Statement for the Record

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Subcommittee on Capital Markets and Government Sponsored Enterprises
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Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, thank you for the opportunity to testify today.

My name is Marc Reich, and I'm president of Ironwood Capital, a private equity firm in Avon, Connecticut, with over $500 million of capital under management. I am here today representing the Small Business Investor Alliance, which is the trade association of lower middle market private equity funds and our institutional investors. SBIA members provide vital capital to small and medium sized businesses nationwide.

My firm manages six private equity funds, four of which are organized as Small Business Investment Companies (SBICs). We provide subordinated debt and equity securities to privately held small businesses in amounts ranging from $5 million to as much as $12 million. These investments support small business owners and financial sponsors in growth financings, recapitalizations, and buyouts. In addition, we seek to invest 50% or more of our total capital in businesses owned or managed by women or minorities and businesses located in low- and moderate-income communities.

I'm here to strongly support a bipartisan bill called the Small Business Capital Access and Job Preservation Act (H.R. 1105), introduced by Representatives Robert Hurt of Virginia, Jim Himes of Connecticut, Scott Garrett of New Jersey and Jim Cooper of Tennessee. Thank you to the Committee for examining this bill today, and especially to the sponsors of the legislation for working so diligently to bring it to this point.

SBIA advocates for a healthy capital markets ecosystem in which every market segment needs to work efficiently in order for the ecosystem to function well. In the private equity marketplace, the market needs to be healthy for the whole investing continuum – from seed and early stage to venture to growth to mezzanine to buyout firms. Fortunately, my firm and the lower middle market private equity industry weathered the global downturn in good shape - a clear indicator that middle market private equity does not pose any systemic risk to the financial system. In fact, private equity saved many small businesses when the financial crisis froze many of their access points to credit.

H.R. 1105 strengthens the ecosystem of the private equity marketplace by reducing over-regulation that threatens capital access for small businesses. This bill will help private equity funds by removing unnecessary regulatory burdens that are tying up precious resources and wasting investor capital which would otherwise be directed towards growing small businesses.

My testimony today will concentrate on four major areas on why the lower middle market should be exempt from SEC registration: 1) lower middle market and middle market funds are not a systemic risk to the financial system; 2) SEC compliance and regulatory costs are high especially for small business investment funds; 3) advisers that manage multiple funds such as Small Business Investment Companies (SBICs) and non-SBICs face a double regulation; and 4) many SEC rules are one-size-fits-all and inapplicable to the private equity industry.

The Investment Advisers Act of 1940, as modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), requires private fund advisers to register with the SEC if the investment advisers manage more than $150 million in assets under management (“AUM”). Since the Act became effective, over 1,500 new private fund advisers have registered with the SEC as investment advisers. Many SBIA members are SEC-registered.

In January 2013, SBIA surveyed its members to identify their “top pain points in complying with SEC rules”.[1] The survey results pointed to many common themes, some of them I quote below:

- “Cost associated with the registration of our size fund”
- “Several layers of paperwork”
- “Rules are not as clear as they could be”
- “Many rules not applicable to private equity especially smaller firms”
- “Double regulation by federal and state agencies”
- “How can the data of a small fund be a systemic financial risk to the economy”
- “Cost of and time to implement and monitor a mandatory compliance program”
- “Hiring of additional personnel to comply”
- “Outside counsel costs”
- “Lack of understanding of what the SEC wants to see in an inspection”
- “Time and paperwork to respond to requests and audits”

The themes highlighted above need to be examined in more detail and my testimony will highlight how my firm and hundreds of other small funds are negatively impacted by SEC registration. I will present for you cost issues, double regulation, inapplicable rules, and many other themes because these are comments from small business investors about how to reduce over-regulation and allow us to do what we do best: invest in our nation’s small businesses.

Private Equity – A Systemic Risk?

