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Protecting the Ability of Private Equity to Provide Capital to Small Businesses

Private equity investment in small businesses plays an important role in creating jobs and in growing businesses. The small business private equity continuum that spans from angel investors, seed funds, venture funds, growth funds, Small Business Investment Companies (SBIC), mezzanine funds, to transition/change in control funds are all private equity that directly invest in domestic small businesses. Not one element of this continuum, or even the entire bloc collectively, poses any systemic risk – none. None of these fund types were a contributing factor to the financial meltdown. To the contrary, these small business investors helped save thousands of small businesses and create new ones. Small business funds provide more than capital. They provide expertise, strategic counsel, management development, and business networking to which the small business owners would otherwise never have access.

Small business investing requires, and in fact thrives on, business and economic risk. Business and economic risk are healthy, manageable, and benefit the economy. Political and regulatory risks, particularly the risk of unintended consequences of new regulations that were designed to target systemically significant entities, pose a real threat to the viability of small business investors and the entrepreneurs they foster. While nothing in the small business private equity continuum contributed to the financial meltdown, these funds are now at risk of taking a disproportionate share of the regulatory burden. As regulators sort through the thousands of pages of Dodd-Frank and write thousands of new pages of regulations to interpret this complex and expansive statute, we would implore you to look not only at the aggregate impact of your actions, but to specifically focus on the real world impacts on domestic small businesses and the funds that provide capital to them – capital that is not and will not be available from banks. We understand the societal imperative to move away from excessive risk for large systemically critical institutions. However, if the new regulatory regime damages the ability of “non-systemic” investors to risk their capital in small businesses, then small businesses and the entrepreneurs who create them will be the ones who ultimately pay the price. The regulatory burdens that a small fund can endure are very different from what a large fund can endure.

You will hear from other associations about their respective investment classes, but take a moment to look at SBICs and lower middle market funds. These private equity funds are set up as partnerships, commonly with a 10 year life span. The partnership nature of these funds aligns the interests of the general partners (fund managers) with the limited partners investing in them. In almost all cases, the “carried interest” (the fund managers’ share of the profits) is contingent on meeting an agreed upon profit target, ensuring pay for performance. The limited partners in small business private equity funds can be wealthy individuals (accredited investors), but more commonly are institutional investors. These institutional investors have teams of professionals that screen fund managers, to ensure that they are dealing with the best management teams available. To diversify their own investment exposure institutional investors generally invest in no more than 5% of a fund, but given the very small size of most small business funds they can be a higher percentage of a small fund without creating any concentration risk. These funds provide patient capital by using equity, debt with equity features, subordinated debt, or a mix of all three – capital that banks cannot and will not provide. Given that these funds are investing in small businesses that are either profitable or at least growing, the risk profile of SBIC and lower middle market funds is relatively low risk. The vast majority of these small business investments are profitable, but generally are “singles” or “doubles” and not “home runs.” While banks have cut off lending thousands of small businesses, SBICs, lower middle market funds, and other small business private equity never stopped backing domestic small businesses. The economy needs more of these funds, not less. As regulations are promulgated they should be fashioned in a way to encourage a greater number of small business funds.

It is important to be clear what Small Business Investment Companies and lower middle market funds are not. These funds are not buy or selling stocks on the exchanges. They are not “hedging” or playing currency markets. They are not large, generally smaller than $500 million, with most being well below $300 million. They are not performing hostile takeovers, but are backing small businesses to grow them. These funds are generally not large organizations. Most have fewer than ten employees, with some having as few as two to three people. Smaller funds are not able to absorb large regulatory compliance costs. The smaller the fund the more painful it is to absorb regulatory compliance expenses. They are very unlikely to invest in larger businesses. It is a fact that that the smaller the fund the more likely it is to invest in small businesses. These funds are not get rich quick schemes trying to time markets or make a quick buck. Investing takes time, commonly years, and the funds themselves have a decade long life span. Because of the size of the funds, these fund managers cannot ride on management fees. The bulk of the fund manager's pay comes from profit sharing and thus maintaining the common interests with the investors. These funds are not limiting their investments to Silicon Valley or to foreign markets. To the contrary, SBICs invest exclusively domestically as do most other lower middle market funds. These funds invest in the areas of the country and in sectors that are routinely passed over by the large funds. There are good small business investments from Montana to Alabama. These funds do not invest exclusively in software or biotechnology, but they do have the audacity to recognize that manufacturing can still be successful in the United States.

