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The Potential Impact of President Obama's Financial Regulatory Reform on Start-Up Companies

by Michael Baker

Editor's note: *In 2009 the Entrepreneurial Actuaries Section sponsored an essay contest and this was one of those entries. It was written in 2009. In July 2010, Congress approved the Financial Reform Bill.*

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Executive Summary

President Obama released his plans for financial regulatory reform on June 17, 2009.[1] While the proposals are not entirely surprising given the state of the economy, they do reflect a potential fundamental shift in the regulation in our capital markets. Of particular interest for a start-up company is the proposal to extend the existing Investment Advisers Act registration requirement[2] to advisers of hedge funds, and, by extension, venture capital funds.[3] I believe that the proposed requirement has the potential to significantly increase the financial burden on an early-stage firm through increased scrutiny and record-keeping. This paper outlines the extent of the issues facing a start-up company due to the Administration's proposals, and offers solutions to the problems facing these entrepreneurs.

Business Problem

Currently, section 206 of the Investment Advisers Act of 1940 ("Advisers Act") is applicable to hedge fund managers. This section generally

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prohibits investment adviser fraud.[4] If the Administration's proposals are enacted, other substantive provisions of the Advisers Act may become applicable to hedge fund managers and managers of venture capital funds thereby changing the landscape for seed capital for a start-up business. These provisions could include requiring registered advisers to keep certain records and, more importantly, subjecting the managers to examinations by the Securities and Exchange Commission staff.[5]

The entrepreneur has a strong interest in this proposed legislation. The potential registration, bookkeeping and examination requirements could increase the administrative burden on managers of venture capital funds, and, consequently, could create an additional compliance burden on the start-up company. Further, the managers of the venture capital may be subject to additional requirements which would ensure minimum investment quality and could subject start-up companies to additional scrutiny to meet this objective, though this possibility has not been included in the Administration's proposal. Although no one can be certain regarding the extent of the new regulations on the hedge fund and venture capital industry at this time, I believe that it seems relatively certain that change will come to the financial industry.

The problem for a start-up business is two-fold: 1) the strain on cash-flow for whatever the eventual additional requirements happen to be; and 2) the uncertain form of this additional strain. Given its financial capital constraints, these two issues create enterprise risk for a start-up firm.

Business Impact

Start-up companies seeking additional rounds of financing subsequent to angel investors' or the founder's seed money may be subject to additional scrutiny by potential investors. Venture capital managers may request assurances from the business and may require audited financial statements from even nascent firms. The cost of an audited financial statement varies, but it is not insignificant. Start-ups typically hire outside auditors who scrutinize the financials of the company to ensure that the accounting for the firm is sufficient.

To make matters worse, many entrepreneurs with a great business idea are not versed in financial and accounting standards. The individual or small staff working at the start-up may not have the expertise to keep complicated financial records. The start-up company would not only be required to factor the outside auditor cost into the company's budget, but would also need to spend its valuable time ensuring that the financials for the audit are up to par.

Unregistered investment advisers may also lose interest in providing financing to entrepreneurs. Additional burdens on advisers mean that the relative attractiveness of providing start-up money may decrease, as the formerly unregulated niche becomes regulated. The registration requirement may cause the adviser to divert his funds elsewhere.

If the above needs can be met, however, entrepreneurs now faced with completing audited financial statements will have some opportunities available to them that may have been precluded in an unregulated industry. Often, start-up companies desire to eventually become public companies. While the Securities Act and the Securities Exchange Act impose many requirements on public companies, a company required to keep audited financial statements may find it easier to meet the financial information reporting requirements in quarterly 10-Qs and annual 10-Ks. Thus, the mandatory audited financial statements could actually make it easier for the start-up company to transition into a public company.

Potential Solutions

Securing Alternate Financing

I believe that under the proposal, venture capital funds may be compelled to saddle start-up companies with additional burdens. Depending on the size and the cash-flow of the firm, these burdens could constrain cash-flow and jeopardize the existence of the firm. A start-up company can avoid this problem by simply employing other types of financing arrangements. Angel investors may become more important in this environment, because they could avoid the registration requirements of the Advisers Act, provided that the angel investor's structure does not fall within the scope of the new laws. Albeit a much more direct type of financing, the angel investor not required to register would be able to continue operating in much the same way that he did prior to any hedge fund adviser registration requirement that may be enacted.

A start-up company could also benefit from employing an acquisition as an exit strategy. As previously mentioned, many companies desire to become public, and use venture capital money as a bridge to take a start-up company from its inception to public company status. An acquisition strategy would mean abandoning hopes of public company status, but would relieve the potentially daunting burden that may be imposed by venture capital funds.

Overall, a company employing this strategy needs to ensure that it has proper connections to angel investors and managers of companies that might be interested in eventually acquiring the start-up company.

Planning for Audited Financials

I believe that if the legislation is enacted, a start-up company planning on securing venture capital financing could be required to complete audited financial statements. Venture capital firms may require this, and the start-up company should factor the audited financial statement cost into early-rounds of budgets and financing. The firm would be prudent to assume that the financials are a condition of subsequent venture capital financing.

Start-up firms should ensure that financial information required for the statements is maintained in an orderly and accessible way. A start-up business seeking venture capital financing may want to consider employing an experienced accountant to maintain these records, especially if the founders do not have sufficient experience to execute this role effectively.

Hiring a Knowledgeable CCO

To navigate the complicated world of the federal securities laws, a start-up company may need to consider hiring a knowledgeable Chief Compliance Officer ("CCO") early in its lifecycle. The CCO would ensure conformity with applicable securities laws, and would hopefully be a great resource for other legal issues that arise in the beginning stages of a firm.

Conclusion

With the Administration's proposals, I believe that the financing landscape for start-up companies will be changing. The extent of this change remains uncertain. Entrepreneurs and start-up companies must be mindful of any forthcoming changes in laws governing hedge funds, as well as any other laws that have the potential to impact their source of financing. Entrepreneurs should keep abreast of the changing environment to give themselves and their companies the best opportunity for success.

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[1] Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury, June 17, 2009.

[2] 15 U.S.C. 80b-3 (1940).

[3] "All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability." Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury, 13 (June 17, 2009).

[4] 15 U.S.C. 80b-6 (1940).

[5] "We further propose that all investment funds advised by an SEC-registered investment adviser should be subject to recordkeeping requirements; requirements with respect to disclosures to investors, creditors, and counterparties; and regulatory reporting requirements. The SEC should conduct regular, periodic examinations of such funds to monitor compliance with these requirements." Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury, 37 (June 17, 2009).

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