EISNERAMPER
ACCOUNTANTS & ADVISORS

www.eisneramper.com

Q2 2016

Asset Management Intelligence

A publication from The Financial Services Group

Specialty Finance: Marketplace Lending

By Brendan J. Keane

INTRODUCTION

This specialty finance commentary is the first in a series of updates on origination, secondary market and regulatory trends in consumer and commercial finance. "Specialty finance" encompasses a broad spectrum of industries, asset origination channels and products across the lending landscape, including mortgages and consumer loans, as well as auto and equipment finance, among others.

Given the potential credit and regulatory risks associated with some of these industries, U.S. banks have generally avoided the sector, though a selective few have acquired or established specialty finance lending units. On the other hand, private equity, credit, and strategic buyers continue to show interest in the market owing to the potentially higher returns in off-the-run lending segments. For these "non-banks," cost-efficient financing, sales and securitizations of underlying assets are critical in freeing up capital and balance sheet capacity to provide credit for their consumer and commercial borrowers.

Investors in asset origination platforms, the assets themselves and/or related securities need to be mindful of trends in both the primary (loan origination) and secondary (financing/sale) markets, particularly as each underlying asset class has its own set of opportunities and challenges. Our goal is to help our clients and prospects better understand relevant market trends and be prepared to navigate issues as they arise.

Below we focus on one specialty finance sector that is garnering a significant amount of attention: marketplace lending.

MARKETPLACE LENDING — A BRIEF HISTORY IN A NEW ERA

In the wake of the 2007-2009 financial crisis, where credit availability in certain industries effectively evaporated (e.g., subprime mortgage lending in the U.S.), alternative asset managers are again focusing on consumer and small business credit. This view is increasingly shifting from the tangled, paper-laden web of traditional mortgage lending to a dynamic "web" of convenience: online, marketplace lending ("MPL"). This rapidly emerging asset class is a hybrid product borne of financial technology and old-fashioned consumer/commercial finance--and one that is quickly becoming a driving force in lending and investment opportunity.

MPL has its roots in peer-to-peer lending ("P2P"), which began in the United Kingdom in 2005, where individuals lend to other individuals or businesses through an online marketplace. While it has since expanded to include direct, alternative lending from institutions, the core features of MPL remain the same: online, internet-based loan application and technology-driven credit approval. Early MPL innovators in the U.S., such as Avant, Lending Club, OnDeck and Prosper, were amongst the first to provide individuals and small businesses an expedient bank alternative by offering loans through online, technology-driven platforms: the new convenience stores for loans that enhance the customer experience. The success of those platforms has spawned a multitude of new lenders that are refining the automated, "machine learning" approach to credit to deliver need-specific financing such as unsecured consumer, payday, auto, student, health care, equipment, commercial/residential solar and real estate loans, among others. The "fintech" aspect of the lending process has also helped expand the geographic reach of marketplace lending, particularly across the Americas, United Kingdom, Europe, China and Australia.

The opportunities for marketplace lending are significant and growing, as approximately $3.6 trillion of U.S. consumer credit is outstanding and is increasing at a rate of nearly 6% per year.[1] Moreover, with over $2 trillion in commercial and industrial loans held among all U.S. commercial banks,[2] even capturing a small percentage of small business loans within that category provides substantial growth prospects. Indeed, MPL lenders

"WHAT MAKES THE DESERT BEAUTIFUL," THE LITTLE PRINCE SAID, "IS THAT IT HIDES A WELL SOMEWHERE…"

—Antoine de Saint-Exupery, The Little Prince

are charging ahead; a recent report indicates 700% growth over the past 4 years amongst the top U.S. MPL originators.[3] Growth in this market continues in other jurisdictions as well; in 2015, the United Kingdom's alternative finance industry grew to £3.2 billion, an 84% increase over 2014 lending volumes.[4]

INVESTMENT OPTIONS

As marketplace lending has evolved, so too have options for alternative investment managers, among them:

