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Legislation to Repeal the Private Equity Fund Adviser Registration Requirement in the Dodd-Frank Act: In Brief

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Introduction

Hedge funds, private equity funds, and venture capital funds are pooled investment vehicles that channel capital from investors to emerging and mature corporations through outright acquisition or through the acquisition of partial stakes in the firms. From the standpoint of federal securities laws and regulations, historically these funds, which are known as *private funds* or *private investment funds*, have largely been defined by what they are not. From a regulatory perspective, they are different from another kind of pooled investment vehicle known as an *investment company*, of which mutual funds are perhaps the best known example. Investment companies are subject to extensive regulation under federal securities laws because they are generally open to anyone throughout the investing public.

By contrast, private funds have largely taken advantage of exemptions that are available in federal securities laws that enable them to face fewer regulatory requirements in return for restricting the number and the types of investors who can invest in them. The basic rationale is that because the funds' securities are only available to select group of investors, they should not have to incur the regulatory burden and costs required of entities whose securities are publicly available without restrictions.

The Investment Advisers Act of 1940 (the Adviser Act; P.L. 76-768) generally requires any person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications, to register as an investment adviser with the Securities and Exchange Commission (SEC). Among other things, registration requires advisers to disclose information about their business, the persons who own or control the adviser, whether the adviser or certain of its personnel have been sanctioned for violating securities laws or other laws, and the adviser's business practices, fees, and conflicts of interest that the adviser may have with its clients.

Generally, advisers to private funds have been exempt from required registration as investment advisers under the Adviser Act. They often took advantage of a provision, which said that if during the preceding 12-month period, they had fewer than 15 clients (each client being essentially defined as one private fund) and did not present themselves to the public as an investment adviser, nor acted as such to a registered investment company or business development company, they could be exempted from the registration requirement, an exemption known as the *private adviser exemption*.

A commonly found generic definition of a private equity fund is an investment pool that funnels capital raised from institutional investors and wealthy individuals or families to a potentially wide range of commercial projects managed by investment professionals, the fund's general partners. Private equity funds employ a variety of investment strategies, including leveraged buyouts (the acquisition of another company using a significant amount of borrowed money in which the assets of the acquired company are often used as collateral), and investing in companies, including distressed ones. The commercial assets that private equity funds invest in are often less liquid than those that hedge funds invest in. Private equity funds are open to a restricted universe of investors and require large initial minimum investments. Private equity firms often manage several separate private equity funds and may launch new funds every few years when existing ones become fully invested.

Private equity funds are typically structured as limited partnerships, with a few general partners who usually serve as the investment managers and the investment advisers, who oversee a fund. The majority of investors are limited investors, the passive investors who often include institutional investors and may also include affluent or wealthy individuals or families. In addition to the return on his or her own invested capital in a fund, the typical hedge fund general partner typically receives 15%-25% of all profits earned by the fund plus an annual management fee of 1%-2% of total fund assets. There is a lock-up period for private equity funds, a time during which investors are not allowed to liquidate their holdings, which is often five years or more.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) was signed into law on July 21, 2010, as a response to the 2008-2009 financial crisis. The act mandated extensive financial regulatory reform.[1]

Title IV of the Dodd-Frank Act requires the private fund advisers, who are usually the general partners (who organize and oversee operations) of the private funds to register with the SEC as advisers under the Advisers Act by eliminating the private fund 15 client exemption from the act. However, if an adviser advises a fund with less than $150 million in domestic assets under management, the adviser is not required to register as the fund's investment adviser. In addition, advisers to venture capital funds, which the act required the SEC to define, are also exempt from the registration requirement.

Various private-sector entities and Members of Congress have criticized the mandatory private equity fund adviser registration provision in Title IV of the Dodd-Frank Act for imposing burdensome costs on certain private equity funds, harming their viability, and undermining their ability to provide capital to companies, especially smaller-sized firms.[2] Such concerns led to the introduction of H.R. 1105 (Hurt), which has been reported out of the House Financial Services Committee. The bill would amend the Advisers Act by generally exempting private equity fund advisers from the adviser registration requirements in the Dodd-Frank Act.

This report examines H.R. 1105 and key public policy issues surrounding the required registration of private equity fund advisers under the Dodd-Frank Act.

H.R. 1105

H.R. 1105 (Hurt), which was reported out of the House Financial Services Committee on June 19, 2013, would exempt investment advisers from the SEC's registration and reporting requirements when they provide advice to a private equity fund with outstanding debt that is less than twice the amount of capital that has been committed to and invested by the fund. It would also direct the SEC to define the term *private equity* and to adopt rules requiring exempt advisers to maintain records and provide reports to the commission as deemed necessary based on the fund's size, governance, risk, and investment strategy.

