8-1254-11e8-940e-08320fc2a277.

164. Ted Seides, *The Hedge Fund Fee Conundrum*, Institutional Inv'r (June 1, 2018), https://www.institutionalinvestor.com/article/b18g7tfmmmjvj7/the-hedge-fund-fee-conundrum.

165. Stephen L. McKee, *Comparing the Lowest Cost Index Funds*, Forbes (May 19, 2016, 9:18 AM), https://www.forbes.com/sites/investor/2016/05/19/comparing-the-lowest-cost-index-funds/#67f70159299b.

166. Flood, *supra* note 163.

to various protections under the federal securities laws, but they are precluded from such protections by regulatory loopholes and ambiguities that will be further discussed in Parts III.B and III.C below. One commentator estimated that pension plans collectively lost $600 billion over an eight-year period by failing to invest in passive investments.[167] An additional commentator provided the following summary of reports that further estimated exorbitant costs resulting from hedge fund allocations by specific pension plans across the country:

> A 2015 report by the New York City comptroller's office found that over ten years, the city's five public pensions had paid more than $2 billion in fees to hedge funds and received virtually nothing in return. According to data compiled by Bloomberg, hedge funds earned 0.4 percent—basically nothing—in 2015, despite the exorbitant fees they charged pensions to manage their money. A report by the Utah Legislative Auditor General's office found that had Utah maintained its 2004 asset allocation and not invested any money in hedge funds, it would have gained $1.35 billion in additional assets by 2013.[168]

A study administered by the American Federation of Teachers further assessed the impact of reducing alternative asset fees charged to twelve pension plans.[169] The study found that cutting such fees in half would have saved these pension plans approximately $3.8 billion on an annual basis.[170]

Many endowments have similarly been subject to comparable losses with respect to underperforming hedge funds. For instance, the Penn State endowment lost over $10 million dollars in a hedge fund investment gone awry, which was compounded by the higher fees charged by such adviser.[171] Another source noted that several prominent endowments are paying a significant portion of their assets to hedge fund advisers.[172] This commentator further estimated that, in 2014, "Yale paid about $480 million to private equity fund managers as compensation—about $137 million in annual management fees, and another $343 million in performance fees, also known as carried interest—to manage about $8 billion, one-third of Yale's endowment."[173] These potential misallocations of capital can adversely impact financial aid, scholarships, and other programs that countless students rely on across the country.

These misallocations can also perpetuate wealth inequality by creating opportunities for advisers to earn excessive fees that do not necessarily match their skillsets in producing superior returns. The studies summarized in Part II.A

167. *See* Faust, *supra* note 12.

168. Tyler Bond, *Are Hedge Funds Hurting Your Pension?*, NAT'L PUB. PENSION COAL. (May 19, 2016), https://protectpensions.org/2016/05/19/hedge-funds-hurting-pension/.

169. AM. FED'N OF TEACHERS, THE BIG SQUEEZE: HOW MONEY MANAGERS' FEES CRUSH STATE BUDGETS AND WORKERS' RETIREMENT HOPES 2 (2017), https://www.aft.org/sites/default/files/bigsqueeze_may2017.pdf.

170. *Id.* at 3.

171. Rachael Levy, *How Teachers, Firemen and College Endowments Ended Up Enriching America's Hedge Fund Billionaires*, BUS. INSIDER (July 7, 2017, 9:01 PM), https://www.businessinsider.com/college-endowments-and-public-pensions-enrich-hedge-fund-billionaires-2017-6.

172. Victor Fleischer, *Stop Universities from Hoarding Money*, N.Y. TIMES (Aug. 19, 2015), https://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html.

173. *Id.*

above document the difficulties that hedge funds have encountered in producing above-market returns, despite the higher fees charged for such allocations. In fact, Simon Lack estimated that, "[f]rom 1998 to 2010, hedge fund managers earned $379 billion in fees. The investors of their funds earned only $70 billion in investing gains. Managers kept 84 percent of investment profits, while investors netted only 16 percent."[174] Hedge fund advisers have essentially accumulated massive amounts of wealth through the collection of hedge fund fees that far exceed the wealth generated for their underlying clients.

Hedge fund advisers are likewise amongst the highest income earners in the country. Although it is difficult to parse out the specific industries that comprise the top 1 percent of income earners, most people would agree that financial services industries comprise a large portion of this figure.[175] Such financial professionals can include financial advisers, investment bankers, and money managers, such as hedge fund advisers.[176] One study noted that, "[f]inancial executives and professionals account for an estimated 14 percent of the much-discussed top 1 percent of earners and over 18 percent of the top 0.1 percent."[177] In terms of the hedge fund industry in particular, President Obama disclosed in an address delivered at Georgetown University that, the top twenty-five hedge fund managers earned more than all kindergarten teachers in 2012. Specifically, the top twenty-five hedge fund managers earned $11.6 billion in 2014, while the 158,000 kindergarten teachers in the country made a collective $8.5 billion in 2012, which was the most current data available at that time.[178] Hedge fund advisers can even earn more than corporate executives, as an additional source noted that the top twenty-five hedge fund advisers "earned more than all the CEOs of the S&P 500 *combined*."[179] One scholar further found that the top twenty-five hedge fund advisers at one point "represented roughly six percent of the total income share of the 'ultra rich' top 0.01% of the US population—the top 15,600 families that collectively had an income of about $372 billion."[180]

174. Steve Denning, *How Hedge Funds Transfer Wealth from Investors to Managers*, FORBES (May 28, 2013, 11:29 AM), https://www.forbes.com/sites/stevedenning/2013/05/28/how-hedge-funds-transfer-wealth-from-investors-to-managers/#7bc46ac218fc; *see* LACK, *supra* note 131, at 63; Barry Ritholtz, *A Hedge Fund for You and Me? The Best Move Is to Take a Pass*, WASH. POST (May 24, 2013), https://www.washingtonpost.com/business/a-hedge-fund-for-you-and-me-the-best-move-is-to-take-a-pass/2013/05/23/17e4689c-c1b3-11e2-ab60-67bba7be7813_story.html?utm_term=.1f4a5954312c (citing Lack).

175. James Surowiecki, *Why the Rich Are So Much Richer*, N.Y. REV. BOOKS (Sept. 24, 2015), http://www.nybooks.com/articles/2015/09/24/stiglitz-why-rich-are-so-much-richer/; *see also* Jonathan Rothwell, *Myths of the 1 Percent: What Puts People at the Top*, N.Y. TIMES (Nov. 17, 2017), https://www.nytimes.com/2017/11/17/upshot/income-inequality-united-states.html.

176. *See* Surowiecki, *supra* note 175; *see also* Rothwell, *supra* note 175.

177. *See* LINDSEY & TELES, *supra* note 15, at 35.

178. Philip Bump, *The 25 Top Hedge Fund Managers Earn More than All Kindergarten Teachers Combined*, WASH. POST (May 10, 2016), https://www.washingtonpost.com/news/the-fix/wp/2015/05/12/the-top-25-hedge-fund-managers-earn-more-than-all-kindergarten-teachers-combined/?noredirect=on&utm_term=.5393c997cb47.

179. LINDSEY & TELES, *supra* note 15, at 35.

180. Jan Fichtner, *The Rise of Hedge Funds: A Story of Inequality*, MOMENTUM Q., Jan. 2013, at 3, 15, https://www.researchgate.net/publication/259904632_The_Rise_of_Hedge_Funds_A_Story_of_Inequality.

In considering the large bulk of pension plans, endowments, and foundations that are invested in this industry, hedge funds provide a troubling mechanism for transferring the wealth from the bottom 90 percent of income earners to a sizable fraction of the top .01 percent of income earners, who have largely failed in earning superior returns for their underlying investors.

This troubling wealth transfer is compounded by the fact that performance fees, also known as carried interest, receive favorable tax treatment under the Internal Revenue Code.[181] Hedge fund advisers can treat carried interest payments as capital gains, which are generally subject to a tax rate cap of only 20 percent.[182] Other categories of income are subject to a tax rate cap of 37 percent.[183] As a result, the collective taxes paid by advisers are not likely to offset these sizable wealth transfers retrieved from average investors.[184]

One would have likely assumed that the bulk of Fiduciary Investors would flee the industry given the abundance of research questioning whether hedge funds can earn above-market returns and the resulting harms discussed in the preceding section. In 2014, the California Public Employees' Retirement System began to divest its entire $4 billion hedge fund allocation due to excessive complexity and costs.[185] A handful of pension plans followed suit, such as New York City's Pension Fund, which pulled its $1.7 billion hedge fund allocation around April 2016.[186] Yet, following these notable departures from the industry, institutional investors, such as pension plans, endowments, and foundations, have increased hedge fund allocations to record levels. The Texas County & District Retirement System for example invested over 21 percent of its entire portfolio in a range of hedge funds in 2017, amounting to $6.26 billion of the system's $28.6 billion portfolio.[187] Around 2014, the Arizona State Retirement System allocated a total of 28 percent into such alternative investments.[188] As one source noted, "[s]ince 2005, state and local pension plans have sharply increased their exposure to alternative investments, including private equity, real estate, and

181. Matthew Gardner, *Mnuchin's Not So Grand Stand on the Carried Interest Loophole Explained*, Inst. Tax'n & Econ. Pol'y (Feb. 15, 2018), https://itep.org/mnuchins-not-so-grand-stand-on-the-carried-interest-loophole-explained/.