The investment adviser threshold of $150 million of assets under management by an adviser to private funds is entirely too low, simply because it does not accomplish the Act’s stated purpose of helping identify and reduce systemic risk in the U.S. financial system. Private funds, especially private funds with assets under management of less than $500 million and unlevered funds, did not cause or contribute to the financial crisis.

I’m asking you to support the Small Business Capital Access and Job Preservation Act first and foremost because you agree that my industry is not systemically risky. The typical private fund in the lower middle market invests over the course of three to five years in a portfolio of ten to twenty companies. Our portfolio company investments are spread out among many growing

[1] SBIA Member Survey 2013; Internal Document.

businesses. Even if several of them failed or underperformed, the overall fund performance should still be acceptable because the risk is spread among investments in many companies.

We don't create systemic risk by trading in synthetic financial instruments, we don't speculate on currencies or commodities, we don't put the retirement funds of individuals at risk, we invest directly in small businesses, the backbone of our economy and the growth engine for job creation. Unlike many hedge funds and some mutual funds, private equity funds are long term investors and investors in such funds understand that capital will be committed for an extended period of time and is not subject to quarterly redemption events that can have a cascading effect in a systemic market breakdown. The only way for our funds to make money is to find and grow businesses. Our country needs more focus on this type of investment and the growth it enables.

Regulatory Costs Higher for Smaller Funds

The lower middle market of the private equity fund space is especially vulnerable to regulatory costs. Smaller funds are highly unlikely to have legal departments, compliance teams, regulatory compliance software regimes and other forms of overhead that the new regulatory system assumes we have or will require. Lower middle market private equity funds generally only specialize in finding and growing small businesses. For most of these funds the idea of adding regulatory compliance staff is largely a foreign concept. While Small Business Investment Company (SBIC) funds need to comply with SBA regulations, their compliance staff are small and compliance is often sent out to specialists. However, the standards of the SEC for reporting and compliance differ from those required by the SBA. SBA reports and filings are not accepted, despite the fact that SBIC filings are designed specifically for private equity.

The cost is relatively high for smaller funds because their management fees (which are a function of assets under management) are low when compared to much larger funds; however, smaller funds face many of the same compliance and reporting levels as larger funds. Absent the compliance infrastructure of larger funds smaller funds often have to pay outside counsel to help with initial and ongoing compliance costs. The effect of the relatively high compliance expense 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 business. Larger funds invest in larger companies, generally not small businesses. Neither option is good for the prospect of a continuing flow of capital to small businesses.

For every $1 that we spend on compliance issues, there is $1 less that we have to invest in our nation's small businesses. And all the money that is tied up by regulatory compliance will not be able to be released into the capital markets, which will hinder economic growth and job creation. H.R. 1105 fixes this by exempting private equity funds from SEC registration, unleashing capital that would have been tied up and places it into the hands of our best job creators. Reporting would still be required under H.R. 1105 so Congress should ensure that reporting requirements are not onerous or costly.

Annual SEC Compliance Costs

At Ironwood Capital, we spend approximately $250,000 annually on compliance costs. This includes complying with the regulations of both the SBA and the SEC but does not include the additional compliance and reporting expenses associated with our investors. Remember, we have four SBIC funds and two non-SBICs funds, so the double regulation that hits Ironwood Capital is multiplied and costly. The SEC estimates that annual SEC costs could be as low as $50,000 for a small firm and as high as $500,000 for a middle market private equity fund.[2] These expenses include paying outside counsel, hiring an internal Chief Compliance Officer and paying other service providers. The cost of an SEC examination adds to this cost. The expense to prepare for an SEC examination includes attorney preparation fees and the cost of internal staff and management that must be deployed to exam preparation from their normal duties. One SBIA member noted that the cost to prepare for an exam totals approximately $25,000.

In addition to the actual dollar costs of compliance the regulations consume time and remove the focus of fund managers from growing businesses. While this is true for both large and small funds, there is a particularly meaningful drag on smaller funds that generally have smaller teams and operate in very lean environments.

