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September 24, 2019

Re: Concept Release on Harmonization of Securities Offering Exemptions, Release Nos. 33-10649, 34-86129, IA-5256, IC-33512

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Ms. Countryman:

We are submitting this letter[1] in response to the request of the Securities and Exchange Commission (the "**Commission**") for comments, pursuant to Release No. 33-10649 (the "**Concept Release**"),[2] on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections.

We represent, among other clients, investment advisers on the structuring, formation, marketing and operation of private investment funds, including private equity funds. Many of the private funds managed by these clients issue securities in reliance on Regulation D under the Securities Act of 1933 (the "**Securities Act**") and Section 3(c)(7) under the Investment Company Act of 1940 (the "**1940 Act**").

We share the Commission's concern, as expressed in the Concept Release, that the current regulatory framework deprives many Americans of the opportunity to make attractive private equity investments precisely, and perversely, at the time when their need to save for retirement is most acute and their opportunities to invest in public markets are shrinking. For that reason, we whole-heartedly support the Commission's consideration of ways to expand the scope of investors who would be categorized as accredited investors and urge the Commission to do so in a manner that would allow accredited investors (however defined) to invest in private equity funds, which are considered a more prudent investment than an investment in a single company

[1] This comment letter focuses on certain aspects of the Concept Release most relevant to investments in private equity funds. Davis Polk has also submitted a second letter commenting on the expansion of the definition of accredited investor in the context of offerings by single issuers.

[2] Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649 (June 18, 2019).

because a fund offers a diversified portfolio of investments chosen by experienced fund managers acting as fiduciaries. We do not believe that simply expanding the definition of accredited investor is sufficient to allow investors to invest in private equity funds because many investors, even if deemed to be accredited investors may not meet the requirements of Section 3(c)(7).

We therefore urge the Commission, not just to expand the definition of accredited investor, but also to expand the definition of qualified purchaser under the 1940 Act, as most private equity funds rely on Section 3(c)(7), which generally requires that all of the fund's investors be qualified purchasers. We believe the definition of qualified purchaser (and accredited investor) should, in the case of a private equity fund,[3] be expanded in a manner that ensures that the original goal of making sure that the persons making the decisions to invest in Section 3(c)(7) private equity funds are sophisticated while at the same time allows retail investors access to lucrative investments that currently only the wealthy can access. In particular, we recommend that:

- The Commission revise the definition of "qualified purchaser" in Section 2(a)(51) under the 1940 Act to include:
    - in the case of a private equity fund;
    - any investor who invested in the fund at the direction of, or based on the advice of, a fiduciary that:
        - is a Commission-registered or state-registered investment adviser or bank (as defined in the Investment Advisers Act of 1940 (the "**Advisers Act**")); and
        - that has at least $50 million in assets under management or advisement.
- The Commission make a corresponding change to the definition of "accredited investor" in Rule 501(a) of Regulation D to include any such investor.[4]

While we applaud the Commission's consideration in the Concept Release of potential changes to the definition of "accredited investor," without our suggested changes to Section 3(c)(7), Main Street investors will lack access to private equity funds, which provide attractive returns over a long-term time horizon and permit investors to take advantage of opportunities to invest in a diversified portfolio of private equity investments. As detailed below, we believe these changes are warranted based on (1) compelling public policy reasons, including the looming retirement crisis in America and (2) the protections already in place where a sophisticated investment adviser or bank is acting as a fiduciary to its client.

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[3] Application of an expanded definition of qualified purchaser to other types of funds, such as venture capital and hedge funds, may be appropriate as well, but discussion of other funds is beyond the scope of this letter.

[4] We also fully support the Commission's consideration, as discussed in the Concept Release, of other ways to expand the definition of accredited investors, while still appropriately protecting investors.

## I. Retail investors need access to higher performing investments that are currently only offered to the wealthy

Both Section 3(c)(7) and Regulation D were drafted with the laudable idea that certain types of investments are inherently complicated and decisions to invest in them should be made by sophisticated persons who can understand the risks involved. Unfortunately, two of the types of investments that generally rely on these exemptions are private equity investments and funds that invest in private equity. These are two of the highest performing asset classes. This has meant that these two types of lucrative investments have been unavailable to retail investors, with the result that "the rich get richer" and the average American is instead finding it difficult to retire on his or her savings and investments.