182. *Id.*

183. 26 U.S.C. § 1 (2018); *see* Jeff Rose, *The New 2019 Federal Income Tax Brackets and Rates*, Forbes (Dec. 5, 2018, 11:00 AM), https://www.forbes.com/sites/jrose/2018/12/05/tax-brackets-and-rates-2019/#42a7ec473ec5.

184. *See* Rose, *supra* note 183.

185. Tom Huddleston Jr., *Biggest U.S. Pension Just Gave Hedge Funds the Boot*, Fortune (Sept. 15, 2014), http://fortune.com/2014/09/15/calpers-pension-manager-divesting-four-billion-hedge-funds/; *see also* Aliya Ram, *Pension Schemes Stay Loyal to Hedge Funds*, Fin. Times (July 24, 2016), https://www.ft.com/content/fcbdf88c-4f1f-11e6-88c5-db83e98a590a.

186. *See* Ram, *supra* note 185.

187. Nico Grant, *Texas Pension Bets Bigger on Hedge Funds as Others Back Away*, Bloomberg (Nov. 22, 2017, 10:19 AM), https://www.bloomberg.com/news/articles/2017-11-21/texas-pension-bets-bigger-on-hedge-funds-as-others-back-away; *see also CalSTRS, Harvard Join Ranks of Giant Allocators*, Hedge Fund Alert (Nov. 7, 2018), https://www.hfalert.com/documents/FG/hsp/hfa-rankings/591124_InstitutionalInvestors.pdf.

188. *See* Pew Charitable Trusts, *supra* note 13, at 4.

hedge funds, from 9% of portfolios, on average, to 24%."[189] An additional source further estimated that, "[m]ore than half of the $3 trillion held in hedge funds nationwide is pension fund and retirement plan investments."[190] With respect to other categories of Fiduciary Investors, a survey administered by Preqin in 2018 found that "[e]ighty-three percent of endowments and 66% of foundations invest[ed] in hedge funds . . . [and that e]ndowments and foundations both have average allocations to hedge funds of 19%."[191]

D. Irrational Allocations Enabled by Hedge Fund Opacity

As discussed in previous sections, investing in hedge funds is not necessarily an irrational decision from an economic standpoint. Given their private status, hedge fund advisers can access an entire universe of financial instruments and strategies that are simply inaccessible to registered mutual funds. Accessing such strategies can greatly assist Fiduciary Investors in diversifying their underlying portfolios while targeting alternative investments that do not directly correlate with equity markets. Examples of common hedge fund strategies include market neutral, global macro, opportunistic, emerging markets, and distressed securities, among several others.[192] Hedge funds also tend to perform better during volatile and declining markets, which are an inevitable component of the natural business cycle. Fiduciary Investors might be increasing allocations to hedge funds to protect against the declining markets that will soon occur.

But given the pervasive evidence of subpar returns and excessive fees that have saturated the industry over the past decade, one can easily infer that large numbers of Fiduciary Investors have made economically irrational decisions to continuously increase allocations over this particular period. The troubling evidence of hidden hedge fund fees briefly revealed in Part II.B above further demonstrates the puzzling difficulties that Fiduciary Investors have faced in optimizing hedge fund investments on behalf of their retail investor constituents. As will be further discussed below, Fiduciary Investors often confront unique incentives to make "irrational" hedge fund allocations, such as the pressure to produce above average returns in the face of staggering funding deficits, and the ambiguities related to pension plan trustees complying with elusive fiduciary duties that typically apply under state law. Economically irrational decisions to invest in hedge funds are further enabled by the opacity of the industry as the details surrounding these decisions are obscured from the public eye.

For instance, pension plans face significant pressure to chase alpha given the staggering funding deficits facing local and state pension plans across the nation,

189. Ryan Derousseau, *Retirement: Your Pension Plan Has a Big Hedge Fund Problem*, Fortune (July 28, 2017), http://fortune.com/2017/07/28/retirement-pensions-hedge-funds/.

190. Ritholtz, *supra* note 114 (quoting Leland Faust, CSI Capital Management); *see also* Preqin, Special Report: Hedge Funds in the US 3 (July 2018), http://docs.preqin.com/reports/Preqin-Special-Report-Hedge-Funds-in-the-US-July-2018.pdf (charting categories of investors in hedge funds).

191. Preqin, *supra* note 115.

192. *See* Friedland, *supra* note 89.

which deficits total $1.4 trillion according to certain estimates.[193] In 2016, New Jersey's pension plan faced a deficit of $168.3 billion, while the pension plan in Illinois faced a deficit of $141.2 billion.[194] Pension plan trustees ("Trustees") have attempted and/or undergone drastic measures to close those shortfalls, such as cutting benefits, reducing funding for schools, and linking pay to performance.[195] Other political leaders have pushed for new government employees to enroll in 401(k) plans as opposed to paying into a government-sponsored pension plan that is guaranteed upon retirement.

In the midst of the political warfare centered around these changes, many Trustees view alternative investments as a more politically feasible solution due to their proprietary nature. Trustee decisions to allocate to hedge funds are not easily scrutinized by policymakers or beneficiaries as disclosure of detailed information regarding strategies and fees is limited.[196] Hedge funds have admittedly demonstrated potential opportunities to produce alpha. Because hedge funds can access exotic and innovative trading strategies that are largely inaccessible to mutual funds, Trustees likely view these entities as an alluring opportunity to easily close the pension plan funding gaps that have tanked state and municipal budgets across the country. Many hedge funds also perform better during declining markets given their abilities to engage in protective strategies by utilizing short-trading, credit default swaps, and other derivative instruments. Countless commentators and researchers predict that our current bull market, which has surprisingly lasted close to a decade, will come to an end in the near future.

But then again, the research on whether hedge funds can earn superior returns in such markets is divided as was discussed at length in Part II.A above. While some scholars have found that hedge funds have earned absolute returns during historic bear markets during the 1990s and 2000s, others have found that, over these same time periods, investors would have been better off investing in trea-

193. Pew Charitable Trusts, The State Pension Funding Gap: 2016 2 (Apr. 12, 2018), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/04/the-state-pension-funding-gap-2016.

194. Laurie Meisler, *Pension Fund Problems Worsen in 43 States*, Bloomberg, https://www.bloomberg.com/graphics/2017-state-pension-funding-ratios/ (last updated Aug. 29, 2017).

195. Elise Young, *Christie Panel Says Only Benefit Cuts Can Fix N.J. Pensions*, Bloomberg (Dec. 6, 2017, 10:16 AM), https://www.bloomberg.com/news/articles/2017-12-06/n-j-worker-benefit-cuts-seen-by-group-as-only-fix-for-pensions.

196. *See, e.g.*, Paul Rose & Jason S. Seligman, Alternative Investments? State & Local Pension Portfolio Use and Performance 6 (Mar. 13, 2014) (unpublished manuscript), http://ssrn.com/abstract=2407538 ("Plan officials may herd with respect to alternative investments because, as a general matter, alternative investments provide a means for funds to limit information about performance; alternative investments are not as capable of being marked-to-market as are publicly-traded investments. Alternative investments tend to suppress information about performance and thus may provide a means of suppressing measured volatility. This possibility presents two layers of potentially problematic agency costs. First, alternative investments may be prone to higher agency costs as the general partner managers of such investments may provide little information on asset values to their limited partners. . . . Second, pension fund officials may themselves have an incentive to provide little information on asset values and performance to their beneficiaries. The limited information on alternative asset performance may thus serve funds as a further source of criticism insurance by damping the frequency and precision of mark-to-market measures.").

sury bills. Additional research has emerged that further correlates hedge fund performance with equities and bonds. According to one such study, "[w]hereas hedge fund managers promise uncorrelated returns and downside protection, all of the 11 pension funds reviewed demonstrated significant correlation between hedge fund and total fund performance," which presumably includes a large share of stocks and bonds.[197] Analyses of this nature are further complicated by the fact that some hedge funds employ strategies that are dynamic, or that are comparable to mutual funds, even after charging higher fees. Assessing fees is also problematic given the pervasive reports of Trustees having to pay billions of dollars to hedge funds in hidden and unanticipated fees, which further gouge into the anticipated returns of such pension plans. Researchers have fortunately utilized sophisticated research strategies to make observations about the hedge fund industry in broad strokes. Nevertheless, accessing particularized information about a single hedge fund allocation is difficult to do if you are not in contractual privity as a direct investor or accessing discovery as a litigant in proceedings against a hedge fund. Information asymmetries of this nature could be partially addressed through a disclosure framework for hedge-fund-like strategies, which will be further discussed in Part IV below. Creating such an opportunity to allocate to transparent hedge-fund-like strategies could similarly assist Trustees in selecting optimal wealth-maximization investments during declining markets.

The proprietary nature of hedge funds similarly makes it less likely that Trustees will be found liable for breaching their already elusive fiduciary duties in deciding to allocate to these private vehicles. As background, these duties generally obligate Trustees to act for the exclusive benefit of plan beneficiaries in managing plan assets.[198] Because public pension plans are exempt from the Employee Retirement Income Security Act of 1974 ("ERISA") and subject to varying degrees of regulation under their respective states, they must consult several sources in determining the precise contours of these duties.[199] Trustees must consistently evaluate state constitutions and statutes, common law, and plan documents.[200] Even still, states often replicate various provisions of ERISA, including provisions codifying the omnipresent *duty of prudence*.[201] Under this duty, states often adopt the standard provided under section 404(a)(1)(B) of ERISA, which obligates fiduciaries to manage the plan "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise

197. Elizabeth Parisian & Saqib Bhatti, All that Glitters Is Not Gold: An Analysis of US Public Pension Investments in Hedge Funds 2 (2015), https://www.aft.org/sites/default/files/allthatglittersisnotgold2015.pdf.