Cost of Calculating Assets Under Management
For many smaller funds, the process is expensive and complicated to calculate assets under management (AUM) to determine if they have to register as an investment adviser. The AUM calculation uses the market value of private fund assets, or the fair value of private fund assets where market value is unavailable. Many private equity funds already value their some of their portfolio companies on a periodic basis as a business practice, but the requirement by the SEC is mandatory and requires full reporting of all the assets under management. Moreover, many SBICs must use a different valuation methodology that is mandated by the SBA, with a resulting doubling of the cost. The SEC estimates that registered advisers would incur costs as a result of the fair market value requirement of $37,625.[3] We believe this number is too low.

Fluctuating Above and Below the Thresholds
The triggering thresholds for adviser registration or reporting falsely assume a static size of the fund. The value of a fund fluctuates over its life. One year a fund may be $140 million in AUM and the next be $160 million in AUM. The following year the fund may again change to $145 million. These normal fluctuations can cause legal and regulatory problems for funds hovering around the triggering thresholds. The triggering thresholds are too low and do not take into account the normal variability of a fund's value.

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[2] Securities and Exchange Commission; Final Rule on Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with less than $150 million in Assets Under Management, and Foreign Private Advisers; Pg. 153. http://www.sec.gov/rules/final/2011/ia-3221.pdf
[3] SEC Final Rule; Pg. 177. http://www.sec.gov/rules/final/2011/ia-3222.pdf

Cost of Initial Registration

The process of registering is not as easy as filling out a one page form, writing a check, and sending it in the mail to the SEC. After the process of figuring out if you need to register by calculating your AUM, the act of registering is a one-time added expense to a firm. The process to fill out form ADV and complete the private fund reporting requirements is estimated by the SEC to cost $15,077.[4] The SEC expects each adviser to spend approximately 40 hours filing their initial reports on Form ADV. This process also requires "preparing and filing interim updating amendments to the form, preparing brochure supplements and delivering codes of ethics to clients."[5]

Cost to Establish and Maintain Compliance Program

For many smaller firms, the cost to establish and maintain the statutorily mandated investment adviser compliance program can be daunting. It includes hiring additional personnel to comply and monitor new regulations and paying an outside counsel to provide advice on rules that are complicated. The SEC estimates the one-time costs to new registrants to establish a compliance infrastructure would be as high as $45,000. The estimation is based on $20,000 in professional fees and $25,000 in internal costs including staff time.[6] Estimated costs for establishing and maintaining a compliance program, as calculated by SEC, are way below actual costs of compliance. In large measure this is due to the lack of clarity to date from the SEC in terms of how it will apply the rules. Greater transparency from the SEC is necessary to the smooth operation of fund managers. In the absence of such clarify and in the face of the SECs current one size fits all approach, private equity mangers are spending time and money on compliance that would be better directed to investment in small businesses.

Inapplicability of SEC Rules to Private Equity Funds

Being an investment adviser comes with a high level of regulatory scrutiny and a body of rules and regulations to follow. Many SEC rules related to registration requirements are based upon mutual fund adviser registration requirements and are not relevant to private equity fund managers. Passage of H.R. 1105 would be the best way to get rid of these costly rules that should not apply to the private equity industry.

Below are some of the most cited rules by SBIA members that are not applicable to private equity funds:

Custodian Requirement Rule

From a logistical and practical standpoint, the custodian rules make little sense for lower middle market and middle market funds. Our "Securities" are little more than a stack of documents specific to a transaction. They are generally not an easily transferable or negotiable document

[4] SEC Final Rule; Pg. 151, http://www.sec.gov/rules/final/2011/ia-3222.pdf

[5] SEC Rules Implementing Amendments to the Investment Advisers Act of 1940; Pg. 147. http://www.sec.gov/rules/final/2011/ia-3221.pdf

[6] SEC Final Rule; Pg. 152. http://www.sec.gov/rules/final/2011/ia-3221.pdf

that would have some potential value in the hand of an unscrupulous third party. The custodian rule requires private funds to spend time and resources hiring a third-party custodian to hold onto unrestricted, untradeable securities. We are not stock brokers or mutual funds and we do not hold publically tradable securities. We are private equity funds and we hold untradeable securities that are prepared by our attorneys. There is no added security for our investors to have the documents held by a custodian, only incremental expense.