While small business investing slowed in the financial crisis, small business private equity has returned and is serving the small business community. Debenture SBICs just had their biggest year in the 52 year history of the program, putting approximately $2 billion into thousands of domestic small businesses. One in four of these investments were made in "smaller enterprises." One in five of these investments were in businesses less than two years old. One in ten of these investments were "Competitive Opportunity Gap" small businesses. Clearly, these funds have already exceeded last year's investment amount and 2011 and 2012 are expected to be even better years for small businesses because scores of new SBICs will be coming online.

Examining the most recent private equity industry data from PitchBook reveals very encouraging trends pertaining to the availability of capital made available by lower middle market funds. So far in first three quarters of 2010, small funds with assets between $50 million and $500 million have matched the number of transactions for all of 2009. If this pace continues these funds are on pace to handily break the previous year's total. Additionally, for funds falling in this same asset size range, $24 billion have been invested so far in FY2010, compared to $23.4 billion for all of FY2009.

Regulatory actions should encourage these trends, not discourage them.

Minimizing the Negative Impact of SEC Registration on Small Investment Funds

Specific Recommendations:

- Raise asset threshold from $150 million to enable small business funds to raise more capital for investing in small businesses. The cost of registration is manageable for very large funds but is onerous on small funds.
- The venture definition, and therefore exclusion, should protect all funds that invest directly in "small businesses." Small Business is clearly defined in the Small Business Investment Act. This should not be the only option for qualifying for the venture exemption, but it should be at least one of the available options for exemption.
- Apply the triggering threshold exclusively to funds that are otherwise non-exempt. For example, a $75 million small business fund would be forced to register if it also had a $90 million SBIC.
- Minimize the record keeping burden for exempt funds. If exempt from registration, offer these funds a true exemption from the burden.
- Create a "Registration Light" system for funds that invest primarily in small business.

While the Dodd-Frank Act is written in a way to specifically exempt SBICs and those who are in the process of qualifying for an SBIC license from registering with the SEC, the same cannot be said for other privately operated small business investment funds. While §408 attempts to address the burdensome registration requirements for these job-creating small funds, it is written in a way that can create an investment disincentive to managers of these small funds, and in turn will be a detriment to small business owners as a whole.

§408 of the Dodd-Frank Act states the following makes the advisor to a small fund exempt from SEC registration requirements:

- Solely advises private funds
- Have total assets under management in U.S. of less than $150 million.

§408 also states that although exempted, these advisers may be required to maintain all records as if registering with the SEC, and the SEC may periodically request reports, annual reports, etc., thus adding no significant benefit to the public, but plenty of burden on a small fund. If they are exempt, why should these funds absorb hundreds of thousands of dollars in costs that add no value to the investors or the public? If a new burden must be created, then creating a record-keeping requirement for small business funds that are exempt from registration will still allows for data collection, but is less onerous and costly, which will allow for more investment in small businesses.

For fund managers that have both an SBIC fund and a non-SBIC fund, the capital under management from the SBIC should not be included in the registration trigger. SBIC are already highly regulated – more highly regulated than any other private equity even under an aggressive interpretation of Dodd-Frank. Given this regulatory structure, small funds should not be penalized with additional regulatory compliance costs if due to the size of their non-SBIC they would not otherwise be required to register.

For the middle-market funds that have more than $150 million in assets under management but are still below the $500 million level should not be required to register with the SEC in the same manner than a fund with billions of dollars of assets under management. The SEC should create a "Registration Light" requirement to where these middle-market funds would still be required to register with the agency, but would not have to perform the time and money-intensive actions that are only applicable to larger funds. A "Registration Light" system would allow these funds, which are still considered extremely small within the private equity industry, to spend more time investing in small businesses and less time stretching their infrastructure and staffs thin in order to report an amount of information to the SEC that is more than the agency needs to track the fund's performance.

<u>Minimizing the negative impact of the Volcker Rule on Small Investment Funds</u>

Specific Recommendations:

- While SBIC investments are explicitly permitted, regulators should not pose any additional restrictions on investments in SBICs.
- Do not require independent Limited Partners in bank-sponsored funds to be required to already be trust, fiduciary, or investment advisory clients of the banking entity.

- When implementing the Volcker Rule, regulators should raise the 3% Tier-1 capital limit on bank investments in a small investment fund.
- Regulators must allow a bank to be a sponsor of an SBIC or other small business fund while still being permitted to provide custodial services to the fund.
- Define "Private Equity Investment" as "cash invested into a private fund minus cash distributed by that private fund."
- Do not force the divestiture of illiquid assets by small investment funds all at one time.

