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Introduction

Mr. Chairman and Members of the Committee, thank you for inviting me back to the Committee to discuss the Private Equity Council's views on financial regulatory reform – specifically legislation recently drafted to require advisers to private investment funds to register with the Securities Exchange Commission (SEC) under the Investment Advisers Act of 1940 (the "IAA").

The Private Equity Council is a two year old trade association representing 12 of the largest private equity firms operating in the United States[1]. Our mission is to educate public policy makers on the positive role private equity ("PE") investments have played in both strengthening hundreds of companies of all sizes and from all sectors of the economy, and in generating above average returns for scores of public and private pension funds and other investors that have allocated a portion of their portfolios to PE funds. While PEC members are among the most visible and well known in PE firms, each with more than $10 billion in assets under management, the Committee should bear in mind that there are more than 2,000 PE firms doing business in the U.S. The overwhelming majority of these are local firms advising very small funds used to make relatively small investments that rarely attract much attention yet help power local, state, and the national economies.

In my testimony to this Committee in July I discussed in some detail the PE investment model, how it works, and how it fits into the financial marketplace. Today, in the interest of brevity, suffice it to say that the goal of all PE investments is to increase the value of the business during the time that it is owned by a PE fund. PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders. Independent research by such distinguished organizations as The World Economic Forum, Ernst & Young, the Boston Consulting Group, and numerous economists and academics document the positive impact PE has on jobs, innovation, and growth.

[1] Apax Partners; Apollo Global Management LLC; Bain Capital Partners; the Blackstone Group; the Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake Partners; and TPG Capital

<u>Private Equity and Systemic Risk</u>

In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. <u>Private equity presents none of these systemic risk factors</u> and thus should pose little concern for policymakers seeking to develop a new regime to guard against catastrophic, cascading financial shocks. Specifically:

- PE firms have limited or no leverage at the fund level (as distinct from leverage incurred by companies in which funds managed by a PE firm have invested).
- PE funds do not rely on short-term funding. Rather, private equity investors are patient and commit their capital for 10-12 years (or more) with no redemption rights. Therefore, investors cannot withdraw their money on short notice, triggering "asset fire sales" to find cash to make the repayments.
- PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships.
- PE investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt. In a sense, private equity investments are structurally firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.
- PE funds invest in long-term illiquid assets that are typically the equity of operating companies. Private equity funds do not normally invest in short-term instruments such as derivatives, options, swaps or listed equities.
- PE funds are diversified by industry sector, geography, and time horizon, thereby safeguarding against over exposure.
- PE funds are not a source of credit to households, businesses, or governments, nor do they act as a primary source of liquidity for the financial system.
- The borrowings of companies owned by PE funds is still a small portion of the overall credit market, well under five percent of all U.S. credit market obligations outstanding. The total value of all holdings of PE funds is equivalent to just 2.6 percent to 4.3 percent of corporate stocks and 3.1 percent to 5.3 percent of GDP.

<u>In short, when applying the Administration's systemic risk factors to private equity, it is hard to see how any particular PE fund could be considered to present a systemic risk. Indeed, in testimony before this Committee last week, Federal Reserve Board Chairman Ben Bernanke said he "would not think that any hedge fund or private equity fund would become a</u>

systemically-critical firm individually", though he added that it remains important for the systemic risk regulator to monitor the industry as a whole.

The Investment Advisers Act

In the interest of restoring confidence in financial markets generally and the credit markets in particular, we have and continue to support requiring registration of managers of PE, venture capital ("VC"), and hedge funds under the IAA. We do so because the IAA enforces best business practices among financial and fund managers. And our support for registration reflects the view that this law is an important and valuable component of the Nation's investor protection regime.

At the same time, it is important to appreciate that the obligations that come with registration are neither modest nor ministerial. In fact, the IAA imposes very significant obligations and burdens – and cost – for any firm, small, medium, or large.

Specifically, SEC Form ADV requires the disclosure of everything from the most basic information – name and address – to more detailed information about the adviser's business. Being a registered investment adviser requires the firm to establish, maintain and enforce a code of ethics, proxy voting policies and procedures and compliance policies and procedures. Registered advisers are required to keep true, accurate and current books and records including ledgers reflecting asset, liability, reserve, capital income and expense accounts; all written communications; evidence of discretionary authority; written agreements, notices, circulars and advertisements; calculations of performance rates; policies and procedures; possession of client funds; personal securities transactions; client referrals; and various other documents. Registered investment advisers are required to send an account statement, at least quarterly to each of the clients for which it maintains an account. An independent accountant must also verify all of the funds and securities by an actual exam at least once a year. On top of all of this, registered firms are subject to periodic SEC audits. To comply with these and other IAA requirements, firms will typically have to hire at least one and perhaps a dozen or more persons to handle the compliance burden.

All that said, as a necessary ingredient of a new regulatory regime, and notwithstanding the lack of a nexus between PE and systemic risk as outlined above, we are generally supportive of requiring registration of advisers to private pools of capital. Further, we agree that registered advisers should provide information to the SEC regarding the funds they manage that enables the SEC to evaluate a firm's potential to pose systemic risk or otherwise threaten the financial system.

The Private Fund Investment Advisers Registration Act of 2009

As outlined below, we do have several significant concerns with the draft bill. We also have several specific technical issues that we will raise with committee staff following this hearing.

We stand ready to work with you, your colleagues and your staff in the coming days and believe together we can resolve all of these issues.

<u>Section 204(b)(7)</u> of the discussion draft would add to the IAA a requirement that registrants provide reports, records and other documents to investors, prospective investors, counterparties, and creditors, of any private fund advised by the investment adviser if the SEC determines such disclosure is necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

We acknowledge the benefits of requiring PE fund managers to disclose information to the SEC regarding systemic risk. But Section 204(b)(7) and its authorization for the SEC to require registrants to make broad disclosures to third parties is unnecessary and problematic.

