June 28, 2019

SEC Issues Concept Release on Harmonization of Securities Offering Exemptions: Potential Opportunities for Both Private Funds and Registered Funds

On June 18, 2019, the SEC published its Concept Release on Harmonization of Securities Offering Exemptions (the "Release") to solicit public comment on exemptions from registration under the Securities Act. The Release notes that, over time, there have been significant changes to the framework for exempt offerings, resulting in gaps and complexities. Therefore, the Release states, the SEC seeks comments on ways "to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections." The Release is the most significant step that the SEC has taken to give effect to SEC Chairman Clayton's stated goal of broadening "main street" access to investments in private companies.

This Alert should be of interest to sponsors of private funds because the Release suggests that the SEC is willing to consider expanding investment opportunities in private equity funds and venture capital funds to retail investors. The first part of this Alert focuses on a twenty-page portion of the Release that discusses "pooled investment funds" – registered funds and private funds. Among other things, this "funds" portion of the Release solicits comments on a number of issues that currently limit retail access to private funds.

The second part of this Alert briefly summarizes the contents of the Release, most of which addresses the variety of private offering exemptions under the Securities Act. The Release's discussions of the exemptions include requests for comments that suggest the SEC is willing to consider a variety of deregulatory changes to its offering exemptions.

Comments on the Release must be submitted to the SEC **no later than September 24, 2019**.

I. THE POOLED INVESTMENT FUNDS PORTION OF THE RELEASE

Among other things, this portion of the Release solicits comments on a number of issues that currently limit retail investment in private funds that invest in exempt offerings, including private equity funds, venture capital funds, and hedge funds, which rely on the exemptions from the definition of "investment company" in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.

Although the release does not articulate a clear roadmap to providing retail investors with unfettered access to private funds, the SEC's requests for comments on these topics suggest a willingness to explore ways to expand the scope of investment opportunities available to retail investors. How far the SEC is willing to expand the scope of these opportunities is unknown. That said, the Release suggests (i) potential avenues for the development of registered "funds of funds" and feeder structures offered to non-accredited investors and (ii) greater flexibility for investor-eligibility requirements to be satisfied through the involvement of registered investment advisers or other financial intermediaries acting on behalf of non-accredited investors.

Any resulting regulatory changes could, for example, allow retail fund complexes to utilize their distribution networks to offer retail products that invest significantly in private funds and/or private companies. This could both expand retail access to private companies and allow private fund sponsors to access new sources of investor capital.

Potential benefits of retail exposure to exempt offerings. The Release notes some of the potential benefits to retail investors that could arise through access to exempt offerings through funds, including greater diversification. The Release states that retail investors "who seek a broadly diversified investment portfolio could benefit from the exposure to issuers making exempt offerings, as these securities may have returns that are less correlated to the public markets." The Release requests comments on the following questions:

> *How have recent market trends affected retail investor access to growth-stage issuers that do not seek to raise capital in the public markets? To the extent that issuers are more likely to seek capital through exempt offerings, do existing regulations make investor access to this market through a pooled investment vehicle difficult?*

Exposure to exempt offerings through 1940 Act funds. The Release notes that for retail investors who are not currently accredited investors, the ability to obtain exposure to exempt offerings through a pooled investment fund is limited to exposure through registered investment companies and BDCs. The Release describes some of the existing limitations on investments by open-end funds (*i.e.*, mutual funds) in exempt offerings, including liquidity restrictions and valuation requirements, noting that closed-end funds and BDCs do not have the same liquidity and valuation-related constraints on their ability to invest in exempt offerings. The Release requests comments on the following questions:

> *Are there any regulatory provisions or practices, including those promulgated or engaged in by the Commission, that discourage or have the effect of discouraging participation by registered investment companies and BDCs in exempt offerings?*
>
> * * *
>
> *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?*

These questions allude to, without specifically identifying, an informal SEC staff position that prohibits a registered fund from investing more than 15% of its assets in private funds unless it restricts its investor base to accredited investors. This position has, as a practical matter, prevented many retail investors from obtaining exposure to private companies through registered fund of funds structures. The SEC requests for comments on these questions suggest a willingness to revisit this position.

Retail access to private funds. The Release notes that, from a regulatory perspective, the ability to invest directly in securities of private funds largely depends on a retail investor's status as an "accredited investor," "qualified purchaser" and "qualified client." The Release requests comment on whether the SEC should consider changes to the existing definitions of these terms, which could potentially make exempt offerings more accessible to groups of retail investors that are broader than those who currently qualify as accredited investors or qualified purchasers. For example, as described below, the Release explores a number of questions relating to the definition of accredited investor, including whether to revise the existing eligibility limitations to consider additional indicia of an investor's sophistication, the involvement of an adviser or other financial professional, the amount of the investment, or other criteria, rather than focusing exclusively on the income or wealth of the investor as a proxy for sophistication.