198. David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. Rev. 2106, 2122 (2014).

199. *Id.* at 2120–21 (citing 29 U.S.C. § 1003(b)(1); Emp. Benefits Research Inst., Fundamentals of Employee Benefit Programs, Part Five: Public Sector 20 (2005)).

200. *Id.*

201. *Id.* at 2120 (noting that many states have copied ERISA's fiduciary duties); *id.* at 2122 (citing 29 U.S.C. § 1104(a)(1)(B) (imposing duty of prudence)); *id.* at 2152–57 (analyzing duty of prudence).

of a like character and with like aims."[202] In broad strokes, this *duty of prudence* essentially requires that Trustees utilize reasonable expertise and diligence in selecting investment allocations for pension plan portfolios.[203] It additionally requires that prospective investments "be examined for appropriate factors such as the risk of loss, the opportunity for return, diversification, liquidity, current return and projected return."[204] Complying with these fiduciary duties is a complicated endeavor that often yields inconsistent results. Investing in markets with limited transparency further muddies the waters in terms of determining whether there has been a breach by Trustees in deciding to invest in hedge funds.

Assessing current and projected returns of hedge funds, for instance, can present conflicting conclusions. As explored in detail in Part II.A, the current returns of the industry have been dismal given the pervasive evidence that hedge funds have collectively been unable to beat the markets over the past decade or so. Yet, assessing projected returns may paint a more positive picture as hedge funds can leverage liberal investment freedoms to outperform declining markets. The research is somewhat split on this issue as discussed at the beginning of this subsection. One can easily imagine a scenario where Trustees justify a hedge fund allocation that is yielding negative returns on the basis that it will yield positive returns in the future, based on precarious promises made by hedge fund advisers. The opacity of the industry obscures the extent to which simultaneously evaluating current and future returns can be thoroughly examined.

With respect to diversity, incorporating hedge funds into a pension plan's portfolio seems essential, in spite of its noted transparency deficiencies, as the industry is comprised of an entire universe of distinctive strategies that are simply unavailable in the mutual fund space. Hedge funds have become a prominent player in the global marketplace and simply dismissing the entire industry, without providing a meaningful justification, seems imprudent on its face. Moreover, if the vast majority of pension plans are allocating to this industry, refusing to do so can be viewed as suspicious. It is presumably an easier strategy to simply "follow the herd" in complying with these seemingly elusive fiduciary duties.[205] On the other hand, following the crowd is problematic if there is clear evidence that an industry is facing significant challenges in producing long-term returns. Several Trustees have indeed made the difficult decision to divest from the hedge

202. *Id.* at 2152 (quoting 29 U.S.C. § 1104(a)(1)(B)).

203. *See* José M. Jara, *ERISA Fiduciary Considerations When Incorporating Alternative Investments in Your Pension Plan's Portfolio*, Cardozo Law 3, https://cardozo.yu.edu/erisa-fiduciary-considerations-when-incorporating-alternative-investments-your-pension-plans (last visited Mar. 19, 2019).

204. *Id.*

205. *See* Rose & Seligman, *supra* note 196, at 6 ("Even though plan officials are relatively well-protected from personal liability for investment decisions, they still may follow other states' leads in alternative investments because doing so is a form of 'criticism insurance' against claims made by various constituencies, including plan beneficiaries and state legislators. Additionally, plan trustees and managers often hire expert consultants, who are likely to provide common investment strategies to plan officials. In both of these respects, plan officials may defensibly claim to have relied on the prevailing wisdom on plan investment—in other words, they completed due diligence and invested prudently under the circumstances and given available information.").

fund industry and many pension plans are facing growing pressures from beneficiaries and other industry groups to follow suit.

In terms of assessing liquidity, alternative investments present similar complications. Many alternative investment options are less liquid than equities and bonds because those instruments are not as heavily traded and/or encompass long-term investments. However, pension plans have more latitude to invest in illiquid investment schemes as its underlying assets are not typically redeemable by beneficiaries until retirement. Challenges still arise with respect to the often opaque and inconsistent valuations of such illiquid instruments. Trustees may have limited expertise in assessing the value of exotic strategies. Retaining the requisite expertise to sufficiently do so can be prohibitively expensive. Making inaccurate predictions in this regard can cost beneficiaries billions of dollars in the long run, thereby widening the already increasing funding deficit tanking pension plans across the nation.

Some commentators have implicated Trustees for engaging in conflict of interest transactions by taking kickbacks from advisers in exchange for significant allocations to their hedge fund(s). Such kickbacks can include campaign contributions and board seats to members of a pension board at additional companies as well as future business dealings. A study summarized by the *Institutional Investor* found that:

> [T]he more members of a pension's board that are affiliated with a third-party service provider—including fund administrators, investment consultants, insurers, custodians and asset managers—the more likely they are to hire that firm. . . . [A]ffiliations could include a director hiring a fund manager they already know, or directors appointing fund managers in exchange for board seats at other organizations.[206]

Litigation also ensued after the New Mexico State Investment Council alleged that political insiders steered state investment money into hedge funds in exchange for receiving 25 percent of the fees received by such advisers.[207] According to the *Albuquerque Journal*, "[t]hose payments were disguised by a fee-sharing deal through a Chicago-based broker-dealer that passed 90 percent of the fees it received from [the adviser] to [the political insiders]."[208] Conflicts of interests of this nature can cause further declines in the overall portfolios of pension plans that get passed down to beneficiaries upon retirement.

To the extent such a conflict occurs, or other allegations of mismanagement, it can be very difficult for beneficiaries to bring such litigation due to the roadblocks potential plaintiffs face in proving standing. In order to demonstrate

206. Alicia McElhaney, *Board Conflicts of Interest Pose Threat to Pension Fund Returns*, INSTITUTIONAL INV'R (Feb. 27, 2018), https://www.institutionalinvestor.com/article/b173s0r46531dy/board-conflicts-of-interest-pose-threat-to-pension-fund-returns.

207. Robert A. Cronkleton & Ian Cummings, *New Mexico Sues Chiefs Owner Clark Hunt, Alleging Kickbacks in $300 Million Investment*, KAN. CITY STAR (Sept. 3, 2017, 12:00 PM), https://www.kansascity.com/sports/nfl/kansas-city-chiefs/article171107222.html.

208. *Id.* (citing Mike Gallagher, *SIC Sues Kansas City Chiefs Owner in Pay-to-Play Scandal*, ALBUQUERQUE J. (Sept. 1, 2017, 11:45 PM), https://www.abqjournal.com/1057513/sic-sues-kansas-city-chiefs-owner-in-paytoplay-scandal.html).

standing, courts often find that individuals must have suffered a substantial loss to retirement benefits actually received from their Trustee.[209] While these standing issues are largely outside the scope of this article, these difficulties are worsened by the limited transparency of hedge funds. Necessary information regarding Trustee relationships as well as cost structures and returns of comparable hedge funds are largely undisclosed to the general public. Even if they are voluntarily disclosed, they are reported in an unstandardized format making it difficult to make comparisons across a range of hedge funds. Such disclosures would have to be mandated through registration under the federal securities laws.

III. How Did We Get Here? An Institutional Theory Lens

Generally speaking, economically irrational hedge fund allocations seem to be enabled by the opacity of the industry. Trustees can effectively mask conflicts of interest or larger problems of underfunded plans by continuing to allocate to an industry that has failed to earn sufficient returns. Retail investors are thus exposed to an opaque and potentially harmful market even though federal securities laws are supposed to entitle such investors to an array of investor protection guarantees. Theories of institutional change, such as "conversion" and "drift," provide a novel and historical lens for assessing how lawmakers may have facilitated this regulatory loophole commonly referred to as "retailization" over extended periods of time. Part III.A thus commences with an in-depth description of the primary tenets of these two theoretical constructs, while explaining how they are distinctive from other more dominant theories of institutional change, such as rational choice institutionalism. Parts III.B and III.C then delve into the deeper theoretical analysis as to how lawmakers initially converted notions of publicness through "conversion" to allow retail investor exposure to private entities under certain circumstances. Part III.D underscores how these new definitions of publicness remained intact, despite increasing evidence of their ineffectiveness, thus generating "drift" within this succinct area of the law. All the while, traditional conceptions of investor protection have remained as an invariable component of federal securities laws irrespective of these hidden changes which have left many retail investors unduly exposed.

A. Historical Institutionalism, Conversion, and Drift

Political and social scientists have long studied the multidimensional factors that influence the extent to which institutions, such as formal laws and regulations, evolve over time and influence human interactions. Various schools have emerged from this broader theoretical construct, such as sociological, political, and rational choice institutionalism.[210] With respect to rational institutionalists,

209. Jacklyn Wille, *DOL Continues Uphill Battle on Pension Plan Standing*, Bloomberg (Oct. 21, 2016), https://www.bna.com/dol-continues-uphill-n57982078962/.