- *Venture capital and early stage investors in MPL and related platforms:* Consolidation will be at the forefront, as some MPLs will make acquisitions to achieve scale while shakeouts are bound to occur as the market matures. In addition, start-up service providers to the industry are emerging, providing credit data, marketing, software, payment collection and related functions.
- *Later stage private and public investors:* As marketplace lenders grow in scale and size through organic development or acquisitions, opportunities will extend to institutional and retail investors, as evidenced by the recent IPOs of MPL firms such as OnDeck and Lending Club.
- *Loan and securities investors:* As marketplace loans make their way from origination to distribution, we expect the market to grow for whole loan portfolio sales and asset-backed securitizations ("ABS"), particularly in the U.S. The MPL ABS market will be of interest as it transitions to an established, liquid asset class. Importantly, as more lenders enter the market, data and reporting metrics will vary—normalization of loan-level attributes and credit performance will be keys to investor and rating agency acceptance of ABS supported by MPL loans.

ECONOMIC AND CORPORATE FINANCE CONSIDERATIONS

Investors in the industry will need to question and research the business models of MPLs as their business functions vary.

- What roles are these MPLs playing and do they have a direct, economic interest in the subsequent credit performance of their loans? For example, is the MPL acting as a true, stand-alone marketplace (purchasing loans from other originators and selling those loans to investors) without retaining any economic interest?
- Alternatively, is the MPL firm "all-in," whereby it originates loans, retains them on a balance sheet and services the collections of borrower payments? Even if it operates such an end-to-end platform, the short maturity of marketplace loans (3-5 years) demands that investors be comfortable with efficient, early-stage servicing, payment collection and operational capabilities to ensure returns on investment.
- How extensive is the lender's competitive reach into consumer and commercial borrowers? As the number of MPL lenders increases, some firms are seeking to deepen their pool of prospective borrowers by, ironically, aligning themselves with traditional banks with co-branded or "white-gloved" origination programs. In the United Kingdom, it is estimated that traditional banks account for 25% of the loans on P2P websites.
- For marketplace lenders that fund their business via the ABS market, risk retention ("skin in the game") will likely be viewed more favorably by ABS investors and rating agencies given the alignment of economic interests.

ADEQUATELY MEASURING PERFORMANCE

A key differentiator between traditional financing and MPL loan origination is the technology deployed in the credit decision-making process. MPLs are increasingly using non-traditional metrics to measure a borrower's ability to pay, often using proprietary algorithms and data sources. The use of technology and integration of data on an automated basis (vs. manual underwriting of loan applications) speeds the credit review process, reducing origination costs. However, that "real-time" credit analysis varies from originator to originator and, given the relatively new construct of this market, only time will tell which MPL firms have best-in-class credit and performance models.

REGULATION AND BEST PRACTICES

Not all jurisdictions are progressing at the same rate in supervising MPL lending practices. For example, in the United Kingdom, the Financial Conduct Authority ("FCA") has already promulgated rules governing the authorization of these platforms to lend in the P2P market. In addition, the Peer-to-Peer Finance Association ("P2PFA"), a self-regulatory body, was established in 2011 to supplement the FCA's regulatory regime.

Specialty Finance: Marketplace Lending
(continued)

However, only recently have U.S. regulators, particularly the Consumer Financial Protection Bureau ("CFPB"), begun to examine MPL lending practices and their potential impact on consumers and small businesses. While U.S. MPLs originate under federal and state laws governing lending, banking and securities activities, many of these laws were enacted before the advent of MPL lending—consequently, developments in these areas require special attention. A recent case, *Madden vs. Midland Funding*, has raised significant concerns in the industry as to whether state usury or federal banking laws should apply in the origination and/or transfer of an MPL loan.

Industry and advocacy groups such as the recently founded Innovative Lending Platform Association, the Marketplace Lending Association and the Structured Finance Industry Group will hopefully develop lending, governance and/or reporting standards that deliver greater transparency to the origination and performance of MPL loans and related asset-backed securities.

CONCLUSION

While the financing needs of consumers and small businesses are omnipresent, we are witnessing the development of a new origination ecosystem for these loans. While formidable in its opportunity, the rapid development of the MPL industry bears watching, particularly in the nature of loan origination and servicing capabilities, asset credit performance and regulatory/judicial oversight. ■

As we go to publication, recent developments have materially affected the world of P2P/marketplace lending. In early May, Lending Club's founder, Chairman and CEO departed the firm over allegations regarding loan misrepresentations made to an investor in a portfolio sale as well as an undisclosed personal interest the executive may have had in a fund that Lending Club invested in. While circumstances are still coming to light, it appears that each issue is rooted in internal control failures.