Interval funds and tender offer funds. A number of the Release's requests for comments relate to the operation of interval funds and tender offer funds, which are two types of generally unlisted closed-end structures that provide limited liquidity through periodic repurchases. The Release notes that, unlike private funds, interval funds and tender offer funds may be open to non-accredited investors. The Release states that these funds could provide investors with access to exempt offerings, but the SEC does "not believe these funds currently are used extensively as a means to provide capital to smaller issuers in exempt offerings." This suggests that the SEC believes these fund structures are currently underutilized as vehicles to provide non-accredited investors with access to growth-stage issuers. That said, the Release requests comment on whether interval funds should be limited to sophisticated investors if they are permitted to conduct repurchase offers less frequently and/or with less predictability than Rule 23c-3 currently permits.

- The Release's requests for comment indicate that the SEC may be open to a variety of changes to its rules relating to interval funds, including: (i) giving interval funds more flexibility to determine the length of their periodic repurchases, (ii) amending the conditions under which the fund's directors can suspend or postpone a

repurchase offer, (iii) relaxing the elements of an interval fund's repurchase policy that may not be changed without shareholder approval, and (iv) facilitating a secondary market for interval fund shares.

- The Release also requests comments on changes to the SEC's rules regarding tender offer funds, including whether the SEC should "permit tender offer funds to use the conditions described in Rule 23c3-3(c) in place of the Exchange Act tender offer rules, if investors in those tender offer funds are limited to accredited investors or qualified purchasers."

Target date funds and reliance on investment advisers. The Release notes that target date retirement funds that have a target date significantly far into the future are designed for investors with longer holding periods and, therefore, may be better aligned with the limited liquidity of securities acquired in exempt offerings. The Release's requests for comment regarding target date retirement funds suggest that the SEC is considering measures to provide these funds with additional flexibility to hold securities from exempt offerings in their portfolios:

> *If a target date retirement fund were to seek a limited amount of exposure to exempt offerings in its portfolio, what measures, if any, should we consider taking to enable this?*

The Release also notes that retirement investors increasingly rely on investment advisory services, including advisory services provided by "robo-advisers." Outside of a registered fund structure, these investors are subject to the traditional purchaser eligibility requirements for exempt offerings (*e.g.*, accredited investor status). With respect to these investors, the Release requests comments on the following questions:

> *[I]f investment advisory services, including robo-advisers, that are focused on retirement savings seek to include a limited amount of exposure to securities from exempt offerings as part of a diversified retirement portfolio that they recommend to retail investors, should we consider making any changes to our rules to enable this? If so, what types of changes?*

Secondary market opportunities for registered funds of private funds. Finally, the Release requests comments on whether the availability of secondary market liquidity affects investor decision-making with respect to closed-end funds and BDCs, and whether the SEC should consider any changes to its rules to encourage the establishment or improvement of secondary trading opportunities for these funds. Because U.S. stock exchanges currently do not permit registered closed-end funds of private funds to list their shares for trading, the requests for comments on these questions may signal that the SEC is more open to the development of listing standards for these types of funds.

II. OTHER SECTIONS OF THE RELEASE

Most of the Release describes in detail the requirements and limitations of Securities Act registration exemptions that make up the existing exempt-offering framework. The Release presents data, including historical trends, regarding the amount of capital raised under each type of exempt offering. Most importantly, for each type of exempt offering, the Release solicits responses to a wide range of questions.[1] Commenters' responses are intended to help the SEC assess whether changes to applicable statutes and regulations are necessary or desirable to improve individual types of exempt offerings and, more generally, the existing exempt-offering framework.

In one of the more provocative set of requests for comments, the Release requests comments on whether the existing exempt-offering framework should be overhauled to focus on investor protections only at the time of sale rather than at the time of offer:

[1] The Release discusses and solicits comments on the conditions and requirements for the following exempt offerings: Regulation D offerings pursuant to Rules 504, 506(b), and 506(c); Regulation A offerings by Tier 1 and Tier 2 issuers; intrastate offerings pursuant to Section 3(a)(11) and Rules 147 and 147A; and certain crowdfunding transactions under Section 4(a)(6).

> *In light of the fact that some exemptions impose limited or no restrictions at the time of the offer, should we revise our exemptions across the board to focus consistently on investor protections at the time of sale rather than at the time of offer? If our exemptions focused on investor protections at the time of sale rather than at the time of offer, should offers be deregulated altogether? How would that affect capital formation in the exempt market and what investor protections would be necessary or beneficial in such a framework?*

Another example of the breadth of what may be open for discussion is the Release's examination of the definition of "accredited investor" in Rule 501(a) of Regulation D. The Release summarizes a 2015 SEC staff report on the definition, noting that the report contained staff recommendations for potential updates and changes to expand the definition. The Release also discusses reports from the SEC Government-Business Forum on Small Business Capital Formation in 2016, 2017 and 2018 that recommended that, consistent with the recommendations of the Advisory Committee on Small and Emerging Companies, the SEC should (i) retain net worth and income thresholds for accredited investors, and (ii) expand the categories of qualification for accredited investor status based on various indicia of financial sophistication, including education and experience, holding FINRA licenses or CPA or CFA designations, or passing a test demonstrating financial sophistication.