210. *See* Amenta & Ramsey, *supra* note 16, at 15–16; Béland, *supra* note 28, at 21–24.

they essentially believe that human beings are rational actors who engage in a series of cost-benefit analyses on an individual level in determining whether to take a particular course of action.[211] Institutions are therefore relevant in terms of how they influence strategic decisions on the part of human actors, such as lawmakers, interest group representatives, and other participants, in the development of institutional frameworks.[212] Public choice theorists similarly assert that lawmakers are entrenched by personal economic interests in deciding whether to pursue a particular legislative and/or regulatory course of action.[213] As such, regulatory capture often results from bureaucrats passing rules that benefit private interest groups to the detriment of the general populace with the hopes of creating future lucrative employment opportunities within such private industries.[214]

Historical institutionalism is yet an additional paradigm within this theoretical realm that relies on historical analysis to "trace the processes behind the creation and persistence of institutions and policies."[215] It is further rooted in the notion "that a historically constructed set of institutional constraints and opportunities affects the behavior of political actors and interest groups involved in the policy process."[216] Historical institutionalists effectively provide a "big-picture" overview of particular contexts or processes that transpire over time with respect to particular institutions.[217] These sorts of identified patterns may go largely unnoticed under other modes of analysis which may focus on the particular events surrounding the succinct institutional changes identified in the underlying study.[218] Moreover, historical institutionalists do not necessarily assume that human actors are naturally rule-abiding citizens on one end of the spectrum, or act in a completely self-interested manner on the opposing end of this same spectrum. But rather, such theorists emphasize the importance of history in identifying the appropriate context in which decisions occur over time, and that expectations with respect to such decisions are in part molded by these past experiences.[219]

Professor Thelen further developed a subset of this theory which is commonly referred to as "conversion."[220] Conversion generally occurs when political actors reinterpret ambiguous rules and redirect them toward new purposes.[221] Such

211. Peter A. Hall & Rosemary C. R. Taylor, *Political Science and the Three New Institutionalisms*, 44 POL. STUD. 936, 944–45 (1996).

212. *Id.* at 941, 946.

213. *See, e.g.*, Michael E. Levine, *Why Weren't the Airlines Regulated?*, 23 YALE J. ON REG. 269, 270–71 (2006); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3–4 (1971).

214. *See* Ernesto Dal Bo, *Regulatory Capture: A Review*, 22 OXFORD REV. ECON. POL'Y 203 (2006).

215. Amenta & Ramsey, *supra* note 16, at 16.

216. Béland, *supra* note 28, at 21.

217. *See* Amenta & Ramsey, *supra* note 16, at 23.

218. *See id.* at 25.

219. Sven Steinmo, *Historical Institutionalism*, *in* APPROACHES AND METHODOLOGIES IN THE SOCIAL SCIENCES 118, 126 (Donatella della Porta & Michael Keating eds., 2008).

220. *See* Thelen, *supra* note 17, at 225–26.

221. *Id.*

new purposes primarily include policies that extend beyond the original intent of the legislation in question.[222] Conversion is more apt to occur when the underlying legislation is ambiguous in nature, thus enabling the courts and/or bureaucratic administrative agencies to provide future interpretations that conflict with the law's original purpose.[223] Lawmakers are therefore empowered to exploit this ambiguity, perhaps at the urging of private interest groups, without having to initiate controversial amendments to the effectuating legislation. For instance, the Sherman Antitrust Act of 1890 was originally intended to prevent corporations from engaging in collusions and cartels.[224] Yet, affected corporations were able to utilize the courts to "redirect [this] legislation in their battles against trade unions whose organizing efforts were then similarly found to be 'in restraint of trade.'"[225] Parts III.B and III.C below will similarly assess the extent to which lawmakers converted notions of publicness under federal securities laws during two phases of regulatory and legislative enactments that occurred in the 1980s and 1990s, respectively.

Professor Hacker identified "drift" as an additional process through which the impact of a particular institutional framework weakens over time due to economic shifts or other societal changes. In broad strokes, drift refers to "systematic, prolonged failures of government to respond to the shifting realities of a dynamic economy."[226] More specifically, "[d]rift occurs when institutions or policies are deliberately held in place while their context shifts in ways that alter their effects."[227] Professor Hacker notably used this concept to explain how the law has perpetuated the severe wealth disparities between the wealthy and the disappearing middle class in this country.[228] For example, drift can be used to examine the government's failure to update the minimum wage laws to reflect economic changes in inflation rates.[229] Special interest groups successfully lobbied against substantial efforts to update these applicable laws. Part III.D below will similarly investigate the extent to which lawmakers have failed to update amended definitions of publicness in the face of increasing harms experienced by retail investor exposure to private investment funds.

Professors Hacker, Thelen, and Paul Pierson from the University of California at Berkeley have further explored the shared characteristics between conversion and drift in their often-cited piece, *Drift and Conversion: Hidden Faces of Institutional Change*.[230] Their collaboration reveals how drift and conversion both enable significant and often "hidden" changes in political outcomes even when their underlying institutions remain intact and relatively stable. These changes also occur during periods of stability, as opposed to being enacted in response

222. *See* Hacker, Pierson & Thelen, *supra* note 19, at 185.
223. *Id.*
224. *Id.* at 180–81.
225. *Id.* at 181 (quoting 15 U.S.C. § 1).
226. HACKER & PIERSON, *supra* note 22, at 43.
227. Hacker, Pierson & Thelen, *supra* note 19, at 180.
228. *See generally* HACKER & PIERSON, *supra* note 22, *passim*.
229. *See* Hacker, Pierson & Thelen, *supra* note 19, at 202.
230. *See id.* at 180–208.

to an exogenous shock or event that often triggers large-scale legislative amendments.[231] Organized interest groups have a distinct advantage over general voters in relying on these inconspicuous strategies. These groups deploy their ample resources in becoming "repeat players" to effectuate these sorts of strategic changes over extended periods of time.[232] The theoretical underpinnings of drift and conversion counter a strand of scholarship that concludes that most meaningful financial legislation is passed in response to a financial crisis or massive fraud. According to the authors, many institutional changes occur without extensive scrutiny from the general populace, thus reflecting the limited power of voters in certain contexts.[233]

B. Stage 1: Conversion of Publicness Through Adoption of Regulation D

Protecting investors from the ubiquitous abuses that led to the Great Depression was the primary goal of Congress in adopting the federal securities laws. In effectuating this goal, Congress incorporated the views implicit in a well-known quote by Louis D. Brandeis. He famously stated that "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman."[234] Broadcasting information to large audiences can serve to uncover malfeasance and bad behavior. Mandating the disclosure of such information can also be an effective tool in preemptively deterring private actors from engaging in fraudulent conduct. In a similar vein, infusing the markets with information was the mechanism through which the federal securities laws sought to protect investors. In a written message delivered to Congress, President Roosevelt stated that: "There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."[235] Representative Sam Rayburn echoed those concerns regarding informational disparity: "We have, on the one hand, 18,000,000 passive citizens having no actual contact with their companies; on the other hand, a few hundred powerful managers directing and controlling the destinies of the companies and the physical properties which they own."[236] Through the passage of the federal securities laws, retail investors are thus protected by a mandatory disclosure framework for public offerings.

These inaugural laws also included a series of exemptions, as it would be unfeasible to subject the entire universe of companies within the United States to

231. *See id.* at 181.
232. *See id.* at 198–203.
233. *See id.* at 190–91.
234. Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (Frederick A. Stokes Co. 1914).
235. 77 Cong. Rec. 937 (1933) (written statement of Pres. Roosevelt on the Regulation of Security Issues presented to the Senate on Mar. 29, 1933).
236. 77 Cong. Rec. 2918 (1933) (statement of Rep. Rayburn regarding H.R. 5480 on May 5, 1933).

regulation of this magnitude. As such, the federal securities laws are largely intended to cover only public offerings and companies. The definition of publicness however springs from a vague and ambiguous provision provided under the Securities Act, which presents fertile ground for conversion to occur within this niche area of the law.[237] As reiterated in the preceding section, conversion is more likely to transpire when provisions are ambiguous, making it easier for political actors to direct them to new purposes. Moreover, because publicness is defined haphazardly through exemptions (which will be further discussed below), it is significantly easier from a strategic standpoint for political actors to facilitate changes, without altering the original effectuating legislation.

Section 4(a)(2) of the Securities Act exempts from certain disclosure requirements "transactions by an issuer not involving any public offering."[238] The term "public" is not defined under the law, and the Securities Act's legislative history fails to illuminate Congress's intent in important regards. In adopting this provision, Congress simply documented that the law is not intended to regulate offerings "where the public benefits are too remote."[239] Countless interpretations arise from this vague description of publicness. It could encompass activities that have an adverse impact on the general public in some capacity, offerings that are open to large numbers of investors across numerous geographical areas, or offerings that raise a high amount of capital in total proceeds. This lack of clarity likely resulted from the rushed process through which this legislation was passed.[240] Roosevelt sought to quickly capitalize on the strong political support that resulted from the Great Depression.[241]

Due to the ambiguity of this provision, the SEC was then empowered to provide additional guidance in outlining the contours of a public offering. In 1935, the SEC published an interpretive release which instructed issuers to evaluate the following factors in determining whether an offering was public or private: "(1) [t]he number of offerees and their relationship to each other and to the issuer . . . (2) [t]he number of units offered . . . (3) [t]he size of the offering . . . [and] (4) [t]he manner of offering."[242] While the first factor (at least in part) seems to reference the access that offerees have to information regarding the issuer, the second and third factors seem to address the overall impact of the offering by referring to the number of units offered and its size. The fourth and final factor alludes to the ways in which the offering was advertised to prospective investors. A broad marketing campaign to a large number of offerees across multiple states likely entails a public offering in evaluating these factors.