Email Screening

In accordance with SEC guidelines, all email messages of SEC-regulated private equity firms are automatically retained and archived so that they may be retrieved, searched and reviewed by the Chief Compliance Officer or a regulator. On at least a monthly basis, the Chief Compliance Officer conducts reviews of all electronic communications sent by firm personnel to detect illegal activities such as insider trading in publically traded securities. Given that middle market private equity firms generally do not deal in or otherwise purchase or sell publically traded securities since they normally invest in privately-held companies, such email screening is purely a regulatory exercise with no benefit to investors nor does it contribute to the safety and integrity of the overall financial system. This is a time consuming and irrelevant compliance procedure that serves only to "paper" the compliance files.

Monitoring of Employee Brokerage Activity

One of the rules that may be applicable to funds focused on publicly traded businesses but small private equity funds is the requirement that they monitor employee (and familial) brokerage activity. While this might make sense if an existing portfolio company is publicly traded (in regards to trading activity in that specific company), it otherwise requires hours of employee time to sort through brokerage statements, record transactions and confirm that the various transactions had been approved prior to execution. One firm has put into place a "gray list" of companies in which employees must not make investments. For example they put public companies on the gray list if they have knowledge of a buyout opportunity, and make sure their employees avoid purchasing public stock in those companies.

Form PF

SEC-registered investment advisers are required to fill out lengthy forms called the PF form.[7] Most private equity funds are required to make annual filings of Form PF. Form PF requires private equity funds to collect and report data that many have never collected, making it a very labor intensive and expensive process. Form PF requires an investment adviser to calculate and report data on the following: 1) total regulatory assets under management[8] and total net assets under management; 2) gross asset value[9] and net asset value of fund; 3) value of the reporting

[7] Form PF is designed to assist the Financial Stability Oversight Council in assessing systemic risk in the U.S. financial system posed by investment funds.

[8] The cost to calculate AUM is estimated to be as high as $75,000 on an annual basis, as reported by the SEC in SEC Final Rule; Pg. 178. http://www.sec.gov/rules/final/2011/ia-3221.pdf

[9] This calculation is also made on Form ADV Section 7.B.1.

fund's borrowings and types of creditors; 4) summary of the fund's assets and liabilities; and 5) performance of the fund during each month of the fiscal year calculated by gross performance and net of management fees and incentive fees and allocations.

We strongly believe that private equity funds, especially smaller funds, do not pose a systemic risk. With that said, even if they were a systemic risk, some of the required responses on Form PF would not help the Financial Stability Oversight Council determine systemic risk. For example, it is not clear how the calculation that requires month-to-month fund performance, broken down by gross performance and net of management fees, will be used to determine if the fund is a systemic risk.

Double Regulation

The Small Business Investment Act of 1958 effectively created the market for small business investing by establishing a program to stimulate and supplement the flow of private equity capital for the sound financing of business operations for growth and expansion.[10] Since the creation of the SBIC program, the Small Business Administration has established a sound regulatory structure, designed for private equity investing, that provides a robust body of rules and safeguards for the industry. For example, the conflict of interest rules that govern SBICs have been developed over the past 50 years and represent historical real world examples of what is and what is not a conflict of interest.