In the same vein, the Release discusses a 2017 report from the U.S. Department of the Treasury that recommended that the SEC amend the accredited investor definition to expand the pool of eligible investors to include (i) investors advised by a fiduciary, such as an SEC- or state-registered investment adviser, and (ii) financial professionals, such as registered representatives and investment adviser representatives, who are deemed qualified to recommend Regulation D investments to third parties.

The Release requests comments on a broad range of questions regarding the definition of accredited investor, including the following:

> *[S]hould we revise the accredited investor definition to allow individuals to qualify as accredited investors based on other measures of sophistication? If so, should we consider any of the following approaches to identify individuals who could qualify as accredited investors based on criteria other than income and net worth . . .*

> *Should we . . . revise the accredited investor definition to expand the eligible pool of sophisticated investors? If so, should we permit an investor, whether a natural person or an entity, that is advised by a registered financial professional to be considered an accredited investor? Being advised by a financial professional has not historically been a complete substitute for the protections of the Securities Act registration requirements and, if applicable, the Investment Company Act. If we were to permit an investor advised by a registered financial professional to be considered an accredited investor, should we consider any other investor protections in these circumstances?*

A final example of the scope of the Release and its deregulatory potential is the Release's discussion of Rule 506(b). By way of background, Rule 506 of Regulation D is a non-exclusive "safe harbor" under Section 4(a)(2) of the Securities Act (*i.e.*, "transactions by an issuer not involving any public offering"). In 2013, the SEC adopted Rule 506(c), permitting a general solicitation under Rule 506's safe harbor; provided, however, that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. The SEC retained the prior Rule 506 safe harbor as Rule 506(b).

The Release states that Rule 506(b) offerings continue "to dominate the market for exempt securities offerings and ***even exceed amounts raised in the registered market***."[2] Further, the "vast majority" of Regulation D issuers continue to raise

[2] Emphasis added. According to the Release, in 2018, the amount raised in Rule 506(b) offerings, $1.5 trillion, exceeded the $1.4 trillion raised in registered offerings. Nevertheless, the Release reports that, while the amount of capital raised in Rule 506(b) and

capital through Rule 506(b) offerings rather than Rule 506(c) offerings. While a Rule 506(b) offering can include up to 35 non-accredited investors, the Release notes, non-accredited investors participate in only a small fraction of Rule 506(b) offerings. The SEC concludes that most Regulation D issuers either are able to satisfy their capital requirements by exempt offerings to accredited investors only or, in the alternative, are limiting Rule 506(b) offerings to accredited investors to avoid that Rule's requirement to provide disclosure to purchasers who are not accredited investors. The Release requests comments on a variety of issues regarding exempt offerings under Rules 506(b) and 506(c), including:

> *If we reduce the information requirements in Rule 506(b), should we include investment limits for non-accredited investors? If so, what limits are appropriate and why? Should accredited investors be subject to investment limits?*
>
> *Should we consider rule changes to allow non-accredited investors to purchase securities in an offering that involves general solicitation? If so, what types of investor protection conditions should apply? For example, should we allow non-accredited investors to participate in such an offering only if: (1) such non-accredited investors had a pre-existing substantive relationship with the issuer or were not made aware of the offering through the general solicitation; (2) the offering is done through a registered intermediary; or (3) a minimum percentage of the offering is sold to institutional accredited investors that have experience in exempt offerings and the terms of the securities are the same as those sold to the non-accredited investors?*

III. OBSERVATIONS

It is far too early to predict whether the Release will lead to changes in the regulatory landscape. However, at the very least, the Release indicates that the SEC is willing to consider expanding access to private funds, such as private equity and venture capital funds, to retail investors. This could afford non-accredited investors the opportunity to more broadly diversify their investment portfolios and otherwise benefit from the securities that may have returns with less correlation to the public markets.

From the perspective of a private fund sponsor, an expansion of investment opportunities in private funds to non-accredited investors could result in substantial new sources of investor capital. Similarly, traditional retail fund complexes might be able to utilize their existing distribution networks and operational capabilities to offer alternative strategies to a much wider section of the investing public, either on their own or in partnership with private fund sponsors.

* * *

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.

Rule 506(c) offerings is significant, "the median size of offerings by non-financial issuers is less than $1 million, indicating a large number of small offerings, consistent with the original regulatory objective to target the capital formation needs of small businesses."