237. 15 U.S.C. § 77d(a)(2) (2018).

238. *Id.*

239. H.R. Rep. No. 73-85, at 5 (1933) (setting forth recommendation of the Comm. on Interstate & Foreign Com. regarding H.R. 5480).

240. Joel Seligman, The Transformation of Wall Street 52 (3d ed. 2003) ("[President] Roosevelt was determined to draft and quickly submit to Congress a securities bill that could be voted on while he still enjoyed the extraordinary political support generated by the bank crisis.").

241. *Id.*

242. Letter of General Counsel, 11 Fed. Reg. 10952 (Sept. 27, 1946) (setting forth opinion dated Jan. 24, 1935).

However, in 1953, the Supreme Court famously emphasized the importance of focusing on the status of offerees in determining whether an offering was indeed public.[243] In *SEC v. Ralston Purina Co.*, the Supreme Court held that an offering to those who can "fend for themselves is a transaction 'not involving any public offering.'"[244] The Court effectively reasoned that, if offerees have access to the same type of information that would be available in a registration statement, then they do not need the protections guaranteed under the federal securities laws.[245] Executive employees of the issuer could appropriately fend for themselves given their direct access to material information related to the issuer.[246] The Court further implied that the size of the offering, in terms of its total offerees, size, and units, is not as relevant in determining whether it is considered public.[247] An offering to a single offeree who is unable to fend for himself could constitute a public offering under the Court's approach. Conversely, an offering to thousands of investors, who could each fend for herself, could still be considered a private offering, and thus exempt from certain disclosure requirements. Following this decision, it was clear that evaluating the status of offerees was the primary determinant of whether an offering would be deemed public.

The 1980s ushered in a new era of political ideology that was largely driven by proponents of free markets and individualism. These advocates shunned the New Deal approach of government regulation over a wide range of private actors and instead opted for a deregulatory agenda which "recaptured political and intellectual influence in America, England, and within a decade, most of the first-world countries."[248] This shift in political ideology precipitated new changes to the definition of publicness and further nourished the terrain for conversion to transpire and alter the definition of publicness. A triggering factor of conversion is referred to as "*actor discontinuity*" where political "actors not involved in (in some cases not even around for) those rules' creation seek to redirect them toward new ends."[249] The administration led by President Ronald Reagan played a major role in influencing the deregulatory approach that unfolded into various areas of the law, including the definition of publicness under federal securities laws. As one author noted, "[t]his state of experimentation reflected the transition from the activist, regulatory-minded SEC of the 1970s to the more deregulatory SEC of the 1980s. . . . The SEC was given an additional push in the early 1980s by . . . the deregulatory force of the new Reagan administration."[250]

243. SEC v. Ralston Purina Co., 346 U.S. 119, 124–27 (1953).

244. *Id.* at 125 (quoting 15 U.S.C. § 77d(a)(2)).

245. *Id.* at 125–26.

246. *Id.*

247. *Id.* at 125.

248. Charles R.T. O'Kelley & Robert B. Thompson, Corporations and Other Business Associations: Cases and Materials 5–6 (6th ed. 2010).

249. Hacker, Pierson & Thelen, *supra* note 19, at 184.

250. Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 Wash. U. L.Q. 225, 237–38 (1990) (footnotes omitted).

As such, in 1982, the SEC promulgated Regulation D, which is a safe harbor that made it even easier for issuers to structure private placement offerings.[251] Among the rules included within this regulation are Rules 504 and 506.[252] Rule 504 imposes restrictions on the amount that may be raised and on how the offering may be advertised; Rule 506 does not limit the amount that may be raised, but does impose restrictions on the number and status of purchasers and on how the offering may be advertised.[253] With respect to the status of purchasers, Regulation D coined a new term, "accredited investor," which provides a more bright line and expansive definition of purchasers who can adequately fend for themselves.[254] Individuals who earn over $200,000 per year, as well as a variety of institutions, are included in this definition.[255] But more importantly, this new definition of accredited investor added pension plans, endowments, and other institutional investors that serve underlying retail investor beneficiaries.[256] This exclusion fostered the final stage of conversion in this era where Regulation D converted original notions of publicness under the Securities Act to exclude large groups of retail investors from its investor protection guarantees. Moreover, under Rule 506, if issuers restrict offerings to accredited investors (among other requirements), they can raise an unlimited amount of capital. These changes precipitated massive growth in a wide breadth of private industries, which rival in size and breadth to public companies, thus contributing to the harms discussed herein with respect to retail investor exposure to private hedge funds.

C. Stage 2: Further Conversion of Publicness Through Passage of the National Securities Markets Improvements Act of 1996

Publicness is further defined through a series of exemptions provided under the 1940 Act, which creates additional layers of regulation for pooled investment vehicles. Private Funds have historically relied on section 3(c)(1) of the 1940 Act to avoid its registration requirements by restricting the number of fund investors to one hundred beneficial owners.[257] Funds that rely on section 3(c)(1) must simultaneously restrict offerings to accredited investors, and are likewise restricted

251. 17 C.F.R. §§ 230.500–.508 (2019).

252. *Id.* §§ 230.504, 230.506. In 2016, the SEC removed and reserved Rule 505. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83494, 83553 (Nov. 21, 2016) (to be codified at 17 C.F.R. pts. 200, 230, 239, 240, 249, 270 & 275).

253. 17 C.F.R. §§ 230.504, 230.506 (2019).

254. *Id.* § 230.501(a).

255. *Id.* The SEC may however lower the accredited investor standard in the near future as, "Chairman Clayton [announced] that the SEC plans to issue a white paper and seek public comment on how best to revamp the capital-raising process. According to Clayton, this could include liberalizing the 'accredited investor' standard that currently locks millions of middle-class Americans out of some of the most lucrative investment opportunities." Daniel Press, *Securities and Exchange Commission Seeks to Liberalize 'Accredited Investor' Standard*, Competitive Enter. Inst. (Aug. 31, 2018), https://cei.org/blog/securities-and-exchange-commission-seeks-liberalize-accredited-investor-standard.

256. 17 C.F.R. § 230.501(a) (2019).

257. 15 U.S.C. § 80a-3(c)(1) (2018).

from "propos[ing] to make a public offering of its securities."[258] This primary emphasis on number of investors in defining the contours of publicness reflects the commonly held notion that smaller pools are less likely to have an adverse spillover effect on the general public. This belief was reflected in the following language retrieved from congressional hearings on the passage of the 1940 Act:

> A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.[259]

In summary, a fund restricting its beneficial owners to less than one hundred security holders would have been considered private irrespective of its underlying activities.[260]

The 1990s however was characterized by yet an additional period of deregulatory initiatives that served to further convert notions of publicness under the 1940 Act. Economic growth initially fueled the mounting popularity of these ideologies. Moreover, such ideologies were carried out by a Republican-controlled House that prioritized deregulation of business, even with President Clinton defeating his Republican opponent in 1996.[261] In assessing the impact to the 1940 Act, President Clinton signed into law the National Securities Markets Improvement Act of 1996 ("NSMIA"), which sought "to amend the [1940 Act] to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation."[262] A new section 3(c)(7) exemption was adopted under NSMIA where funds that restrict offerings to "qualified purchasers" are considered private.[263] Qualified purchasers are similar to accredited investors, but they are subject to higher net-worth requirements.[264] They include any institution (or natural person) that owns not less than $5,000,000 in investments.[265] Qualified purchasers of course include large numbers of pension plans and other institutional investors with retail investor exposure. If a fund restricts the status of its purchasers in this manner, then the fund could raise an unlimited amount of capital from an unlimited number of qualified purchasers without having to register under the 1940 Act.[266]

258. *Id.*

259. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before Subcomm. of the Comm. on Banking & Currency*, 76th Cong., 3d Sess. 179 (1940) (quoting David Schenker, Chief Counsel, Inv. Tr. Study, U.S. Sec. & Exch. Comm'n).

260. PROTECTING INVESTORS STUDY, *supra* note 55, at 105.

261. *See* Johnson, *supra* note 29, at 184–85.

262. Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996) (quoting introductory language of the NSMIA).

263. 15 U.S.C. § 80a-3(c)(7) (2018).

264. *Id.* § 80a-2(a)(51)(A)(i).

265. *Id.*

266. In order to simultaneously maintain exemptions under the Exchange Act, a hedge fund must also restrict its number of investors to less than 2,000. 15 U.S.C. § 78*l*(g) (2018).

These revisions resulted in the conversion of initial notions of publicness within the investment fund industry, which originally emphasized smaller pools and investor protection guarantees to retail investors. Despite the clear investor protection violations that could arise from this massive loophole, the SEC's Division of Investment Management supported the adoption of such an exemption. In 1992, "the Division recommend[ed] an amendment to the [1940] Act to create a new exception for funds whose securities are held exclusively by 'qualified purchasers' . . . premised on the theory that 'qualified purchasers' do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance, and leverage."[267] This statement served to reinforce traditional notions of investor protection that are deeply embedded within the law, even though such an exemption would simultaneously strip away such guarantees for certain investors. One could assume that institutional investors would effectively pass along their resources and sophistication to underlying retail investors by selecting sound investments on their behalf. But Part II above summarizes the extensive evidence that proves that many such institutional investors are ill-equipped to perform this task. This seems to be a classic case of conversion where fundamental legislation and/or policy remains intact despite massive "hidden" amendments that may occur through bureaucratic layers of regulation that go unnoticed by the general populace.

