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SEC Seeks Expanded Access to Private Fund Strategies

On June 18, the Securities and Exchange Commission (SEC) issued a "Concept Release on Harmonization of Securities Offering Exemptions" (the Release). At over 200 pages, the Release seeks public comment on a wide variety of topics related to the current framework for private securities offerings.

This Client Alert will focus on two topics raised by the Release that are relevant to private fund managers: (i) potential changes to the definition of "accredited investors"[1] and (ii) the potential for expanded access to private fund strategies, including private equity, venture capital and hedge fund strategies for retail investors who do not qualify as accredited investors. Public comments on the Release are due by Sept. 24.

Potential Changes to the Definition of Accredited Investor

Many private securities, including most private funds, are offered pursuant to an exemption from registration under Regulation D of the Securities Act of 1933, which generally requires that investors meet the qualifications of accredited investors.[2] The Release seeks comment on whether to modify and/or expand the definition of that term.

In doing so, the Release revisits the SEC staff's 2015 "Report on the Review of the Definition of Accredited Investor" (the 2015 Report),[3] which recommended certain changes to the accredited investor definition, a summary of which can be found in a prior Client Alert (https://www.stradley.com/insights/publications/2016/01/private-funds-alert-january-2016). While the SEC declined to act on any of the changes recommended in the 2015 Report, this year's Release seeks comment on largely the same list of recommendations as well as certain additional potential changes, two of which are highlighted below.

Similar to the 2015 Report, the Release again seeks comment on whether to maintain the current income and net worth tests and whether to index those amounts for inflation. Further, the Release asks whether to consider other measures of qualification, such as (i) a minimum investment test, rather than net worth; (ii) permitting individuals with certain professional credentials or prior experience investing in private offerings to qualify as accredited investors; or (iii) permitting individuals who pass an accredited investor exam to qualify as accredited investors. Two new suggestions from the Release not found in the 2015 Report are worth highlighting.

Opting In to Accredited Investor Status

First, at the suggestion of three commenters on the 2015 Report and with little additional context, the Release asks whether individuals should be permitted, "after receiving disclosure about the risks of a private offering, to opt into being accredited investors."

Non-Accredited Investors Advised by Registered Financial Professionals

In addition, the Release then explores in considerable detail another manner of qualifying as an accredited investor, which in some ways could be viewed as an expansion of the purchaser representative concept currently part of Rule 506(b) under Regulation D. As noted above, such offerings currently may choose to permit a limited number of non-accredited investors

who, together with a purchaser representative, are able to meet the requirement of sufficient knowledge and experience to evaluate the prospective investment. Any such offerings are subject to greater disclosure obligations, however, and are less common, particularly among private fund issuers.

Based in part on the recommendation of a 2017 Report[4] from the U.S. Department of the Treasury (the 2017 Treasury Report) to permit "otherwise non-accredited investors to retain professionals to advise them in order to qualify as accredited investors without limitation," the Release asks whether the definition of accredited investor should be expanded to include those advised by registered financial professionals.

The Release asks a lengthy series of questions related to this concept, including whether any limitations or other investor protections would be appropriate for such new category of accredited investors to participate in private offerings (e.g., limitations on the type or amount of investments, or additional disclosure requirements). For example, the SEC seeks comment on whether it should allow such investors

> to invest in pooled investment funds, such as private funds under Section 3(c)(1) under the Investment Company Act, if these investors are: (1) subject to limits on the amounts of investments in such pooled investment funds, such as a dollar amount or percentage of investments; and/or (2) limited to making the investment out of retirement or other similarly federally-regulated accounts? Would such a change substantially eliminate current distinctions between registered funds and private funds?

While the level of support for such an expansion of the definition of accredited investor is unclear, the three pages of detailed questions devoted to it suggest that the SEC is at least open to facilitating broader participation in private fund offerings by retail investors who are advised by registered financial professionals but otherwise unable to meet the relevant income or net worth tests.

Potential for Expanded Access to Private Fund Strategies for Non-Accredited Investors

Recognizing that private companies, particularly growth-stage companies, often see pooled investment funds as a valuable source of capital, the Release asks whether the SEC "should take steps to expand such issuers' ability to raise capital through pooled investment funds … ." In addition, citing the potential advantages to retail investors of portfolio diversification and return profiles that are less correlated to the public markets, the Release asks "whether retail investors should be allowed greater exposure to growth stage issuers through pooled investment funds … ."

The Release goes on to highlight some of the challenges currently faced by retail investors seeking exposure to private offerings through pooled investment funds, noting that for non-accredited investors, their options are limited to seeking

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exposure through funds registered under the Investment Company Act of 1940 (the Investment Company Act) and business development companies[5] (BDCs). Further, as the Release notes, such funds generally have limited, if any, exposure to privately offered securities.

To that end, the Release seeks comment on whether there are any regulatory provisions or SEC practices that discourage registered investment companies and BDCs from participating in private offerings.

Registered Funds of Funds

Specifically addressing the concept of a registered fund open to retail investors serving as a "feeder fund" into private funds such as private equity and hedge funds, the Release notes that historically such an approach has raised SEC staff concerns, in that such retail investors would not be eligible to invest directly in the underlying private funds. However, the Release suggests a willingness to consider other views on this topic.