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[1] See CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary*, coordinated by (name redacted).

[2] Ibid.

Upon introducing H.R. 1105, the bill's sponsor, Representative Robert Hurt, stated,

> By reducing over-regulation, this legislation will promote greater access to capital for small businesses in the 5th District [of Virginia] and across the country…. In order for our economy to grow and for our small business owners and family farmers to be able to create the jobs that we need, we must remove unnecessary regulations that tie up private capital and create economic uncertainty, and put in place policies that encourage investment, innovation, and the entrepreneurial spirit that makes America great.[3]

Capital Formation

H.R. 1105 has received support from a number of business-related entities, including the U.S. Chamber of Commerce and the Small Business Investor Alliance, a trade association of lower middle market-sized private equity (informally, higher than $100 million in assets under management up to a few hundred million dollars in assets under management) and their institutional investors. Several of the bill's supporters note that the SEC has a statutory mandate to consider whether its actions promote capital formation, a central aim of H.R. 1105's focus on removal of the investment adviser registration requirement and its attendant costs.[4]

Many advisers to large private equity funds were registered before the Dodd-Frank Act. Also, due to scale economies, larger funds are seen to be much better positioned to absorb the investment adviser registration compliance costs. As mentioned, the Dodd-Frank Act exempts advisers who advise funds with less than $150 million in assets under management.

As a consequence, some of the proponents of H.R. 1105 argue that the bill will principally benefit medium-sized private equity firms, which tend to provide capital to smaller firms. One commentator, the head of a private equity firm with smaller-sized funds, warned that if legislation like H.R. 1105 is not enacted, "the relatively high compliance expense [of the adviser registration regime] leaves managers of smaller funds with two choices—raise far more capital for their next fund to get fees to pay for the added compliance costs or exit the [private equity fund] business."[5]

Steven Kaplan, a professor of Entrepreneurship and Finance at the University of Chicago's Booth School of Business, has written about private investment funds and talked extensively with various members of the private equity industry. The Congressional Research Service (CRS) questioned Professor Kaplan about Mr. Reich's assertions on the probable impact of the costs of adviser registration on the medium-sized private equity funds and the possibility that they might have to "exit the business." Professor Kaplan first noted that he did not think that private equity

[3] "Robert Hurt Introduces The Small Business Capital Access And Job Preservation Act," *Press Release from the Office of Congressman Robert Hurt*, March 13, 2013, available at http://hurt.house.gov/index.cfm/press-releases?ID=4a566807-6e1c-4d5c-bb5a-d6c989042f55.

[4] For example, see the comments of House Financial Services chairman Jeb Hensarling in: "Representative Jeb Hensarling Holds a Markup on the Small Business Capital Access and Job Preservation Act," *Political Transcript Wire*, June 20, 2013, available at http://search.proquest.com/docview/1369849956?accountid=12084, and the comments of Thomas Quaadman, Vice President for Capital Markets Competitiveness U.S. Chamber of Commerce, in: "Representative Scott Garrett Holds a Hearing on Capital Markets and GSE Bills," *Political Transcript Wire,* May 23, 2013, available at http://search.proquest.com/docview/1354390247?accountid=12084.

[5] "Testimony of Marc Reich, President, Ironwood Capital, on behalf of the Small Business Investor Alliance at the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing," May 23, 2013, available at http://search.proquest.com/docview/1355948745?accountid=12084.

funds generally posed a systemic risk. He then indicated that he believed that the investment adviser compliance costs were non-trivial in significance and that the large private equity firms like Kohlberg Kravis Roberts and the Carlyle Group are more easily able to absorb those costs through their ability to amortize the costs over a larger asset base, giving them a competitive advantage over smaller-sized funds. In turn, he argued that this would make it more difficult for new smaller-sized private equity funds to be created. Professor Kaplan, however, expressed some doubts over the assertion that funds might be forced to exit the industry due to the burden of the costs.[6]

Investor Protection

Another key statutory mission of the SEC is investor protection, a duty that it performs largely through its enforcement and oversight of a disclosure regime aimed at the provision of all relevant investor information on such things as the entities that issue securities, an issuer's securities themselves, and investment advisers.[7]

