ACG®
Association for Corporate Growth

August 7, 2018

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington D.C. 20549-1090

**RE: Comments of the Association for Corporate Growth on "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation," File Number S7-09-18**

Dear Mr. Fields:

The Association for Corporate Growth ("ACG") welcomes the opportunity to comment on the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers and Request for Comment on Enhancing Investment Adviser Regulation (the "Request for Comment") issued by the U.S. Securities and Exchange Commission ("SEC" or "Commission").[1]

ACG agrees that as a fiduciary, investment advisers should be held to the highest standards of conduct and must act in the best interests of their investment advisory clients. In addition, ACG agrees with the Commission's recent focus on increasing protections for Main Street investors and combatting retail securities fraud.[2] With microcap "pump and dump" frauds, Ponzi schemes, sales of unsuitable products and boiler-room scams all targeted at retail and elderly investors as described by Chairman Clayton in a recent speech,[3] it is important that the SEC work to protect Main Street investors.

However, as described in detail below, the sophisticated institutional investors who invest in middle-market private funds are not similarly situated as the Main Street investors the SEC seeks to protect in its Request for Comment. As a result, while the benefits of the enhanced protections described in the Request for Comment make sense to shield Main Street investors from well-documented harms in the marketplace, applying the enhanced regulation on the institutional investment side creates significant costs without a clear corresponding benefit.

[1] 83 Fed. Reg. 21203 (May 9, 2018).
[2] *See* Statement of SEC Chairman Jay Clayton, Remarks on the Establishment of the Task Force on Market Integrity and Consumer Fraud (July 11, 2018), *available at* https://www.sec.gov/news/speech/task-force-market-integrity-and-consumer-fraud.
[3] *Id*.

As a general matter, ACG is concerned that the enhanced regulations described in the Request for Comment will impose unnecessary burdens on investment advisers that advise private funds. Two of the proposed new regulations in particular would result in a significant, unnecessary burden on middle-market private fund firms with little corresponding increase in investor protections or benefits. Specifically, ACG urges the Commission to not move forward with proposals that would require: (1) federal licensing and continuing education requirements for investment adviser representatives, and (2) the provision of account statements from investment advisers.

Foregoing these proposed requirements strikes the appropriate balance between the Commission only increasing regulatory obligations when there is a clear benefit with ensuring there are meaningful investor safeguards in place, an important goal of the Commission.[4]

## I. <u>Background on the Association for Corporate Growth and Middle-Market Private Equity</u>

ACG was founded in 1954 and has more than 14,500 members and 59 chapters throughout the world, 45 of which are located within the United States. ACG members are people who invest in, own, advise or lend to growing middle-market companies. This includes professionals from middle-market private equity and private debt firms, corporations, banks and other public and private lenders to middle market companies, as well as professionals from law firms, accounting firms, investment banks and other advisors engaged in the process of middle-market deal making.

The mission of ACG is to "drive middle-market growth." ACG helps to facilitate growth by bringing together middle-market dealmakers and business leaders who build value in companies. ACG accomplishes this by hosting more than a thousand chapter events every year, providing online tools for its members, structuring networking opportunities and providing leading-edge market intelligence and thought leadership.

Given the depth and breadth of ACG's diverse membership, ACG is the voice of the middle market. ACG engages with regulators and legislators to educate them about the important role played by middle-market private capital providers and businesses and to advocate for well-reasoned policies that are clear, appropriately balanced, and reflective of marketplace realities.

### A. Middle Market Private Equity

A particular focus of ACG is middle-market private investment. ACG's membership includes over 2,000 middle-market private equity (MMPE), mezzanine and private debt

[4] *See* Statement of SEC Chairman Jay Clayton, Remarks to the Annual Government-Business Forum on Small Business Capital Formation (Nov. 30, 2017), *available at* https://www.sec.gov/news/public-statement/annual-government-business-forum-small-business-capital-formation.

firms that focus on providing capital to middle-market businesses. ACG's private investment firm members invest in small and midsize U.S. businesses, providing these companies with vital capital allowing them to expand and grow.