In fact, there is a looming retirement crisis in America. According to the Government Accountability Office, certain changes to the U.S. retirement system are "making it harder for retirees to achieve financial security in retirement."[5] The GAO Study noted that many employer-sponsored retirement plans "have experienced a shift from traditional defined benefit (DB) plans that generally provide set monthly payments for life, to defined contribution (DC) account-based plans like 401(k)s . . . . which require individuals to assume more responsibility for planning and managing their savings."[6] When compared to defined contribution plans, defined benefit plans historically have had more flexibility in terms of the investment opportunities in which they are permitted to participate, such as private equity investments and private equity funds. Indeed, just as individuals have had to assume more responsibility for their investing, they generally have not been able to participate in the growing private markets, which are typically limited to accredited investors and qualified purchasers, and investment opportunities in the public markets have shrunk.[7] As Chairman Clayton has noted, "Main Street investors . . . have extremely limited, and in many cases costly and otherwise less attractive access to our private markets . . . ."[8]

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[5] *See* United States Government Accountability Office, The Nation's Retirement System: A Comprehensive Re-evaluation Needed to Better Promote Future Retirement Security, Testimony Before the Special Committee on Aging, U.S. Senate, Statement of Gene L. Dodaro, Comptroller General of the United States (Feb. 6, 2019) ("GAO Study") *available at* https://www.gao.gov/assets/700/696766.pdf

[6] *See* GAO Study.

[7] *See* Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation, Chairman Jay Clayton (April 10, 2018) *available at* https://www.sec.gov/news/speech/speech-clayton-2018-04-10; *infra* notes 17-20.

[8] *See* Remarks to the Economic Club of New York, Chairman Jay Clayton (Sept. 9, 2019) *available at* https://www.sec.gov/news/speech/speech-clayton-2019-09-09#_ftn20. In testimony before the House Financial Services Committee, Chairman Clayton also noted:

> I view Mr. and Ms. 401(k) as bearing a potentially significant cost as a result of the shrinking number of public companies. I expect this dynamic, if not addressed, will lead to fewer opportunities for Main Street investors to invest directly in high quality companies . . . . To be clear, it is not fewer opportunities to invest in IPOs themselves that troubles me. But without IPOs of growing companies, we have a shrinking and generally more mature portfolio of public companies. This is a significant concern. A shrinking proportion of public companies, particularly smaller and medium-sized companies, has costs beyond investment choices, including that there will be less publicly available information about the operations and performance of companies that are important to our economy.

*See* "Examining the SEC's Agenda, Operations, and Budget," Testimony of Chairman Jay Clayton before the House Financial Service Committee (Oct. 4, 2017).

As the Commission noted in the Concept Release,[9] for retail investors there are potential advantages to obtaining greater exposure to private issuers through pooled investment funds, including a diversified portfolio professionally managed by a fiduciary. Evidence suggests that over the past seven years, private equity has been the best returning asset class in public pension portfolios.[10] Indeed, in recent years, defined benefit pension funds have significantly increased their investment in these private equity funds.[11] Unfortunately, however, 401(k) and other defined contribution plans where retail investors make decisions on their own pension investments cannot invest in these lucrative investments because of Section 3(c)(7) and Regulation D. As more Americans run the risk of outliving their retirement savings,[12] the need for higher returns to provide for income in retirement becomes more pronounced. As described below, we believe that allowing retail investors who are advised by a fiduciary to invest in private equity funds will help level the playing field and allow retail investors to experience some of the high returns currently available only to the wealthy as well as help stem the retirement crisis.

## II. The definition of "qualified purchaser" in Section 3(c)(7) needs to be expanded in parallel with the definition of "accredited investor" in Regulation D

It is important that not only private equity investments but funds that invest in private equity investments be available to retail investors. In fact, a fund of private equity investments is a less risky investment than a single investment in a private company because a fund offers diversity across a variety of investments and the investments are selected by a professional fiduciary manager. It would therefore be incongruous to allow retail investors the ability to invest in private equity but not allow them the ability to invest in private equity funds. In order to allow retail investors access to private equity funds, the Commission will need to expand not only the definition of accredited investor but the definition of qualified purchaser in Section 2(a)(51) under the 1940 Act. Although some private equity funds rely on Section 3(c)(1), which is limited to funds with no more than 100 beneficial owners, most private equity funds would likely find Section 3(c)(1) unworkable because a fund limited to 100 investors would in most instances not find it economic to use up its limited capacity on retail investors investing smaller sums. Similarly, funds limited to 100 investors would be unlikely to create enough capacity to meaningfully address America's retirement needs. Without a parallel expansion of the definition of "qualified purchaser" for purposes of Section 3(c)(7), an expansion of the definition of "accredited investor" would do little to help retail investors invest in a prudently diversified portfolio of private equity investments either directly or through their retirement account.