Criticism of H.R. 1105 has largely focused on concerns that it would eliminate investor protections given to private equity fund investors or prospective investors by the Dodd-Frank Act. Among those who have raised such concerns are the North American Securities Administrators Association, a group of state and provincial securities regulators; the Consumer Federation of America; Common Cause; the United Food and Commercial Workers; the Economic Policy Institute; and the Communications Workers of America. Many of these entities are members of Americans for Financial Reform, a coalition of some 250 entities, including consumer groups, labor unions, human rights groups, and a think tank, which also criticized H.R. 1105 as legislation that "would exempt nearly all private equity fund advisers from registration, and therefore deny investors in these funds the protections that come with adviser registration."[8]

In a letter critical of H.R. 1105, Mary Jo White, the SEC chair, spoke of the importance of the investor protections that the legislation would eliminate:

> Private equity fund investors are in need of the same protections as other private fund investors. As with other types of funds advisers, the Commission has brought enforcement actions against private equity funds and their advisory personnel involving unlawful pay to play schemes, insider trading, conflicts of interest, valuation, and misappropriation of assets. Registration provides the Commission with tools to discover and prevent fraud and other violations of the securities laws, enhancing confidence in our capital markets and promoting fair dealing.[9]

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[6] Telephone conversations between CRS and Professor Steven Kaplan during October 2013.

[7] For example, see "The SEC's 2006 Performance and Accountability Report," available at http://www.sec.gov/about/secpar/secpar2006.pdf.

[8] "Letter from Americans for Financial Reform to Members of Congress," May 22, 2013, available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2013/05/AFR-Oppose-HR-1105-5-22-13.pdf.

[9] "Letter from Mary Jo White to the Honorable Jeb Hensarling and the Honorable Maxine Waters," June 18, 2013.

Similarly, on December 3, 2013, the White House issued a statement opposing H.R. 1105 in which it said that "[t]he bill's passage would deny investors access to important information intended to increase transparency and accountability and to minimize conflicts of interest."[10]

Other observers, including House Financial Services Committee Chairman Jeb Hensarling, however, reportedly counter that if H.R. 1105 were enacted, the SEC would still enjoy broad authority for investor protection. For example, Rule 10b-5 of the Securities Exchange Act of 1934 authorizes the agency to enforce rules that prohibit any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.[11]

Under Rule 506 of Regulation D of the Securities Act of 1933, private funds, including private equity funds, are commonly exempt from registering their securities with the SEC. As such, they are able to avoid the non-trivial costs of disclosures about themselves and the securities that are generally part of the securities registration process. The exemption, however, restricts the issuance of securities to an unlimited number of investors known as *accredited investors*,[12] which is commonly described as a proxy for sophisticated investors, and 35 non-accredited (unrestricted) investors.

H.R. 1105's proponents also argue that private equity funds' investors are chiefly accredited investors (largely institutional investors such as pension funds and wealthy or affluent individuals or families.) As mentioned earlier, some critics of the bill argue that the legislation will harm private equity fund investors by depriving them of investor protections. However, referring to the assumption that accredited investors are generally financially sophisticated, the bill's supporters counter that the investor protection concerns are overstated.

The bill's opponents, however, point to a body of academic work that has questioned the notion that affluent or wealthy individuals or families who would qualify as accredited investors should be expected to be financially sophisticated.[13]

Likewise, according to some recent research, institutional investors such as pension funds, which are generally thought to be among the more sophisticated investor groups, may also face challenges. A 2013 Oxford University study by Jenkinson, Sours, and Stucke examined how private equity firms valued some 761 private equity funds held by CALPERS, the giant California public pension complex and reportedly the largest single investor of domestic private equity funds.[14]

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[10] "Statement of Administration Policy. H.R. 1105—Small Business Capital Access and Job Preservation Act," *Executive Office of the President*, December 3, 2013, available at http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/113/saphr1105r_20131203.pdf.

[11] See the comments of Chairman Hensarling in: "Representative Jeb Hensarling Holds a Markup on the Small Business Capital Access and Job Preservation Act," *Political Transcript Wire*, June 20, 2013.

[12] Accredited investors include banks, insurance companies, registered investment companies, employee benefit plans, charitable organizations, corporations, persons who have an individual net worth, individually or jointly with their spouse, in excess of $1 million, excluding the value of the primary residence, and persons with an income that exceeds $200,000 in each of the two most recent years or joint income with a spouse that exceeds $300,000 for those years and have a reasonable expectation of the same income level in the current year.