D. Stage 3: Lawmakers Fail to Update Amended Definitions of Publicness Resulting in Drift

Converting the definition of publicness as discussed in the foregoing sections was followed by a period of "drift," where lawmakers failed to update the amended definitions to resolve the increasing retail investor exposure to hedge funds. As stated by Professor Hacker, drift refers to "changes in the operation or effect of policies that occur without significant changes in those policies' structure."[268] He further explains that drift extends beyond a simple case of political inaction and requires that:

> (1) the circumstances around policies or institutions change in ways that alter the effects of those policies or institutions on the ground, (2) this change in outcomes is recognized, (3) there are alternative rules that would reduce the degree to which these shifts in outcomes occur (in other words, that the shifts are *potentially* remediable), and (4) efforts to update these rules are not undertaken or are blocked.[269]

External shifts such as inflation, technological change, or financial innovation frequently trigger drift as lawmakers encounter a range of roadblocks in responding to such changes.[270]

267. Protecting Investors Study, *supra* note 55, at 104–05.
268. Hacker, *supra* note 21, at 246.
269. Hacker, Pierson & Thelen, *supra* note 19, at 184.
270. *Id.* at 193–95.

In assessing this first condition, according to at least one commentator, the adoption of section 3(c)(7) facilitated rapid growth in the hedge fund industry so that, "[b]y 2000, the . . . industry had grown to manage $491 billion, more than 10 times the amount from a decade earlier, according to HFR data."[271] Hedge fund growth alone is not problematic if it was solely fueled by wealthy individuals or institutions that could bear the full risk of any losses associated with such private investments. Fiduciary Investors, however, were the primary drivers of this growth. Moreover, as discussed at length in Part II, Fiduciary Investors have encountered significant difficulties in selecting optimal hedge fund allocations. Trustees seemly rely on the opacity of the industry to mask larger problems of underfunded pools fueled in part by poor investment decisions and a growing number of retirees. Negotiating for lower fees via contract has not resulted in a sufficient decline in collective fees charged by the industry given the uneven bargaining power held by Fiduciary Investors. Many such institutions may simply lack the expertise to properly assess hedge funds given the complexities of the industry's trading strategies, as well as its unstandardized mechanisms for reporting fees and performance.

With respect to determining whether this change in outcomes is recognized, which is the second requirement for drift, several regulators, commentators, and industry participants have acknowledged the growing need to address the harms resulting from retailization.[272] In a study published in 2003, the SEC staff found that:

> Although these institutions typically qualify as "accredited investors" or "qualified purchasers," these institutions, by investing in hedge funds, expose their participants or other beneficiaries to hedge funds. Thus, for example, a pension plan that experiences substantial losses as a result of hedge fund fraud may be unable to meet its obligations to pensioners.[273]

The staff further concluded that the exemptions that enable retailization make it difficult for the SEC to anticipate and/or protect retail investors from inadvertent exposure to hedge fund losses.[274] Orice M. Williams, a GAO representative, similarly found that many Fiduciary Investors lack the expertise to appropriately understand hedge funds' complex valuation mechanisms, strategies, and fees,

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271. Levy, *supra* note 171.

272. *See, e.g.*, *The Recent Developments in Hedge Funds: Hearing Before S. Comm. on Banking, Housing & Urb. Affairs*, 108th Cong., 1st Sess. 32–39 (2003) (statement of William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n); Alexander R. Roche, Comment, *The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt to Regulate Hedge Funds and What It Missed*, 33 U. Dayton L. Rev. 145, 153–54 (2007) (acknowledging the SEC's concerns regarding indirect retail investor exposure to hedge funds and other alternative investments).

273. Implications of the Growth of Hedge Funds, *supra* note 61, at 82.

274. *Id.* at 82–83 ("The collective indirect investment of the assets of less sophisticated individuals into vehicles that are managed by entities that are not examined by the Commission leaves open the possibility that the Commission will be unable to anticipate problems involving hedge funds that may invest on behalf of these institutions.").

exposing its retail investor beneficiaries to undue harm.[275] Professor Jennifer Taub from Vermont Law School has even advocated that hedge funds be brought into the purview of the 1940 Act, at least in part to provide investors with protections that extend beyond material disclosures, such as capital constraints and restrictions on conflict of interest transactions.[276]

However, many scholars have dismissed the harms created by retailization because such an acknowledgement would perhaps place them in the precarious position of dismantling historic notions of investor protection. Such principles presume that institutional investors should have the resources to protect themselves (understandably so), and that regulators should not devote limited resources to protecting such wealthy individuals and prestigious institutions. In a similar vein, other scholars have dismissed the magnitude of retailization, predicting that a minimal number of Fiduciary Inventors have exposure to such alternative investments.

A profusion of scholarly research has thus separated the harms resulting from retailization and systemic risk. Such scholars have primarily focused on how the law should be updated to regulate the growing threat of systemic risk, and many such solutions have sought to navigate how the fractured nature of our regulatory system could effectively regulate the blurred distinctions between hedge funds and banks.[277] For instance, Professors John C. Coffee and Hillary Sale rejected the notion that the SEC should extend its existing authority to protect the general public against systemically harmful hedge funds, given the SEC's limited expertise in this area. They instead proposed that "the Federal Reserve [be granted] authority to monitor and restrict the leverage of all financial institutions that are 'too big to fail'"[278] in part because "banking regulators have the natural comparative advantage in this area."[279] Other scholars have emphasized the need for consolidation of regulatory agencies, such as the SEC and CFTC, because systemic risk can be transmitted through a variety of channels and financial

275. *See Perspectives on Hedge Fund Registration: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov. Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong., 1st Sess. 136–53 (2009) (statement of Orice M. Williams, Dir., Fin. Mkts. & Cmty. Inv.).

276. Jennifer Taub, Recommendations for Reality-Based Regulatory Reform of Hedge Funds and Other Private Pools of Capital 2, 3 (Oct. 21, 2009) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1543862.

277. Martin Shelby, *supra* note 59, at 666–67 ("With respect to the federal securities laws, the SEC holds primary responsibility for regulating the securities industry and protecting investors, while the Commodity Futures Trading Commission ('CFTC') regulates commodity futures markets and the bulk of OTC derivatives. . . . These agencies further delegate certain regulatory functions to self-regulatory organizations such as the Financial Industry Regulatory Authority ('FINRA') and the National Futures Association ('NFA'), which create additional registration requirements for industry participants. With respect to the banking industry, the FDIC and the Federal Reserve are the administrative bodies charged with monitoring the banking system and monetary policies. The Federal Reserve must frequently work with the Department of the Treasury in ensuring the nation's financial stability." (footnotes omitted)).

278. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 776 (2009).

279. *Id.* at 777.

instruments.[280] Researchers have also proposed creating yet an additional administrative entity that would act as an omnipresent regulator of all systemically harmful financial institutions.[281]

In skipping to the fourth requirement for drift, which examines whether efforts to update these rules have failed, the Dodd-Frank Act was similarly focused on regulating large and interconnected financial institutions to prevent the creation and transmission of systemic risk, with a minimal focus on resolving retailization. Although banks were identified as being the primary culprit of the financial crisis that precipitated this legislation, hedge funds were swept in due to their abilities to take on unlimited leverage and to trade in risky financial instruments. Systemic risk prevention took center stage as systemically harmful hedge funds can be subject to prudential "bank-like" regulation by the Financial Stability Oversight Council ("FSOC").[282] However, FSOC has yet to identify a hedge fund as being systemically harmful and with the influence of the current Trump administration, it is unclear whether FSOC will maintain its existing power to regulate systemically harmful financial institutions.

Other components of the Dodd-Frank Act increased hedge fund disclosures to a degree because many hedge fund advisers must now register under the Advisers Act.[283] This could partially mitigate the harms resulting from retailization due to the increased transparency guarantees provided under this law. Registered advisers must provide disclosures to their clients regarding their underlying advisory business.[284] These disclosures include material information relating to their business practices, fees, disciplinary history, certain conflicts of interest, and other material information.[285] In addition, they have heightened fiduciary duties to act in the best interests of their clients when dispensing investment advice.[286] Yet, the Dodd-Frank Act does not require standardization with respect to valuations, fees, or risk, which would provide meaningful protections to hedge fund investors who are perhaps incapable of optimizing hedge fund investments. The Advisers Act is likewise limited in its ability to require specific transparency mandates related to the underlying strategies and holdings of such private investment vehicles.

280. Roberta S. Karmel, *The Future of the Securities and Exchange Commission as a Market Regulator*, 78 U. Cin. L. Rev. 501, 533–34 (2009).

281. *See, e.g.*, Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 Ohio St. L.J. 1087, 1113–19 (2015); Alan Beattie & Sarah O'Connor, *Bernanke Calls for Powerful Regulator*, Fin. Times (Mar. 10, 2009), https://www.ft.com/content/6d4f943a-0d6e-11de-8914-0000779fd2ac.

282. 12 U.S.C. § 5321 (2018); *Financial Stability Oversight Council*, U.S. Dep't Treas., http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx (last visited Mar. 19, 2019).

283. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (amending 15 U.S.C. § 80b-3(b) to limit or eliminate certain exemptions).

284. 15 U.S.C. § 80b-3 (2018).

285. *Id.*; *see also Fast Answers: Form ADV*, U.S. Sec. & Exchange Commission (Mar. 11, 2011), https://www.sec.gov/fast-answers/answersformadvhtm.html.