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[9] *See* Concept Release ("We also examine whether we should take steps to expand issuers' ability to raise capital through pooled investment funds, and whether retail investors should be allowed greater exposure to growth-stage issuers through pooled investment funds in light of the potential advantages of investing through such funds, including the ability to have an interest in a diversified portfolio.").

[10] *See* American Investment Council, Public Pension Study (July 2019) *available at* https://www.investmentcouncil.org/wp-content/uploads/2019-public-pension-study.pdf. In addition, in terms of absolute returns, the Preqin Private Equity Index outperformed the S&P Total Return Index by 70% over 17 years as of December 31, 2017. Private Capital Performance Update: Q4 2017, August 2018, Preqin.

[11] *See* Cheng, Evelyn, Private equity coffers boom as pension funds look for somewhere else to put money beyond stocks, CNBC.com (Aug. 4, 2017) *available at* https://www.cnbc.com/2017/08/04/private-equity-coffers-boom-as-pension-funds-look-for-alternatives.html.

[12] *See* Martin, Emmie, "56% of Americans don't know how much they need to retire – here's why that's a problem" CNBC.com (July 13, 2019) *available at* https://www.cnbc.com/2019/07/12/americans-dont-know-how-much-they-need-to-retire.html.

## III. Retail investors should be considered qualified purchasers when advised by sophisticated, professional fiduciaries

We are cognizant that the Commission must not only facilitate capital formation but must also protect investors. We believe that both these goals can be met by allowing retail investors to invest in Section 3(c)(7) private equity funds when they are advised by a sophisticated adviser that is acting as a fiduciary for that investor.

We believe that an investor who is in a fiduciary relationship with an investment adviser registered with the Commission or a state or a bank acting in a fiduciary capacity is protected by the robust regulatory frameworks and fiduciary duties to which they are subject. An investment adviser, whether registered with the Commission or a state, owes its clients a duty of care, which includes, among other things, a (1) duty to provide advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client,[13] (2) duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client transactions, and (3) duty to provide advice and monitoring over the course of the relationship. An investment adviser also owes its clients a duty of loyalty, in that it may not subordinate its clients' interests to its own.[14] Similarly, a bank acting in a fiduciary capacity owes various fiduciary duties, such as loyalty and prudent investment, which are governed by state, and in some cases, federal law.[15] In addition, we propose that the fiduciary be required to have at least $50 million in assets under management or advisement so that it is clear that the fiduciary is a sophisticated entity with significant experience advising clients.

As investors advised by these investment advisers and banks will have the benefit of their sophisticated advice, and be protected by their fiduciary duties, treating such investors as accredited investors and qualified purchasers would be consistent with the policy of limiting Regulation D and Section 3(c)(7) investments to investors who are able to appreciate the terms and risks of the investment. Accordingly we recommend that the Commission revise the definition of "qualified purchaser" for purposes of Section 3(c)(7) under the 1940 Act to include, in the case of a private equity fund, any investor who invests in the fund at the direction of, or based

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[13] To provide advice that is in the best interest of the client, the Commission explained that, among other things, an investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives and that whether the advice is in a client's best interest must be evaluated in the context of the portfolio that the adviser manages for the client and the client's objectives. To provide advice that is suitable, the Commission explained that an investment adviser must have a reasonable understanding of the client's objectives, including, in the case of retail clients, an understanding of their investment profile. The Commission further noted that to develop an understanding of a retail client's objectives, an investment adviser should, at a minimum, make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals.

[14] The Commission explained that in order to meet this duty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. Such material facts would include the capacity in which the firm is acting with respect to the advice provided. Moreover, the Commission explained that an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.