In recognition of the SBA already providing a regulatory structure for SBICs, Congress provided an exemption from investment adviser registration for SBICs. The Act states, in summary, that an investment adviser that solely advises a licensed Small Business Investment Company is exempt from registration under the Advisers Act.[11]

SBICs Trigger the $150 Million AUM Threshold

However, if an adviser advises for SBICs and any other private funds and the total assets under management exceed the $150 million registration threshold (as it does for Ironwood Capital) the threshold for full registration is triggered. The double counting of capital, even otherwise exempt capital, causes double regulation for advisers that advise SBICs and any other private funds (non-SBICs). Firms should not be required to count the SBIC exemption as part of the $150 million threshold. Congress did not intend for firms to face the threat of double regulation, and it is important to remove the double regulation of SBICs and non-SBICs. H.R. 1105 is one way to address this issue.

[10] P.L. 85-699, as amended.

[11] See Section 203(b)(7) of the Advisers Act. In addition to licensed SBICs, entities that have received from the SBA notice to proceed to qualify as an SBIC, and applicants that are affiliated with one or more licensed SBICs and that have applied for another SBIC license, are also exempt from registration under the Advisers Act.

Conflict between SBIC Statutory Accounting and GAAP Accounting
Many firms are experiencing a mountain of new paperwork and auditing burdens on already regulated private funds. One issue we are hearing about is the conflict between SBIC statutory accounting and GAAP accounting. SEC registered investment advisers must get a GAAP audit for all their funds. This is in addition to the already required financial and compliance audits (using statutory accounting) required by the SBA. One SBIA member with SBIC funds and one non-SBIC fund is being told to re-audit all the SBIC funds using SEC standards at a cost of about $600,000. So now the SBIC funds will have two sets of books and two sets of audits to comply with two sets of regulators. This is effectively throwing money down the drain instead of investing in domestic small businesses. Given that SBIC reporting is designed for private equity and has been developed for private equity for over 50 years, the SEC ought to accept the financial reporting that is already required to maintain an SBIC license.

SBICs can be Registered by the States
Congress exempted SBIC fund managers but inadvertently triggered double regulation via state regulation. There is not any explicit language in the Dodd-Frank Act, the Advisers Act or the new regulations promulgated by the SEC that prevents any state from requiring the registration of an adviser that solely advises SBICs. Even if such an SBIC adviser had assets under management of $150 million or more, it is unclear in the Act whether the SEC would permit the adviser to register with the states. Because of this drafting oversight in the Act, it is possible that SBICs would have to register with multiple states and multiple territories despite being licensed and regulated at the Federal level by SBA. A technical correction in the Dodd-Frank Act is needed to remove this unintended double regulation so that SBICs are only regulated by the SBA.

SBICs can be leveraged up to 3:1 leverage ratio
It is important to note that statutory rules permit SBICs to borrow up to three times the amount they raised from private investors. This amount is leveraged by an SBA-backed credit facility and is only approved by the SBA after a thorough evaluation of the status of the SBIC. Advisers that manage more than one fund including an SBIC and a non-SBIC also need an exemption from SEC registration because they are already regulated by the SBA.

Reduce Burdens for Small Business Investment Funds

Small business investment funds are especially vulnerable to the burdens of over-regulation. We agree with the intent of H.R. 1105 that private equity funds can provide basic and limited information to the SEC, provided that this takes into account fund size, governance, investment strategy, risk, other regulation, and other factors. But it is critical to remember that the cost of compliance on smaller funds is disproportionate to their size. We ask the SEC and the Committee to consider reducing the regulatory burden for funds investing in small and medium

sized businesses. The SEC should refer to the Small Business Investment Act of 1958, which indicates that the Administration should include full and detailed accounts relative to a report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the SEC, the Administration and other agencies of the executive branch.[12]

Conclusion

Thank you to the Committee for holding this hearing on HR 1105, a bill that removes over regulation of small business investors so that we can focus our time and capital on investing in and growing small businesses. Some small technical changes could be made to the underlying legislation and we look forward to working with you to advance this bill into law. I am happy to answer any question you may have.

[12] P.L. 855 699 as amended, Section 308 (g)(2)(h)