In 2013, ACG, in collaboration with the University of Wisconsin Extension Division for Business and Entrepreneurship's Business Dynamics Research Consortium (BDRC) and PitchBook Data, Inc., launched its ground-breaking research database, www.GrowthEconomy.org. GrowthEconomy.org is a dynamic database, drawing from multiple independent databases, to better understand the positive impact that private capital investment has on corporate growth and job creation in the United States. It is currently being updated to track data through the year 2017, and the tentative results show the substantial positive impact made by private capital investment between 1998 and 2017:

- Private equity-backed companies grew jobs by 72.2%, while all other companies in the U.S. economy grew jobs by 24.7%;
- Private equity-backed companies grew sales by 86.7%, while all other companies in the U.S. economy grew sales by 28.9%; and
- Middle-market private equity-backed companies created 81.8% of all the jobs created by private equity firms.[5]

Investors in private equity funds largely include pension funds and university endowments.[6] These investors have benefited from a 10-year return of 9.7% (period ending June 2017)[7] superior to the 7.9% return by the S&P 500 in that same time period[8] – helping enable these organizations to meet their ongoing obligations. MMPE firms provide this rate of return by improving the operational efficiency, governance and market strength of the companies in which they invest. 58% of institutional investors participate in private equity investment, and 53% of institutional investors plan to increase their allocation to private equity over the long term.[9]

These benefits, backed by supporting data, are among the reasons that private equity continues to attract the investment and trust of highly demanding, sophisticated investors.

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[5] *See infra* Appendix I.
[6] *See* "Private Equity Funds," Investor.gov, *available at* https://www.investor.gov/introduction-investing/basics/investment-products/private-equity-funds.
[7] Indexed using mPME. *See* Cambridge Associates, "New Method for Comparing Performance of Private Investments with Public Investments," Press Release (Oct. 2013), *available at* https://www.cambridgeassociates.com/press-releases/new-method-for-comparing-performance-of-private-investments-with-public-investments-introduced-by-cambridge-associates
[8] *See* Bain & Company, "Global Private Equity Report," (2018), *available at* http://www.bain.com/publications/articles/global-private-equity-report-2018.aspx.
[9] *See* Preqin, "Investor Outlook Alternative Assets H1," (2018), *available at* http://docs.preqin.com/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2018.pdf

### B. ACG's Private Equity Regulatory Task Force

Over the past several years through a series of speeches and enforcement actions, the Commission and SEC staff have made clear that investment advisers to private funds owe a fiduciary duty to their clients – i.e. the private funds that they advise.[10] In response to this new regulatory environment, in 2014, ACG formed its Private Equity Regulatory Task Force (PERT), comprised of chief compliance officers, chief financial officers and in-house counsel to middle-market private equity firms from around the country. Central to PERT's mission is to better enable middle-market private equity firms to fulfill their fiduciary obligations. PERT accomplishes this by helping middle-market private equity firms navigate the changing regulatory landscape and also by creating a community of peers to discuss industry and compliance best practices.

## II. Middle-Market Private Funds are Not Marketed to Retail Investors

It is crucial to understand that, like all private funds, middle-market private equity firms do not target retail investors. Interests in middle-market private funds are offered not through public offerings, but rather via a private placement under Rule 506(b) of Regulation D of the 1933 Securities Act.[11] While after the 2012 JOBS Act private offerings may be conducted using general solicitations and advertising via Rule 506(c), middle-market private equity firms continue to offer their funds solely to high net worth, sophisticated investors through Rule 506(b) private placements.

There are several reasons for this. First, the overwhelming majority of middle-market private equity funds only accept investors who are not only "accredited investors" under the Securities Act of 1933, but who are also "qualified clients" under the Investment Advisers Act of 1940 – a higher standard for potential investors to meet.[12] In addition, private funds are subject to the Investment Company Act of 1940 ("ICA"), and to ensure a fund is not required to register as an investment company under the ICA, firms take great care to ensure the fund qualifies for an exemption under either ICA Section 3(c)(1)[13] or

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[10] It is well-established law that where an investment adviser advises a private fund or pooled investment vehicle, the "client" of the adviser under federal securities law is the fund and not the investors in that fund. *See Goldstein v. SEC*, 451 F.3rd 873, 371 U.S. App D.C. 358, 2006 (D.C. Cir. June 23, 2006).