Coincidentally, the U.S. Department of the Treasury published a white paper (https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf) on May 10 surveying online marketplace lending in the U.S., underscoring the need for greater transparency for investors and borrowers alike. Importantly, the white paper recognizes the growing importance of marketplace lending for individuals and small businesses in accessing credit. However, in citing the industry's fast growth and its relatively untested credit models and operations, the white paper calls for greater transparency around loan terms (e.g., annual percentage rates) and other borrower protections. Given the CFPB's broad authority, it seems likely that regulatory oversight will soon follow. As our commentary notes, adequate governance and transparency standards are key elements of any investor's decision-making process, particularly in a fast-growing industry. We will keep our readers apprised of related developments and their impact on the marketplace lending industry...stay tuned.

Brendan Keane is a Senior Managing Director of EisnerAmper Portfolio Analytics. For more information, feel free to contact him at brendan.keane@eaportfolioanalytics.com, 212.891.4148.

1. Federal Reserve Consumer Credit Data as of February 2016 at http://www.federalreserve.gov/releases/G19/Current/.

2. St. Louis Federal Reserve Report (March 2016) at https://research.stlouisfed.org/fred2/series/BUSLOANS/.

3. American Banker "Marketplace Lending Grew by 700% in Four Years," (April 8, 2016) citing a report published by the California Office of Business Oversight (April 2016) at http://www.americanbanker.com/news/marketplace-lending/marketplace-lending-grew-by-700-in-four-years-report-1080341-1.html.

4. The University of Cambridge, Cambridge Centre for Alternative Finance: "Pushing Boundaries, The 2015 UK Alternative Finance Industry Report" (February 2016) at https://issuu.com/cambridgejbs/docs/2015-uk-alternative-finance-industr/3?e=1935864/33468920.

5. The Financial Times, "Banks Behind a Quarter of Loans on Peer-to-Peer Websites," (February 17, 2016) at http://www.ft.com/intl/cms/s/0/357f6df0-d4bd-11e5-829b-8564e7528e54.html#axzz46ZWd0nXY, citing the University of Cambridge report, infra.

6. See Consumer Financial Protection Bureau March 7, 2016 press release at http://www.consumerfinance.gov/about-us/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender/. See also April 26, 2016 The Wall Street Journal "Consumer Finance Watchdog Plans to Supervise Marketplace Lenders at http://www.wsj.com/articles/consumer-finance-watchdog-plans-to-supervise-marketplace-lenders-1461794493.

The SBIC Advisers Relief Act: Impact and Opportunities

By Robert Sawyer, Partner, Foley Hoag

For many managers to private investment funds, the 2010 adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") changed the landscape of how they do business by subjecting these managers to registration requirements with the SEC and/or state securities regulators, or requiring them to qualify for one of several newly established exemptions from registration under the Investment Advisers Act of 1940 (the "Advisers Act"). Immediately following the passage of Dodd-Frank, the private fund industry's primary focus fell on the exemptions established for advisers solely to venture capital funds (the "VC Fund Adviser Exemption")[1] and for advisers solely to private funds having less than $150 million in regulatory assets (the "Private Fund Adviser Exemption").[2]

Both of these exemptions allowed advisers who qualified to operate under the less restrictive "exempt reporting adviser" notice filing regime. A further and less discussed exemption (the "SBIC Exemption"),[3] exempted from registration with the SEC advisers to small business investment companies ("SBICs") - private funds that have qualified for a license from the U.S. Small Business Administration ("SBA") to operate as an SBIC. SBICs invest in debt and/or equity securities of U.S. small businesses, and typically may supplement their investor capital with low-interest leverage in the form of SBA-issued debentures (up to an aggregate amount of 2 times the capital commitments of the SBIC's investors). As originally adopted, the SBIC Exemption was of somewhat limited utility, providing only a federal exemption and only for advisers whose business solely consisted of managing SBICs.

