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Blueprint for expanding access to private markets

As the SEC considers changes to its accredited investor definition, it's time to do more to deliver the benefits of private markets to investors safely

Private capital markets offer significant opportunities for financial advisers to improve the return potential and diversification of client portfolios. The Cambridge U.S. Private Equity Index, for example, has delivered more than 300 basis points of outperformance versus the S&P 500 Index over the past 20 years, according to Preqin. Unfortunately, the benefits of private market strategies like private equity and private credit have accrued primarily to institutional investors while remaining out of the reach of most high-net-worth investors.

The SEC is taking steps to address this issue. In December, the agency voted to consider changes to the accredited investor definition, which outlines the requirements for accessing alternative investments, including private equity and private credit. Updating the definition would open the door for more individual investors to access the private markets and expand the investment toolkit available to financial advisers.

We agree that it's time to update the accredited investor definition but believe more needs to be done – both by the SEC and industry participants – to deliver the benefits of private markets to individual investors safely.

Items for the SEC to consider include revising the accredited investor proposal beyond the inclusion of financial services industry professionals and opening more investment vehicles for accredited investor use. Items for industry participants include doing more to educate advisers and clients about these strategies. Collaboratively, the SEC and industry participants can create better liquidity options for investors.

Expanded definition should cover more investors

The SEC's current proposal suggests investors could gain accredited investor status based on knowledge, experience, or certifications, in lieu of the asset and income requirements in place today. This includes individuals holding certain Finra licenses as well as knowledgeable employees of private funds investing in those funds.

While this is a positive step, we believe access to these investments could be safely extended to more individuals outside of the financial services industry, including the clients of qualified financial advisers acting as fiduciaries. In lieu of a certification, these investors could submit an attestation that they understand the key characteristics, drawdown schedules and potential risks of strategies before they invest in them. In conjunction with advice from qualified financial advisers, this attestation would help reduce the risk of an unsuitable allocation.

Investors need more vehicles to access private markets

Once the accredited investor definition is broadened, investors need appropriate vehicles to access private market strategies. Many in the industry have called for the expansion of registered private market funds to meet this need. These funds offer benefits for investors, including simplified tax reporting and an up-front funding mechanism rather than multiple capital calls. While a handful of larger firms have entered this arena in recent years, the opportunities available to retail investors remain limited.

With relatively minor rule changes by the SEC, Section 3(c)(7) feeder funds could offer accredited investors an additional, more direct path to access private markets. These funds allow high-net-worth investors to participate alongside institutions in these strategies. Further, many 3(c)(7) funds offer relatively low investment minimums and a more attractive fee structure compared to registered funds. A wide range of 3(c)(7) funds could be made available to accredited investors quickly. In fact, many top-quartile managers already offer them because they give general partners a way to diversify their investor base by efficiently aggregating capital from the retail market.

The industry needs to provide more educational resources

The SEC's proposal focuses in part on opening access to private markets to knowledgeable investors. We agree that a strong base of knowledge should be table stakes for gaining access to the private markets, even when the minimum wealth and income levels are met. These strategies are nuanced and warrant careful consideration by financial advisers and clients before investing.

Among other aspects, this knowledge should include an understanding of the asset class, including its relative illiquidity, and the process of evaluating and selecting managers. This last point is particularly important given the significant performance dispersion between top- and bottom-quartile managers. There are two educational elements required here: broad asset class education, and unbiased and affordable fund-specific research.

On the first point, there exists a wealth of information about private market investing that should be packaged and made available to financial advisers and clients seeking to access the asset class. Regarding research, private market funds are well-covered on behalf of institutional investors and family offices, and a mechanism must be established to cost-effectively provide this existing, high-quality research to financial advisers and investors to consider.

Mechanisms for providing liquidity are critical

The relative illiquidity of private market funds keeps many individual investors on the sidelines, but it is during this period of illiquidity that the best managers create value for their investors. Private equity is perhaps the most "active" of active investment approaches, and the changes made by private equity firms to create value in portfolio companies require time to implement.

Still, it's inevitable that unforeseen circumstances may mean that investors need the ability to exit these funds. The formation of marketplaces to facilitate periodic liquidity for a wide range of private market funds would satisfy the needs of both fund managers, who require continuity of investment funding, and retail investors. This opportunity already exists for institutional investors and should be offered to the retail market with similar price-competitive dynamics.

Portfolio growth and diversification are sought by institutional and high-net-worth investors alike, and we applaud the SEC's efforts to responsibly expand the population of investors who can access private investments. These changes are particularly timely as outliving retirement savings is a growing concern for investors. Opening private markets to a wider audience of retail investors has the potential to help address this problem. The SEC's proposal is a strong first step, but we encourage the agency and industry participants to consider additional, prudent ways to make the benefits of private markets available to a significantly broader audience.

Lawrence Calcano is chief executive of iCapital Network.