[11] Rule 506(b) offerings require that the issuer not use general solicitation or advertising to market the securities. To avoid a general solicitation or general advertising, securities may only be offered to persons with whom the issuer has a pre-existing substantive relationship.

[12] Under Investment Adviser Act Section 205(a) and Rule 205-3 promulgated thereunder, an investment adviser is prohibited from receiving compensation on the basis of capital appreciate – i.e. a carried interest – from non-qualified clients. A "qualified client" is defined in Rule 205-3 as a natural person who has at least $1,000,000 under the management of the investment adviser or has a net worth of more than $2,100,000 (not counting the value of the person's primary residence.

[13] ICA Section 3(c)(1) exempts investment vehicles with fewer than one hundred (100) beneficial owners from having to register as an investment company.

Section 3(c)(7).[14] Qualifying for either exemption (i.e. accepting fewer than 100 investors or only investors with no less than $5,000,000 in investments) precludes investment advisers from accessing the retail markets for their funds.

In short, the investors in middle-market private funds are not retail investors – the category of persons the Commission is most concerned about protecting in the Request for Comment.

## III. There is No Need For Enhanced Investment Adviser Regulation as it Relates to Middle-Market Private Fund Advisers

In its Request for Comment, the SEC asks for public comment on certain areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context. ACG is particularly concerned about the prospect of new regulations on private fund advisers, particularly regulations that would establish (i) federal licensing or continuing education requirements for investment adviser representatives, or (ii) additional reporting requirements.

### A. The SEC Should Not Establish Federal Licensing and Continuing Education Requirements for Investment Adviser Representatives

The Request for Comment notes that the federal securities laws do not require investment adviser representatives ("IARs") to become licensed or to meet qualification requirements, even though most states impose registration, licensing, or qualification requirements on IARs who have a place of business in the state regardless of whether the investment adviser is registered with the Commission or the state. The Request for Comment then goes on to question whether IARs should be required to register with the Commission and, if so, whether such registration requirements (if imposed) should apply to individuals who provide advice on behalf of SEC-registered investment advisers but fall outside the current definition of "investment adviser representative" because, for example, they have five or fewer clients who are natural persons.

Investment Advisers Act Rule 203A-3(a)(1) generally defines an "investment adviser representative" as a supervised person of an investment adviser who (i) has more than five clients who are natural persons and (ii) more than ten percent of whose clients are natural persons. Thus, advisers solely to private funds, including to middle market private equity funds, generally do not have any employees who fall within the definition of an IAR because such advisers generally do not have any natural person clients.

ACG believes that the current federal regulatory regime for investment adviser representatives is sufficient, and it is neither necessary nor prudent to impose a host of

[14] ICA Section 3(c)(7) exempts investment vehicles, all of whose beneficial owners are "qualified purchasers" from having to register. A "qualified purchaser" is defined to include a natural person or trust with not less than $5,000,000 of investments and a company with not less than $25,000,000 of investments.

registration, examination, licensing and/or continuing education requirements on personnel from investment advisers that do not have natural persons as clients.

Passage of the Series 65 examination is required by nearly all states for individuals who seek to act as an IAR for a state-registered investment adviser.[15] This examination is geared towards ensuring that IARs are knowledgeable about financial planning matters, and focuses on topics such as retirement planning, fixed income securities, derivative securities, insurance-based products, portfolio management strategies and fiduciary responsibilities.

It may not be unreasonable to impose such a licensing requirement on IARs who provide advice to natural persons (typically including the providing of investment advice to retail investors). However, it is both unnecessary and would be unduly burdensome to require federally-registered private fund investment advisers with no or limited natural person clients to have certain personnel pass a Series 65 or similar examination. The imposition of such a licensing requirement would provide little tangible benefit for either the adviser or the client (the investment fund) in that most examinations required of IARs focus on retail-facing topics (such as retirement planning, portfolio management, etc.) that are not relevant to the adviser's focus of making direct equity or credit investments in privately held businesses. Such a requirement would result in firm personnel being distracted from their core investment activities and having to spend valuable time and resources studying irrelevant topics rather than maximizing investor returns.