To be clear, we acknowledge and support the need to ensure that investors are well-informed. In this regard, The Securities Act of 1933 and The Securities Exchange Act of 1934 already impose a series of requirements obligating PE funds to provide extensive information to investors (subject to stringent antifraud rules). Further, as a matter of common practice, the fund contracts we negotiate with our investors typically require us to provide information that goes far beyond that required by the 1933 and 1934 Acts. Given the highly sophisticated nature of our investors, and our dependence on them for funding our investments, they have both the knowledge and the leverage to obtain the information they need to ensure they are fully protected. Thus, the proposal mandating the provision of reports and other materials to investors and prospective investors is duplicative and unnecessary.

It is even more troubling to contemplate the provision of reports and materials to counterparties, creditors, and others. As a general rule, third parties that privately negotiate with PE funds (whether creditors, counterparties, or investors) are all highly-sophisticated market participants with the leverage to bargain with the fund at the time that the counterparty or creditor relationship is first established to obtain whatever information they believe necessary to evaluate the contract, relationship or credit. For example, a lender can simply refuse to lend to the fund if the lender is not satisfied that it has received sufficient upfront information about the fund and its investments and adequate commitments from the borrower to provide ongoing reporting. And if it does lend, credit agreements typically require periodic reporting of financial information and certain operational reporting, as well as certain management certifications.

Requiring open-ended disclosures to these third parties, as the draft contemplates, is highly problematic because such a requirement is potentially destructive of normal commercial relationships and could expose proprietary information and trade secrets to those with whom we compete.

Many of the parties from which private funds obtain credit or enter into mutually beneficial arrangements are competitors of the PE funds and the provision and use of information provided to such parties is subject to confidentiality agreements. The maintenance of such confidentiality is critical to the success of the PE funds' businesses. The threat that the SEC would mandate the provision of documents that would otherwise be subject to confidentiality agreements would eviscerate the ability of the funds to obtain such agreements with the consequence of creating a serious competitive disadvantage. For example, this provision could result in the disclosure of a proprietary strategy to a competitor with the result that the competitor adopts the strategy for its own purpose. Or, it could require the disclosure of highly sensitive, material, non-public information about our valuation of a current or prospective investment, information that creates the potential for the counterparty to trade on that information, or pass it along to another client.

We urge that this entire section be struck from the bill.

<u>Section 204(b)(1)</u> appears to require investment advisers who may be unaffiliated with a particular private fund that it advises to make disclosures about that unaffiliated fund. Our concern is that in some contexts, a private fund may use an unaffiliated investment adviser for particular matters, or in addition to an affiliated investment adviser. We suggest that the language be modified to clarify that a private fund's information is only the information of the registered investment adviser and subject to disclosure and reporting only if that private fund is sponsored by the investment adviser or any affiliated person of the investment adviser. This change would ensure that only one adviser is required to provide information about a private fund, and help avoid potential duplication and confusion.

<u>Section 204(b)(3)</u>of the discussion draft provides that the Commission can obtain optional information as it deems necessary and it further authorizes the Commission to set different reporting requirements for different classes of private fund based on the size and type of funds.

In fact, we are very supportive of the concept of calibrated reporting requirements for different types of funds. However, we urge that the language base this calibration not just on the type and size of funds, but on their potential to cause systemic risk.

At the same time, we believe the optional reporting requirement in this subsection is a sweeping and troublesome grant of information gathering authority to the Agency, especially given the enormous detail already required to be filed under the IAA. The section in the draft immediately preceding this provision -- Section 204(b)(2) -- itself authorizes the SEC, in consultation with the Federal Reserve, to collect such information as it deems necessary or appropriate "in the public interest and for the protection of investors or for the assessment of systemic risk." That should be sufficient to carry out the goals of protecting investors and guarding against systemic risk. Thus, we ask that you strike the optional reporting portion of this subsection while retaining and modifying the broader mandate to the SEC that it calibrate all reporting requirements based on the type and size of funds and their potential to cause systemic risk.

Section 6 creates a venture capital exemption. Let me say first that I sympathize with the intent to offer relief to certain funds that may not have the resources or the infrastructure to absorb the administrative costs that accompany registration, and which also are too small to create systemic risk, individually or collectively. However, as currently drafted, the provision may not accomplish its purpose and prove impossible to implement.

PE and venture capital funds (along with other investment firms like real estate and energy funds) have virtually the same business model, skill set and compensation structure. Indeed, many members of the Private Equity Council have funds that invest in early-stage companies, and many venture firms have several billion dollars under management. Given these similarities, I think it will prove nearly impossible to define a "Venture Capital" firm and to distinguish these from most other investment firms.

But as I said, it is reasonable to consider some exemptions from the new registration requirement but I suggest it is simpler, fairer, and fully consistent with the purposes of the Act to base exemptions not on what a fund says its business is, but rather on the activities a fund engages in, the potential for those activities to cause systemic risk, and the fund's size.

Specifically, I would suggest that the most direct and equitable solution is to raise the threshold above which registration is required from $30 million to a level that Congress believes is appropriate. This would ensure that the registration requirement captures the larger firms, regardless of their classifications, that are more likely to pose a systemic risk. This approach has the virtue of treating all small investors similarly, and will still result in many VC funds being exempted. As importantly, it helps ensure that the SEC can focus its scarce resources on overseeing those firms that are most relevant to the public policy concerns underlying this proposal.

Thank you again for the opportunity to express our views on the "Private Fund Investment Advisers Registration Act of 2009." We look forward to working with the Committee to enact sound registration requirements.