In December of 2015, the SBIC Advisers Relief Act (the "SAR Act") was adopted into law, which (i) preempts state registration requirements for advisers relying on SBIC Exemption, providing a full, self-executing exemption from registration with securities regulators for advisers solely to SBICs, and (ii) amends several key provisions of the Advisers Act to provide additional exemptive relief for advisers who manage both SBICs and non-SBIC private funds, as summarized below.

EXPANSION OF THE VENTURE CAPITAL FUND ADVISER EXEMPTION

As initially adopted under Dodd-Frank, neither the VC Fund Adviser Exemption nor the SBIC Exemption was available to an adviser that managed both venture capital funds and SBICs. The SAR Act provides relief to such advisers, by providing that SBICs will be considered to qualify as "venture capital funds" for purposes of the VC Fund Adviser Exemption, thereby allowing advisers to SBICs and venture capital funds to operate in reliance on the VC Fund Adviser Exemption at the federal level.

EXPANSION OF PRIVATE FUND ADVISER EXEMPTION

The SAR Act will also provide additional exemptive relief for certain investment advisers that advise an SBIC Fund and other non-venture capital private funds. As referenced above, the Private Fund Adviser Exemption exempts advisers whose clients are solely private funds and whose regulatory assets under management ("RAUM") in the United States are less than $150 million. This $150 million calculation includes the gross value of the assets of all private funds managed by the adviser, including any uncalled capital commitments, without deduction for any liabilities of the private funds. The SAR Act expands the Private Fund Adviser Exemption by excluding assets of SBICs managed by the adviser from the assets included in the $150 million threshold. As a result, an adviser whose non-SBIC private funds have gross assets of less than $150 million may qualify for the exemption, regardless of the AUM of the adviser's SBIC funds. By way of example, the maximum size of a typical levered SBIC is $225 million (assuming that the SBIC qualifies for and maintains 2:1 leverage on $75 million of capital commitments). Thus an adviser relying

1. Section 203(l) of the Advisers Act and SEC Rule 203(l)-1
2. Section 203(m) of the Advisers Act and SEC Rule 203(m)-1
3. Section 203(b)(7) of the Advisers Act.

on the Private Fund Adviser Exemption could, with the introduction of a single levered SBIC, increase their maximum permitted assets under management to $375 million.

INTERACTION WITH STATE REGULATION

Neither the Venture Capital Fund Adviser Exemption nor the Private Fund Adviser Exemption will preempt state regulation of fund managers, and state level exemptions are not uniform. Private fund managers must examine the laws of each state in which they do business, or intend to do business, in order to determine the availability of state level exemptions. However, several states have adopted a private fund adviser exemption, based on a model rule developed by the North American Securities Administrators Association ("NASAA"), which requires filing with the applicable state securities regulator a copy of the exempt reporting adviser filing submitted to the SEC. In addition, the NASAA model rule requires that, in order to claim the exemption provided thereby, each private fund that is not a venture capital fund or a 3(c)(7) fund (also known as a "qualified purchaser" fund) must (i) limit investors to those that satisfy the "qualified client" standard set forth in SEC Rule 205-3 (the SEC's performance fee rule), a higher standard than the "accredited investor" definition, and (ii) deliver to each fund investor annual audited financial statements for the private fund. One current area of uncertainly with respect to NASAA model rule jurisdictions is the extent that an SBIC will be considered to be a "venture capital fund" for purposes of the additional "qualified client" and audit requirements. The SAR Act introduced the change to treat an SBIC as a venture capital fund directly into Section 203(l) of the Advisers Act. The NASAA model rule on the other hand solely cross-references the definition of "venture capital fund" set forth in SEC Rule 203(l)-1. Several state securities regulators have informally indicated that they are considering whether a harmonizing amendment will be introduced to resolve this uncertainty.

As a result of the amendments introduced by the SAR Act, advisers with both SBIC and non-SBIC private funds, and advisers pursuing investment strategies focused on investments in smaller private companies for whom SBICs may be an alternative to expand their advisory business, should consider the effect of these amendments carefully.