### B. The SEC Should Not Require the Provision of Account Statements from Investment Advisers

The Request for Comment also asks whether the Commission should propose rules that would require registered investment advisers to provide account statements, either directly or via the client's custodian, regardless of whether the adviser is deemed to have custody of client assets under the Advisers Act.

ACG believes that requiring private fund investment advisers to provide account statements regardless of whether the adviser is deemed to have custody of client assets under the Advisers Act is unnecessary. Advisers to private funds are generally deemed to have custody of their clients' assets and are therefore already subject to Rule 206(4)-2 (the "Custody Rule"). In addition to the Custody Rule, investors in middle-market private funds firms enter into a detailed limited partnership agreement ("LPA") that give the investors (referred to as limited partners) detailed rights and impose specified obligations on the fund's general partner. LPAs, as a matter of course, require the general partner to annually distribute audited financial statements of the fund and the fund's portfolio companies as well as quarterly unaudited financial statements to all fund investors. These financial statements already include a statement of all management fees and other investment advisory fees charged to the fund.

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[15] In many states, the Series 65 examination is merely a pre-requisition and RIAs must also obtain a Series 7 or a Series 66 license.

Requiring middle-market private fund advisers to provide account statements is unnecessary in light of the detailed information that investors already receive pursuant to the Custody Rule and fund LPAs.

## IV. Conclusion

Middle-market private funds are not marketed to retail investors – they are marketed to institutional investors and sophisticated high-net worth individuals through private placements conducted without the use of general solicitations or advertising. As such, ACG is particularly concerned about the prospect of imposing either (i) federal licensing and/or continuing education requirements on personnel of advisers with no or few natural person clients and/or (ii) additional reporting obligations on middle-market private fund advisers. ACG does not believe that these or any of the other enhanced regulations discussed in the Request for Comment are necessary or warranted. Indeed, the imposition of such regulations would result in a significant, unnecessary burdens on middle-market private equity firms with no corresponding increase in investor protections or benefits.

ACG appreciates the opportunity to comment on the SEC's Request for Comment on Enhancing Investment Adviser Regulation and welcomes the opportunity to further discuss any of the issues addressed in this letter. If you have any questions, or if we can provide any additional information, please feel free to contact Maria Wolvin, Vice President & Senior Counsel, Public Policy, at mwolvin@acg.org or at 312-957-4274.

Sincerely,

Patrick J. Morris
President & CEO
Association for Corporate Growth

**Appendix I:**

## Growth Economy

ACG® Association for Corporate Growth

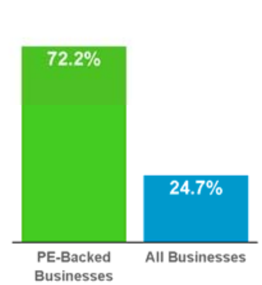
### UNITED STATES
**1998-2017**

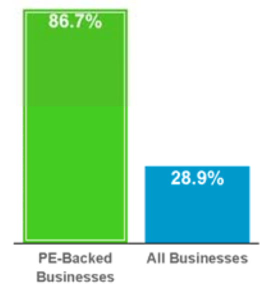
**Summary**

**Jobs grew 72.2%**
Private equity-backed companies in **middle market segment 3** with sales between $100 million and $1 billion led the way with 47% of job growth.

**Sales grew 86.7%**
Private equity-backed companies in **middle market segment 3** with sales between $100 million and $1 billion led the way with 49% of sales growth.