[13] For example, see Wallis K. Finger, "Unsophisticated Wealth: Reconsidering the SEC's 'Accredited Investor' Definition Under the 1933 Act," *Washington University Law Review,* issue 3, 2009, available at http://digitalcommons.law.wustl.edu/cgi/viewcontent.cgi?article=1126&context=lawreview.

[14] Tim Jenkinson, Miguel Sousa, and Rudiger Stucke, "How Fair are the Valuations of Private Equity Funds?" (continued...)

After examining the CALPERS's funds, the study concluded that investors in new private equity funds "should be extremely wary of basing investment decisions on the [reported] returns…of the current fund."[15] The study explained that this concern derived from its findings that private equity fund managers tended to inflate the valuations of their current funds when they began to solicit funding from investors like CALPERS to buy stakes in new follow-on private equity funds.[16]

In requiring advisers to private equity funds to register as advisers, the Dodd-Frank Act also opens the door for periodic SEC examination of the funds and other private funds through presence exams. Administered by the agency's Office of Compliance, Inspection and Examinations, the examinations are compliance examinations of new private fund registrants that will focus on higher-risk areas of their operations, including marketing, conflicts of interests, and asset valuation.[17]

A provision in the JOBS Act of 2012 (P.L. 112-106) requires the SEC to implement rules necessary for eliminating a ban on private funds from general solicitation and advertising their securities to accredited investors under the Rule 506, Regulation D exemption of the Securities Act of 1933. The ban prohibited the funds from widely soliciting and advertising their securities to accredited investors via mass media, including the placement of advertisements on radio, newspapers, television, and the web. In July 2013, the SEC completed rulemaking required by the JOBS Act to eliminate the ban on general solicitation and advertising. Agency rules implementing the lifting of the ban went into effect in September 2013. The SEC observed that "by requiring the SEC to remove this general solicitation restriction, Congress sought to make it easier for a company to find investors and thereby raise capital."[18]

It has also been argued that lifting the general solicitation and advertising ban increases the likelihood that greater numbers of individual and family-based investors who qualify as accredited investors and a limited number of allowable non-accredited investors (Rule 506, Regulation D allows up to 35 investors for a securities issuance) become more aware of private equity funds' solicitations.[19]

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University of Oxford's Said Business School, February 27, 2013, available at SSRN: http://ssrn.com/abstract=2229547 or http://dx.doi.org/10.2139/ssrn.2229547.

[15] Ibid.

[16] Ibid.

[17] For example, see "Comments by Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, on Enforcement Priorities in the Alternative Space Before the Regulatory Compliance Association," December 18, 2012, available at https://www.sec.gov/News/Speech/Detail/Speech/1365171492012#.UoKE24a8jJY. On September 13, 2012, House Financial Services Committee Chairman Jeb Hensarling and House Financial Services Capital Markets Subcommittee Chairman Scott Garrett wrote to SEC Chair Mary Jo White raising concerns over the "burdensome, costly, inefficient and inflexible" SEC presence examinations. They also noted that due to resource constraints, the SEC was involved in an in ongoing struggle to examine the totality of investment advisers; generally only be able to conduct a fraction of the examinations in any given year. Because of this, the letter argued that the SEC should prioritize the examination of registered advisers whose clients are the less financially sophisticated retail investors instead of advisers to private funds. Arguing that the examinations did not "appreciably further the goals of investor protection or financial stability"—the letter noted that private equity fund investments are limited to accredited investors.

[18] "Fact Sheet: Eliminating the Prohibition on General Solicitation and General Advertising in Certain Offerings, *SEC* Open Meeting," *SEC,* July 10, 2013, available at http://www.sec.gov/news/press/2013/2013-124-item1.htm.

[19] For example, see "Letter to the Honorable Jeb Hensarling, and the Honorable Maxine Waters from Heath Abshure on Behalf of the North American Securities Administrators Association Regarding H.R. 1105," June 18, 2013, available at (continued...)

Noting that investors such as CALPERS have the option to simply avoid investing in a given private equity fund, which is known as voting with their feet, some have downplayed concerns over H.R. 1105's impact on the investor protections on such institutional investors.[20] Others, however, might argue that the aforementioned research on private equity funds and CALPERS raises concerns regarding institutional investors' level of sophistication when investing in new funds. Some might also argue that the lengthy private equity fund investor lock-up periods are major impediments to investors who would like to vote with their feet by divesting out of a fund before the lock-up period ends.

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http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-on-H.R.-1105-06-18-2013.pdf.

[20] "Representative Jeb Hensarling Holds a Markup on the Small Business Capital Access and Job Preservation Act," *Political Transcript Wire*, June 20, 2013.