■

Robert Sawyer is a partner at Foley Hoag. (http://www.foleyhoag.com/) Questions? You can contact Robert at 617.832.3071 or rsawyer@foleyhoag.com

What Is a Liquidating Trust?

By Garth Puchert and Richard Shapiro

When "Liquidating Trust" is mentioned, most people associate this with bankruptcy. In a bankruptcy, a liquidating trust may be formed whereby certain assets are placed in a trust for the benefit of creditors who may have certain claims against those assets.

A liquidating trust may also be an effective method for a fund manager to wind down a fund without having a significant role in the liquidation. At the end of the fund's life cycle or term, the fund manager may have certain assets that are not easily liquidated and convertible into cash for distribution to the owners of the fund. It may take several years for such assets to be converted into cash. Such assets may consist of securities that are illiquid or have certain restrictions or monies held in escrow where it will take several years for the conditions to be met for release of such funds. The objective of a liquidating trust is to help expedite the liquidation of the entity, and allow the owners to recognize gain or loss and to receive proceeds in an orderly manner.

In addition, it may be prudent for the fund manager to set aside certain cash reserves before making final distributions to the fund owners. This reserve could be held in the trust for any contingent liabilities as they become due.

A liquidating trust is a new legal entity that becomes successor to the liquidating fund. The remaining assets and liabilities are transferred into the newly formed trust and the former owners of the liquidating fund become unit holders or beneficiaries of the trust. The newly formed trust is governed by a trust agreement executed between the former fund and the trustees before liquidation of the fund. Such agreement provides for trustee duties, compensation of trustees, and governance as well as distributions and other administrative matters.

The liquidating trust normally has a lower cost structure than the existing fund and is managed on an "as needed" basis by the trustee as opposed to a full-time basis for the fund. The trustee takes control of the newly formed liquidating trust.

The role of the trustee of the liquidating trust is to administer and manage the liquidating trust, sell assets, pay creditors, resolve any claims and distribute any available funds to the beneficiaries of the trust. Over the last decade, a number of firms have been established to provide trustee services in addition to trust departments of banks.

TAX IMPLICATIONS OF A LIQUIDATING TRUST

A liquidating trust is generally considered a grantor trust for tax purposes. The trust will be considered a liquidating trust with the primary purpose of liquidating its assets. Should the purpose of the entity change, such as to carry on a for-profit business, then the entity will no longer be considered a liquidating trust. Also, if the time period is unreasonably prolonged, the status of the entity may change from a liquidating trust.

If a trust is created outside of Chapter 11 of the Bankruptcy Code, a private letter ruling may be requested if conditions of Revenue Procedure 82-58 are met. Under Revenue Procedure 82-58, the IRS will issue a private letter ruling if 8 conditions are met. Such conditions include, among other things, that the primary purpose of the trust is liquidation of the assets with no objective of carrying on a trade or business and the trust agreement should contain a fixed or determinable termination date. That term generally should not exceed 3 years.

A "business trust" should be considered instead of a liquidating trust if the purpose of the trust is to carry on a trade or business. A business trust is either treated as a corporation or partnership for federal income tax purposes.

What Is a Liquidating Trust?
(continued)

TAX TREATMENT OF A LIQUIDATING DISTRIBUTION FROM A CORPORATION

Since the business assets are deemed to have been distributed to the owners and then transferred to the liquidating trust, there will be an immediate recognition of a gain or loss from liquidation of the former business by the owners. Each owner must recognize a gain or loss on the deemed distribution received in liquidation. Such gain or loss is measured by the difference between the fair value of the liquidating distribution and the owner's adjusted basis in the corporation. The fair value of the contribution to the liquidating trust would represent the new owner's basis in the liquidating trust.

TAX TREATMENT OF A LIQUIDATING DISTRIBUTION FROM A PARTNERSHIP

Similarly, in the case of a liquidating distribution from a partnership, the business assets are deemed to have been distributed to the partners and transferred to the liquidating trust. Generally, a partner recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. A partner does not recognize loss on a partnership distribution unless (1) the adjusted basis of the partner's interest in the partnership exceeds the distribution, (2) the partner's entire interest in the partnership is liquidated and (3) the distribution is in money, unrealized receivables or inventory items. However, a partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property during the 7-year period before the distribution. A partnership generally does not recognize gain or loss because of distributions it makes to partners.