286. *See* 15 U.S.C. § 80b-3 (2018); *see also SEC Fiduciary Standard*, Inv. Adviser Ass'n, https://www.investmentadviser.org/home/side-content/sec-standard (last visited Mar. 19, 2019).

There are a range of alternative rules that would swiftly reduce the harms resulting from retailization, implicating the final requirement for drift. One such solution would entail simply prohibiting Fiduciary Investors from investing in hedge funds and other alternative asset vehicles. This is an unlikely scenario, however, given the severe costs to hedge funds of completely eliminating such a large class of its investors from the industry. Including a degree of alternative asset exposure in Fiduciary Investor portfolios could also be beneficial to retail investors who are seeking additional protections in declining markets. While the research is divided as to whether hedge fund advisers can successfully do this, additional disclosure obligations for such alternative investments could perhaps assist Fiduciary Investors in selecting optimal investments during these time periods. On the other end of the spectrum, the law could be updated to subject hedge funds to enhanced regulation under the 1940 Act if they are available for investment by Fiduciary Investors. Each of these solutions, however, would further entail a direct onslaught of investor protection principles by countering the strongly held notion that such institutional investors can appropriately fend for themselves. Moreover, such a proposal will not likely succeed during the current administration given its free-market ideology.

New evidence on the severity of the hedge fund conundrum may sway scholars and lawmakers to fully digest the risks of retailization in the event that the administration converts to being pro-regulation in the near future. Even still, hedge fund advisers are powerful repeat players in advocating for beneficial regulatory outcomes. In 2015, for example, hedge funds spent $7.34 million in lobbying activities.[287] Moreover, "[h]edge funds delivered $52 million to candidates during the 2014 midterms" and "are wildly distorting democratic governmental processes for their own benefit."[288] An additional source provides that:

> Whereas in 1990 hedge fund managers contributed just $125,000, this sum increased to $1.6 million in 1996, to over $4 million in 2002 and then to over $19 million in 2008. In the 2012 election cycle hedge funds contributed over $32 million—24 percent to Democrats and 76 percent to Republicans. Private equity and investment firms contributed over $54 million . . . . These are still comparably small shares of total party contributions, but they are rising fast.[289]

Part IV below will discuss a well-tailored solution that concedes the unlikelihood of subjecting hedge funds to direct regulation, while relying on conversion in the development of an institutional framework that could successfully resolve the hedge fund conundrum.

287. David Dayen, *What Good Are Hedge Funds?*, AM. PROSPECT (Apr. 25, 2016), http://prospect.org/article/what-good-are-hedge-funds.

288. *Id.* (quoting, in the second instance, Michael Kink of Strong Economy for All).

289. Fichtner, *supra* note 180, at 17 (citing *Hedge Funds: Long-Term Contribution Trends*, CTR. FOR RESPONSIVE POLITICS, http://www.opensecrets.org/industries/totals.php?cycle=2012&ind=F2700 (last visited Mar. 20, 2019)).

IV. Conversion as a Well-Tailored Solution

Although developing a detailed solution is largely outside the scope of this article, Part IV explores the extent to which actors can rely on conversion to develop unique and well-tailored solutions to the hedge fund conundrum discussed herein. Part IV.A summarizes preliminary thoughts on Prong 1 which entails loosening section 18 capital restrictions under the 1940 Act to increase investor protection for Fiduciary Investors interested in allocating to innovative "hedge-fund-like" strategies. If Fiduciary Investors continue to allocate to hedge funds in an inefficient manner however, then, as addressed in Part IV.B., Congress should consider implementing Prong 2, which involves taking more drastic measures to further protect underlying retail investor beneficiaries from excessive fees and subpar returns. Part IV.C attempts to address potential drawbacks to this proposal, which include a possible increase in speculative trading activities that may result from loosening these restrictions. Additional benefits could counter these drawbacks, such as lower hedge fund fees and/or weeding out low-performing hedge funds resulting from an increase in competition for trading innovative strategies in regulated markets.

A. Prong 1: Converting Section 18 Capital Restrictions Under the 1940 Act

The historical institutionalist analysis provided above infers that conversion and drift are inevitable aspects of the development of the law, akin to the business cycle which naturally moves through the economy irrespective of government or private interventions. Institutional design strategies exist that could admittedly reduce the likelihood of conversion, such as creating more unambiguous laws and increasing oversight over administrative agencies.[290] However, more clearly defined provisions that specifically outline covered activities are more likely to lead to drift, i.e., laws failing to adapt to shifting realities, as they would be more difficult to amend and less responsive to changed circumstances.[291] On the other hand, preventing drift would entail building in a degree of automation to existing rules so that future administrations are forced to update underlying provisions periodically.[292] But providing lawmakers with this inherent flexibility to amend laws could expose such laws to conversion, i.e., political actors redirecting laws to meet divergent goals, as they may utilize this power to convert its original purposes.[293]

Given the ubiquity of drift and conversion, Professor Hacker suggests that "actors who wish to change popular and embedded institutions in political environments that militate against authoritative reform may find it prudent *not* to attack

290. Hacker, Pierson & Thelen, *supra* note 19, at 189.

291. *See id.* (contending that specific and detailed laws, while less susceptible to conversion, are "potentially more vulnerable to drift . . . because what is not *in* the rule is also not covered *by* the rule").

292. *Id.* at 190–91.

293. *Id.*

such institutions directly."[294] He further advises that, "[i]nstead, they may seek to shift those institutions' ground-level operation, prevent their adaptation to shifting external circumstances, or build new institutions on top of them."[295] Thus, actors who wish to resolve the hedge fund conundrum should refrain from proposing drastic regulatory solutions that serve to directly attack investor protection. Instead, such actors should perhaps utilize conversion or drift to redirect existing legislation under various aspects of the federal securities laws to new purposes.

One such example would entail relying on conversion to redirect provisions under the 1940 Act to create additional leeway for mutual funds to compete with hedge funds in pursuing more innovative strategies. In particular, section 18 imposes a series of capital restrictions that hinder mutual fund advisers from pursuing innovative strategies involving short-trading and illiquid instruments.[296] For instance, under the section 18 restrictions on indebtedness, mutual funds must sufficiently "cover" any derivative positions by earmarking or segregating liquid securities equal in value to the fund's potential exposure from the leveraged transaction.[297] Reserving such a large portion of cash reserves to cover any and all potential losses is simply not a viable investment scheme for most vehicles. As such, mutual fund advisers limit the extent to which their vehicles rely on derivatives to pursue innovative strategies or to hedge against risk. Loosening these restrictions to a degree would create additional opportunities for Fiduciary Investors to earn returns in declining markets and to diversify within more regulated spaces.

While such a conversionist tactic appears to align with free-market ideologies by eroding investor protections for mutual fund investors, it inadvertently creates a regulated hedge fund market (at least in part) without pressuring Congress to directly impose such regulation on these private entities. And because mutual funds are subject to the detailed registration requirements under the 1940 Act, retail investors would still be given appropriate investor protections through mandated disclosures and other heightened governance requirements.[298] Fiduciary Investors would therefore be free to invest in alternative investments that

294. Hacker, *supra* note 21, at 244.

295. *Id.*

296. 15 U.S.C. § 80a–18 (2018).

297. *See id.*; Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25128, 25132 (Apr. 27, 1979) (to be codified at 17 C.F.R. pt. 271).

298. Other scholars have proposed comparable solutions which similarly advocate that retail investors gain indirect access to innovative strategies. *See, e.g.*, Gubler, *supra* note 29, at 804–05 ("Thus, the only reasonable second-order solution to the crowding-out problem is one that attempts to give retail investors access to this market while addressing the information and liquidity issues presented by the private securities market. To this end, we might want to think about increasing retail investors' indirect access to the private securities markets, as opposed to direct access. Most Americans' stock ownership is indirect anyway . . . . Moreover, investing in private securities through mutual funds would allow the retail investor to have a more diversified portfolio of these securities, thereby reducing the risks that would result from opening up direct access to the private securities markets."); Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. Legis. & Pub. Pol'y 251, 309–10 (2008) (proposing the creation of "a retail [Fund of Hedge Funds ('FOHF')] that raises capital through a private placement to an underwriter (or syndicate of underwrit-

are fully transparent and standardized, making it easier to identify such optimal investment strategies, while weeding out those that are subpar.[299] This assumes that some innovations currently utilized by hedge funds are helpful in producing returns in bear markets that are collectively declining in value. Such a protectionist strategy should presumably be available to retail investors in light of the bear market that we will inevitably encounter in the future. Loosening (but not eliminating) section 18 restrictions would allow retail investor access to these strategies while providing such investors with attendant investor protection guarantees.

The section 18 provisions are also relatively antiquated, so urging the revision of these provisions seems to be a necessary endeavor, as opposed to a direct onslaught on investors protection. Such an approach would also make it easier for underlying retail beneficiaries to hold Trustees accountable for conflicts of interest and other potential fiduciary breaches that were previously shrouded in secrecy. It would improve the transparency of an essential subset of alternative investments that enable economically irrational allocations. In many ways, this approach extends the theoretical framework of conversion by urging actors to utilize seemingly opposing regulatory approaches to achieve their purported goals.

B. Prong 2: Excluding Fiduciary Investors from Private Fund Access

If Fiduciary Investors continued allocating to hedge funds in an inefficient manner, despite the increased access to protectionist strategies granted under Prong 1 above, then Congress should consider taking more drastic measures to further protect underlying retail investor beneficiaries from excessive fees and subpar returns. Such drastic measures would directly exclude Fiduciary Investors from accessing Private Funds altogether. Carving out Fiduciary Investors from the definitions of "accredited investor" under Regulation D and "qualified purchaser" under the 1940 Act would automatically serve this end. Congress would have to initiate such amendments as the SEC would probably exceed its regulatory authority in doing so.