> What restrictions should there be, if any, on the ability of closed-end funds, including BDCs, to invest in private funds, including private equity funds and hedge funds, and to offer their shares to retail investors?

Interval Funds

In addition, the Release spends time exploring one such closed-end fund structure registered under the Investment Company Act, the interval fund, which provides liquidity to investors through periodic share repurchases. Suggesting that the SEC views such structures as underutilized, and also noting the recommendation of the 2017 Treasury Report,[6] the Release seeks comment on a series of questions focused on, among other things, the liquidity mechanism of share repurchases and ways to decrease the compliance costs of these vehicles more broadly.

For example, the Release asks whether it should permit interval funds to mirror the five-year investment period of a typical private equity fund, with periodic repurchases following such

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period, rather than the current maximum period, generally 12 months. Further, the Release seeks comment on whether it should make changes to facilitate compliance with certain technical aspects of the Investment Company Act by interval funds, particularly those pursuing a private equity or venture capital strategy (e.g., by permitting a two-year ramp-up period for funds to meet the relevant diversification requirements or by providing relief from the restrictions on affiliated transactions for control investments made by interval funds).

Retirement Savers – Target Date Funds and Robo-Advisers

The SEC also highlights target date funds aimed at retirement savers, which are typically structured as open-end funds registered under the Investment Company Act (i.e., mutual funds), as potentially appropriate vehicles to seek exposure to private offerings. The Release suggests that relative to other mutual funds, such funds with target dates far into the future may have holding periods that are better aligned with the limited liquidity profile of privately issued securities.

Therefore, the Release asks whether it should take steps to enable certain target date funds to seek limited exposure to private offerings. The Release also seeks comment on a similar concept of facilitating limited exposure to private offerings in the portfolios recommended by robo-advisers to the extent their services are focused on retirement savings for retail investors.

Performance Fees

The Release also asks whether the SEC should consider changes to the restrictions on performance fees under the Investment Advisers Act of 1940 (the Advisers Act). Performance fees, typically charged by private fund managers, may generally be charged only to a fund vehicle managed by a registered investment adviser[7] if all the fund's investors meet the standard of "qualified client,"[8] which is generally considered a higher bar to meet than the accredited investor test.

Although the Release provides little additional context, the request for comment below implies an awareness by the SEC of the effect of regulatory constraints on the market for financial product development.

> How do the restrictions on performance fees under the Advisers Act affect the offering of venture strategies by registered investment companies and BDCs? Should we make changes to the restrictions on performance fees?

And while the question above relates to registered funds and BDCs offering venture strategies, a similar analysis of the restriction on performance fees would be relevant to expansion of access to private funds for retail investors more generally, whether by an expansion of the definition of accredited investor or by permitting broader participation by non-accredited investors in private funds, either directly or indirectly (e.g., through a registered feeder fund as outlined above).

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[1] To be an accredited investor, a natural person generally must either have an annual income that exceeds $200,000 in each of the two most recent years (or $300,000 joint income with spouse) or a net worth exceeding $1 million (individually or jointly with spouse), excluding the value of their primary residence.

[2] Note that under Rule 506(b) of Regulation D (the exemption most commonly used by private funds), a private security may be offered to an unlimited number of accredited investors. In addition, the issuer may also choose to permit up to 35 non-accredited investors, provided that all non-accredited investors, either alone or together with a third party that meets the requirements of a "purchaser representative," must be sophisticated, i.e., they must have sufficient knowledge and experience to evaluate the prospective investment. If any non-accredited investors are included, however, the offering will be subject to greater disclosure obligations, and as a result, this is part of the reason few private fund issuers make offers to any non-accredited investors. In fact, according to the Release, only 6% of all private offerings under Rule 506(b) between 2015 and 2018 permitted non-accredited investors.

[3] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, every four years the SEC is required to review the accredited investor definition as it relates to natural persons.

[4] A Financial System That Creates Economic Opportunities, Capital Markets. U.S. Department of the Treasury (October 2017), https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf.

[5] As described by the Release, "BDCs are a category of closed-end investment companies that do not register under the Investment Company Act, but rather elect to be subject to the provisions of sections 55 through 65 of that act."

[6] The Release notes that as of Dec. 31, 2018, there were 57 interval funds with about $29.7 billion in assets under management. In addition, as the Release states, "the 2017 Treasury Report recommended that the Commission review its rules regarding interval funds to determine whether more flexible provisions might encourage the creation of registered closed-end funds that invest in offerings of smaller public companies and private companies whose shares have limited or no liquidity."

[7] Note that the restriction on performance fees does not apply to "exempt reporting advisers," which include, among others, certain venture capital managers and private fund advisers who manage less than $150 million in assets from a place of business in the United States.

[8] Pursuant to Rule 205-3 of the Advisers Act, a qualified client must generally have at least $1 million in assets under management with the adviser immediately after entering into an investment advisory contract, or the adviser must reasonably believe the investor has a net worth (together with assets held jointly with a spouse) of more than $2.1 million exclusive of the value of their primary residence.

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