Small business private equity funds and SBICs are funds that invest directly in small businesses. The Volcker Rule should be implemented in a way to encourage small business investing instead of inhibiting it. The SBA has stated that 65% (9.8 million) of new jobs created from 1993-2009 were due to small businesses. It must be implemented in a manner such that funds that invest in small businesses will continue to be able to receive investment, sponsorship, and organizational guidance from banks. Banks, both large banks and community banks, are critical sources of investment capital for small business funds. The funds are not critical to the banks, but the banks are critical to the funds. Without a mutually beneficial relationship with banks, many of these small private equity funds cannot serve the small business community.

Often confused with hedge funds that, who in volatile situations can affect the nationwide economic outlook and pose a systemic risk, small business private equity funds investing in only a tiny fraction of the total U.S. economy and bank capital therefore do not pose a systemic risk. In implementing the Volcker Rule, it will be extremely important that systemic risky practices are clearly delineated in such a way that they do not apply to small business private equity funds or SBICs. If these funds were forced to adhere to the same policies reserved for systemically risky entities then the result would be extremely detrimental to the small business owners that rely on this niche small business investment industry as a primary source of patient capital.

The risk associated with bank investment in and sponsorship of small business private equity funds is minimal because banks and other institutional investors commonly diversify their risk by limiting their amount of investment in any one small fund; rather, banks spread out their investments across a range of vehicles.

The sponsoring of small business private equity funds and SBICs allows banks to not only provide capital to their communities and neighboring areas, but also to invest in both early-stage and existing companies that create jobs and stimulate economies. These small job-creating companies generally are not eligible for traditional bank loans, but are excellent candidates for capital or equity infusions from private equity funds that receive their funds for investment from banks. In this manner, small companies are given the opportunity to grow and hire new workers; only in this case the capital is not commonly coming from a single bank or from a single loan, but rather through investments made by funds of experienced investment professionals who specialize in this type of transaction. Of further importance, the fund's investment in small businesses mitigates risk by distinguishing standard loans from direct investments and maximizing returns while compartmentalizing the risk to the bank.

Small business private equity funds fill a crucial void for small businesses looking for capital, as these small businesses generally cannot receive investment from most large funds. It is critical to recognize that most large funds must invest in sizes too large for small businesses to absorb. A $200 million funds will likely make investments in $1 million to $5 million sizes. A $1 billion plus fund commonly deploys capital in $50 million investments.

As it is written, the Volcker Rule may not allow a banking entity deemed a "sponsor" of a private equity fund to offer certain services in relation to this sponsorship. For example, a bank that is deemed a "sponsor" of a private equity fund is not allowed to provide any custodial services or offer any services that are considered "covered transactions." These "covered transactions" include extensions of credit; therefore, as a "sponsor," a banking entity would be considered a directed trustee but unable to provide basic credit services to its fund clients. This policy of prohibiting banks from performing basic custodial services will not only discourage banks from sponsoring small business investment funds, but will cut off capital to small businesses. If implemented with this prohibition on banks, it would also be very onerous for entities located in areas that aren't financial hubs. It would be tragic if the Volcker Rule were to cut off investment to the next generation of entrepreneurs due to regulatory actions cutting off bank capital and banking relationships to small business funds

In implementing the Volcker rule regulators are tasked with defining terms such as "Private Equity Investment." "Private Equity Investment" should be defined as "cash invested into a private fund minus cash distributed by that private fund." In this manner, the definition of "Private Equity Investment" will not be based on capital commitments, which are not called all at once for private equity funds, but rather over a course of 10 or more years. If the definition of this investment is based on capital commitments rather than cash on hand, total private equity investments allowed under the Volcker Rule would decrease substantially, further disrupting the flow of capital to small businesses.

When regulators are examining the best way to implement the Volcker Rule to allow for its provisions dealing with the appropriate timing of the divestiture of illiquid assets, they must take into account that lives of illiquid private equity funds may extend for 15 or more years, and that there are very high penalties for failing to meet future capital calls, including the loss of all previously invested capital. Given this information, it will be extremely important regulators do not force the liquidation of small private equity funds all at one time as this would saturate the secondary markets, cause a loss of value for all funds, and negatively impact the small businesses that rely on these funds for capital.

The key theme throughout these comments is to be careful when dealing with small business. As regulators are looking at the big picture it is imperative that the impact on small business is constantly assessed. It is all too easy to cut off capital to small businesses while focusing on the big institutions that get all the attention. Please take the time to drill down to the real world impact on small business investing as you interpret and implement financial regulatory reform.

Sincerely,

Brett Palmer

Brett T. Palmer
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