"...THE USE OF A LIQUIDATING TRUST MAY BE A COST EFFICIENT METHOD TO LIQUIDATE CERTAIN ASSETS"

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction. Thus, the partner's basis in the property can never be greater than the partner's basis in the partnership.
Upon the deemed contribution of the assets to the liquidating trust, the trust will have the same adjusted bases in its assets as the partners had in those assets immediately prior to the transfer to the trust.

CONCLUSION

As noted, the use of a liquidating trust may be a cost efficient method to liquidate certain assets. However, as with new legal entities, fund managers should consult with tax advisors before embarking on a liquidating trust to make sure that this type of entity makes sense for the situation.■

Garth Puchert is a partner at EisnerAmper LLP and Richard Shapiro is a tax director. For more information, feel free to contact them: garth.puchert@eisneramper.com, 212.891.4091; richard.shapiro@eisneramper.com, 212.891.6926.

Alternative Investment Industry Outlook for Q2 and Beyond in 2016

By Elana Margulies Snyderman

INTRODUCTION

Despite the fact that hedge funds underperformed the first couple of months of the year until March, the overall challenging markets have not deterred investors from continuing to express interest in the alternative asset class, even though trustees of the New York City Employees' Retirement System recently voted to redeem from hedge funds. Long/short equity managers, many sector-focused, are a popular choice amongst allocators, along with macro portfolios in hopes of capitalizing on the significant macro uncertainty, at least in the medium-term. Given those investor preferences, perhaps it is no mere coincidence that the majority of hedge fund launches in the next year are expected to be long/short strategies, many sector-specialists, along with macro offerings.

Meanwhile, private equity is also expected to continue to garner a lot of attention, both from investors, and in terms of new launches.

HEDGE FUNDS

Both family offices and institutional investors are looking at long/short equity managers, many sector-focused. According to one capital introductions professional in a prime brokerage group, family offices are specifically eyeing long/short managers focused on health care, energy and regional banks, many to managers with less than $100m in assets under management. Meanwhile, one small endowment also recently hired a health care-focused long/short equity manager and is exploring macro opportunities going forward given the significant macro uncertainty in the medium term.

There is no shortage of upcoming launches focused on long/short equity specialists and macro to accommodate investor demand.

"We are seeing a continuation of 2015 and given the recent rebound in the equity markets, we anticipate the trend will continue through 2016," said Jaclyn Greco, Manager, Business Development, in EisnerAmper's Financial Services Group. "A number of new launches are spinning out of the big hedge funds and are focused mainly on specific sectors which include energy, consumer, and TMT or strategies including long/short equity, distressed, macro and specialty credit."

"…FAMILY OFFICES ARE SPECIFICALLY EYEING LONG/SHORT MANAGERS FOCUSED ON HEALTH CARE, ENERGY AND REGIONAL BANKS, MANY TO MANAGERS WITH LESS THAN $100M IN ASSETS UNDER MANAGEMENT."

PRIVATE EQUITY

Private equity and venture capital continue to be popular amongst allocators. Sean Holland, former Manager of Private Equity – International, Venture Capital and Special Situations at the New York State Teachers' Retirement Systems, said that that early-stage venture, infrastructure and distressed are tactical themes that are gaining significant investor attention. In addition, he specified co-investments remain popular but successful execution requires timely judgement and coordination with the lead investor.

"Given dampened return expectations from traditional asset classes in domestic markets, the importance of allocating to alternative investments should remain firm and possibly increase among institutional investors seeking outperformance," he said.

Seemingly, there are more launches focused on these private equity opportunities. Todd Hankin, Partner in EisnerAmper's Financial Services Group based in San Francisco, specified there is continued interest in the fintech space, hybridization of early stage venture capital/later stage private equity funds and real estate funds.

"We are still signing up new business for 2015, an indication of the stress of the market, and there seems

to be no letup," he said. "We are seeing a lot of activity in these spaces and it seems like it is going to continue into the second quarter."