**2015 Total Capital Invested**
**United States:** $407,576,680,000



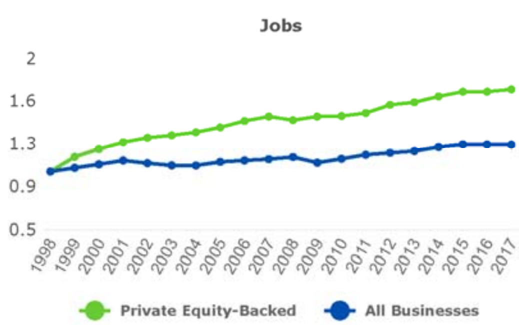




| ESTABLISHMENTS | 1998 | 2017 | Change | % |
|---|---|---|---|---|
| Private Equity Totals | 9,758 | 14,989 | 5,231 | 53.6% |
| All Company Totals | 10,670,164 | 15,963,692 | 5,298,759 | 49.6% |

| JOBS | 1998 | 2017 | Change | % |
|---|---|---|---|---|
| Private Equity Totals | 1,117,803 | 1,925,285 | 807,482 | 72.2% |
| All Company Totals | 132,056,434 | 164,127,700 | 32,878,748 | 24.7% |

| SALES | 1998 | 2017 | Change | % |
|---|---|---|---|---|
| Private Equity Totals | 420,605,221,000 | 785,421,240,395 | 364,816,019,395 | 86.7% |
| All Company Totals | 20,122,723,137,000 | 25,701,642,403,510 | 5,943,735,285,905 | 28.9% |

**Private Equity-Backed Index 1998-2017: United States**




PE MARKET SEGMENTS

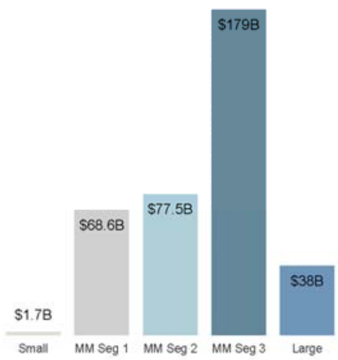
## Middle Market Results

**1998-2017**

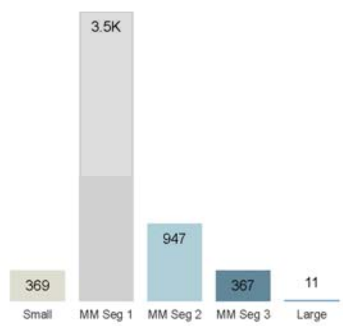
**Small** Less than 10M in Sales
**Middle Market 1** 10-50M in Sales
**Middle Market 2** 50-100M in Sales
**Middle Market 3** 100M-1B in Sales
**Large** More than 1B in Sales

### PE GROWTH NUMBERS breakdown of sales, establishments, and jobs

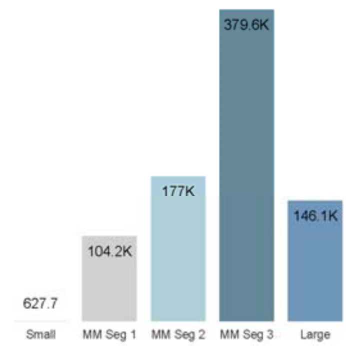
**SALES NUMBERS by Segment**




**ESTABLISHMENTS NUMBERS by Segment**

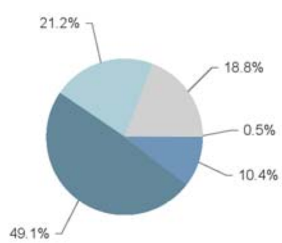



**JOBS NUMBERS by Segment**

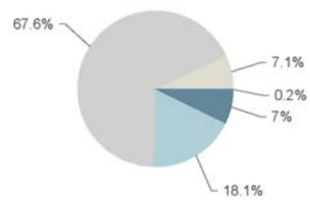



### PE GROWTH PERCENTAGE (%) breakdown of sales, establishments, and jobs

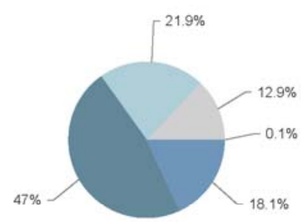
**SALES % by Segment**




**ESTABLISHMENTS % by Segment**




**JOBS % by Segment**

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