Adopting such an extreme solution would be met with more stringent opposition from the hedge fund industry as institutional investors, such as pension plans, endowments, and foundations, comprise the bulk of hedge fund allocators. Eliminating such a large portion of hedge fund investors would likely re-

ers) who, in turn, lists the securities of the retail FOHF on a trading platform accessible only by sophisticated investors").

299. The successful implementation of Prong 1 would likely require the retooling of certain tax laws that serve to incentivize allocations to hedge funds. *See, e.g.*, Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap*, 65 Ala. L. Rev. 139, 184 (2013) ("Forced realization income exists as a result of the combination of mutual funds' obligation to redeem shareholders on demand and the requirement that they distribute substantially all of their capital gains. These two requirements, separately, cause mutual funds to approximate direct investments, but as a result of their interaction, mutual fund investors face additional tax costs that rich investors can avoid.").

quire an exogenous shock, such as a financial crisis or massive fraud, in order to justify the accompanying costs. A regulatory solution of this nature would also directly challenge the long-held belief, which is an intrinsic component of the investor protection paradigm, that Fiduciary Investors are fully capable of fending for themselves and thereby protecting underlying retail investor beneficiaries. Imposing such a radical regulatory solution would necessarily require a change in the political ideology of our current administration, which is rooted in free-market principles. Nevertheless, Prong 2 should be considered by Congress if recalibrating section 18 capital restrictions fails to deter Fiduciary Investors from allocating to low-performing hedge funds with excessive fee levels.

C. Potential Drawbacks and Additional Benefits

Loosening the section 18 restrictions provided in Prong 1 above could undeniably result in unintended consequences related to compromising market integrity and exposing investors to undue risk. Permitting mutual funds to trade more derivatives for instance could increase collective levels of speculative trading activities in the broader capital markets. John Bogle, a prominent expert in the mutual fund industry, has explored the risks of increasing speculation in the broader economy in prior works.[300] Exclusively profiting from the short-term prices movements in instruments, as opposed to making long-term investments in companies, could arguably compromise economic growth. Moreover, actively traded mutual fund advisers have been subject to extensive critiques in terms of their abilities to earn above-market returns, as well as the extent to which such advisers charge similarly excessive fees.

Excessive speculation could however be resolved by implementing the regulatory solution set forth under Prong 2 above. Congress should thus explore implementing this solution as a means to bolster market integrity in addition to enhancing investor protection. Excluding Fiduciary Investor access to Private Funds would likely decrease overall speculation because hedge funds can freely utilize derivatives and leverage to engage in speculative trading strategies. Closing the systemic risk loopholes within the hedge fund industry that have been left unresolved under the Dodd-Frank Act is yet an additional solution that should be explored by Congress in response to excessive speculation.[301] Scaled regulation under the 1940 Act for hedge funds could serve as a unique and effective mechanism in protecting against systemic risk. For instance, hedge funds that exceed a certain size could be subject to a range of disclosure requirements and/or capital constraints provided under section 18 of the 1940 Act.

The extensive investor protection guarantees provided under the 1940 Act and other federal securities laws naturally provide greater protections against excessive risk-taking on the part of mutual fund advisers. They, along with their

300. *See, e.g.*, John C. Bogle, The Clash of Cultures: Investment vs. Speculation *passim* (2012) (expressing concerns regarding excessive speculation which can divert capital from its optimal use).

301. *See* Martin Shelby, *supra* note 59, at 682, 684–87, 698–700 (proposing an SEC mandated regulatory framework for systemically harmful hedge funds).

underlying funds, would still be subject to extensive disclosure requirements, standardized valuation procedures, and enhanced governance requirements to protect against conflicts of interest. Many of the harms associated with excessive trading of derivatives were related to the opacity in which these markets were permitted to function, which served to obscure valuations and risk.[302] Mutual fund fees are also collectively lower than hedge fund fees because most are not permitted to charge separate performance fees. Such advisers have fewer opportunities for charging hidden fees given their extensive disclosure obligations which also obligate standardized reporting mechanisms. Measuring the extent to which actively traded mutual fund advisers can earn above-market returns in a variety of market conditions should be an ongoing task on the part of regulators and researchers. Increasing transparency with respect to the subset of innovative strategies permitted under this approach would greatly assist researchers in this regard.

Any such loosening of section 18 provisions should be further accompanied by a degree of automation where a team of experts within the SEC is obligated to review and update such provisions periodically, perhaps every four years. The SEC's Division of Economic and Risk Analysis should undertake this task as this relatively new "think tank" division "relies on a variety of academic disciplines, quantitative and non-quantitative approaches, and knowledge of market institutions and practices to help the Commission approach complex matters in a fresh light."[303] Incorporating a team of experts in this regard would reduce drift and would ensure that the best and brightest are charged with protecting against speculation in reviewing the section 18 restrictions.

Generally speaking, increasing competition with respect to innovative strategies could effectually lower the fees charged by hedge fund advisers and similarly reduce the wealth gap created by these unfettered opportunities to charge excessive fees.[304] Increasing the number of entrants to these niche markets would effectually lower fees because a larger number of advisers would be competing for the same pools of investors. Creating a pathway for more regulated funds to compete in this space would likewise make it easier for investors to pay advisory

302. *See, e.g.*, Steve Denning, *Big Banks and Derivatives: Why Another Financial Crisis Is Inevitable*, FORBES (Jan. 8, 2013, 6:26 PM), https://www.forbes.com/sites/stevedenning/2013/01/08/five-years-after-the-financial-meltdown-the-water-is-still-full-of-big-sharks/#7ee9bf9a3a41; Sarah H. Wright, *Explaining the Credit Crunch*, NAT'L BUREAU ECON. RES., http://www.nber.org/digest/mar09/w14612.html (last visited Mar. 19, 2019).

303. *About the Division of Economic and Risk Analysis*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/dera/about (last modified Jan. 18, 2017).

304. Jonathan Rothwell, *Make Elites Compete: Why the 1% Earn So Much and What to Do About It*, BROOKINGS INST. (Mar. 25, 2016), https://www.brookings.edu/research/make-elites-compete-why-the-1-earn-so-much-and-what-to-do-about-it/ ("The law has also inflated the compensation of hedge fund workers—roughly $500,000 on average—by restricting competition. Mutual funds—which charge tiny fees by comparison—are currently barred from using hedge fund strategies because they have non-rich investors. If the law was changed to allow mutual funds to offer hedge fund portfolios, hundreds of billions of dollars would be transferred annually from super-rich hedge fund managers and investment bankers to ordinary investors, and even low-income workers with retirement plans.").

fees that more closely match the skillsets offered by such advisers. Economic theory similarly posits that increasing competition has the effect of reducing wealth inequality. A study published by the Organization for Economic Cooperation and Development found that:

> Market power may contribute substantially to wealth inequality, augmenting wealth of the richest 10% of the population by 12% to 21% for an average country in the sample. . . . Sources of market power vary, and many are generally considered legitimate such as intellectual property protection for products, processes or brands. But violations of competition law, government-created barriers to entry or natural monopolies may be significant sources of market power.[305]

This study further reiterated the need for policymakers to reshift focus toward laws that increase competition as a means to reduce income inequality, as opposed to the standard "wealth redistribution" policies that are repeatedly proposed and debated by scholars/commentators in this area.[306]

Conclusion

This article dissects the severity of the hedge fund conundrum which has unduly exposed retail investors to excessive losses. Fiduciary Investors, such as pension plans, endowments, and charitable foundations, have extensively allocated to hedge funds despite increasing reports of poor returns. Even if hedge funds can earn superior returns in declining markets, Fiduciary Investors do not seem to possess the tools for effectively navigating the opacity of the industry. Historical institutionalism provides a novel framework for revealing the extent to which lawmakers may have enabled a conundrum of this nature across extended periods of time. By and large, lawmakers converted original notions of publicness under federal securities laws by expanding indirect retail investor access to private investments. Lawmakers then failed to update these amended definitions of publicness despite growing evidence of the harms resulting from retailization. Examining how institutions have evolved throughout history provides hints as to what solutions would be successful in the current political and economic climate. Subjecting hedge funds to direct regulation would likely be unsuccessful given the industry's repeated success in advocating for favorable regulatory outcomes. Instead, regulators could create a regulated market for "hedge-fund-like" strategies by loosening the section 18 capital restrictions that currently apply to mutual funds. Such a strategy would ensure that Fiduciary Investors can successfully access opportunities for wealth maximization during declining markets, while providing retail investors with the investor protection guarantees that they are entitled to under the federal securities laws. If the hedge fund conundrum persists, then Congress should consider implementing the more extreme measure of excluding such Fiduciary Investors from accessing

305. Sean Ennis, Pedro Gonzaga & Chris Pike, Inequality: A Hidden Cost of Market Power 23 (2017), https://www.oecd.org/daf/competition/Inequality-hidden-cost-market-power-2017.pdf.

306. *Id.* at 23–24.

private fund investments. These preliminary proposals should, however, be subject to additional scrutiny given the harms that could result from increasing access to speculative investments. In a similar vein, researchers should dedicate more attention to the evolving definitions of publicness in this area of the law given the growing prominence of investment funds in managing retirement assets for households across the country.