CONCLUSION

Between upcoming investor allocations from both institutions and family offices, along with more launch activity, outlook is positive for the alternative investment industry, especially for long/short equity specialists, followed by macro offerings, along with numerous private equity and venture capital opportunities. And further, with an eye on emerging managers or managers less than $100m in assets under management, some of these new launches spinning out of the big hedge funds should also be well-positioned for allocations. ■

Elana Margulies Snyderman is a Senior Manager in EisnerAmper's Financial Services Group. Questions? Contact Elana at elana.margulies-snyderman@eisneramper.com or 212.891.6977.

What Regulatory Risks Do Unregistered Investment Advisers Hold?

The title of this article is an interesting question, one that we often hear advisers discussing amongst colleagues. Responses to this vexing question we have been privy to vary, depending on whether the entity is registered with the SEC. Generally, responses range from 'no risk unless the adviser is fully registered with the SEC,' to 'low when filing as an exempt reporting adviser ("ERA"),' and back to 'no risk at all for firms not registered in either one of the two above categories because the SEC would be overreaching.'

Recent SEC actions demonstrate that these responses significantly understate the risk.

The Investment Advisers Act of 1940 (the "Advisers Act") provides certain exemptions from SEC registration and excludes certain firms from the definition of an investment adviser. Unless these criteria are met, however, any person or firm who provides advice to others on securities and receives compensation must register with the SEC. Unregistered entities may avoid many requirements of the Advisers Act, but regulatory risk remains. Even unregistered advisers can be subject to SEC action through rulemaking and enforcement.

A REGULATORY PERSPECTIVE

To understand the regulatory risks, one must consider the SEC's core mission: protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC advances its mission by identifying areas that present material risks to investors and securities markets, and mitigates these risks through regulation and enforcement actions. For example, the SEC adopted Rule 206(4)-8 in 2007, which explicitly prohibits fraud by private fund advisers. Consistent with the SEC's mission, the rule's main purpose was to protect investors in private funds. The rule applied to registered and unregistered advisers of private funds, although many such advisers later registered after the Dodd-Frank Act was enacted in 2010.

Recent enforcement cases also demonstrate how the SEC will take direct action against unregistered advisers.

RECENT SEC REGULATORY ACTION

A Canadian resident and general partner to a private fund marketed a fund based on a scientific stock selection strategy. However, in practice, the adviser, who was not registered with the SEC, deviated from its stated strategy, and the fund suffered heavy losses. The manager then decided to market the fund based on a combination of actual and hypothetical performance returns. However, the manager failed to notify fund investors that most of the assets were invested in a single penny stock and, among other things, misrepresented the value of the penny stock and did not maintain proper documentation to support the price.

The SEC charged the adviser with violating the anti-fraud rule by knowingly providing false and misleading material to investors. The manager was ordered to pay approximately $3 million to reimburse investors and in fines. In addition to the monetary penalty, the SEC barred the adviser from the securities industry. The adviser's unregistered status did not shield him from SEC sanctions.

In another administrative proceeding, an individual owner of a state-registered investment adviser was barred from the securities industry by the SEC for actions taken against the adviser by a state regulatory body. The state-registered adviser, operated by its owner, caused its client to invest in unsuitable investments in the form of leveraged and inverse ETFs.

CONCLUSION

The key takeaway: regardless of registration status, the SEC maintains the regulatory reach to take action against advisers. The aforementioned cases demonstrate that attempting to fly under the SEC's radar is an ineffective strategy. Whether or not registered with the SEC, advisers should adopt a compliance program that incorporates the same principles of the Advisers Act

What Regulatory Risks Do Unregistered Investment Advisers Hold? (continued)

under Rule 206(4)-7, even when relying on an exemption from registering with the SEC (either as an ERA or state registered investment adviser). While this can be a costly undertaking, especially for new or emerging managers, failure to implement such a program significant increases an adviser's regulatory risk. ■

Questions? For more information, please contact Venkat Rao, a Director in our Financial Services Group. You can reach Venkat at 347.735.4761 or venkat.rao@eisneramper.com.

EISNERAMPER

www.eisneramper.com