[15] *See, e.g.*, Office of the Comptroller of the Currency, Interpretive Letter #734, Part 2 (Aug. 1996) ("Federal and state statutory and common law impose substantial duties and obligations on national bank trustees and managing agents in their relations with beneficiaries and accounts . . . [t]he obligations include duties of loyalty and care."); 12 C.F.R. § 9.12. For this reason, the Advisers Act generally exempts banks from the definition of "investment adviser" when acting as an adviser to individual clients, regardless of the sophistication of the clients or the nature of their investments. *See* Section 202(a)(11).

on the advice of, a fiduciary that is a Commission-registered or state-registered investment adviser or bank (as defined in the Advisers Act) and that has at least $50 million in assets under management or advisement. We would further urge the Commission to make a corresponding change to the definition of "accredited investor" in Rule 501(a) of Regulation D to include any such investor.[16]

*A. Our recommendation is consistent with the existing exemptions under the Securities Act and the 1940 Act.*

Importantly, we would note that our recommendation to expand access to Section 3(c)(7) funds is an extension of a concept already present under Regulation D. Specifically, Rule 506(b)(2)(i) permits an issuer in an offering to sell securities to 35 purchasers who do not otherwise meet the definition of accredited investor, provided that "[e]ach investor, alone or with his purchaser representative(s)[17] has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment . . . ."[18] Our recommendation similarly would permit investors to invest in Section 3(c)(7) funds due to the presence of a third party who possesses a sufficient level of sophistication. Because our proposal contemplates a much higher level of sophistication and experience than a "purchaser representative," and there would be Commission, state or bank regulator oversight of the entity making the investment recommendation, it would not be necessary to apply to our proposal the 35 investor limit or other restrictions under Regulation D applicable to non-accredited investors represented by purchaser representatives. Similarly, the presence of a fiduciary or other sophisticated entity representing the investors in a fund has been the basis for the protections

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[16] We understand that our proposal will not help all retail investors, because not all investors have access to the type of professional fiduciaries contemplated by our proposal. Nonetheless, we believe there are meaningful numbers of investors who could be aided by our proposal. For example, the Form ADV of Charles Schwab Investment Advisory, Inc. discloses that it has 355,150 investment advisory clients that are not high net worth clients and the Form ADV of Merrill, Lynch, Peirce, Fenner & Smith, Incorporated discloses that it has 1,203,984 investment advisory clients that are not high net worth clients. We further encourage the Commission to consider additional measures it could take to make private equity funds available to more investors. For example, for the reasons discussed in this letter, we believe that a 401(k) investor should be deemed to be a qualified purchaser and accredited investor when the investor invests in a private equity fund that has been approved for inclusion in the plan by a fiduciary of the type contemplated by our letter.

[17] Rule 502(i) defines "purchaser representative" to mean "any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions: (1) is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the purchaser is: (i) a relative of the purchaser representative by blood, marriage or adoption and not more remote than a first cousin; (ii) a trust or estate in which the purchaser representative and any persons related to him . . . collectively have more than 50 percent of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as trustee, executor, or in any similar capacity; or (iii) a corporation or other organization of which the purchaser representative and any persons related to him . . . collectively are the beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; (2) has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment; (3) is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in connection with evaluating the merits and risks of the prospective investment; and (4) discloses to the purchaser in writing a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship."

[18] Rule 506(b)(2)(i).

under the 1940 Act being deemed unnecessary for certain types of funds. For example, subject to certain conditions, Section 3(c)(3) of the 1940 Act exempts a common trust fund or similar fund maintained by a bank exclusively for collective investment by the bank in its capacity as a trustee, executor, administrator, or guardian.[19] Likewise, under the Securities Act, the status of an investor changes under Regulation S if the investor is advised by a fiduciary. For example, a U.S. investor is considered a non-U.S. investor if advised by a non-U.S. fiduciary.[20]

*B. Our recommendation is consistent with recommendations in the 2017 Treasury Report and suggestions from other stakeholders.*

We further note that there is growing consensus across policy makers, industry participants, and the American public to expand the definition of accredited investor. For example, the Department of the Treasury has recommended that the accredited investor definition be broadened to include any investor who is advised on the merits of making a Regulation D investment by a fiduciary, such as a Commission- or state-registered investment adviser.[21] The Department of the Treasury made this recommendation after extensive consultation with trade groups, financial services firms, consumer and other advocacy groups, academics, experts, financial market utilities, investors, investment strategies, and others with relevant knowledge. Some industry participants have urged the Commission to amend the definition of accredited investor to include investors whose relevant investments are made by Commission-registered investment advisers they retain, as fiduciaries, to manage their investments on a discretionary basis.[22] Moreover, consumer groups have been open to the expansion of the definition of accredited investor to include individuals who rely on an independent, fiduciary adviser in making their investment decisions.[23]

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[19] *See also* Section 3(c)(11) of the 1940 Act (excluding from the definition of investment company, among other things, any collective trust fund maintained by a bank consisting solely of assets of certain types of employee benefit trusts).

[20] *See* Offshore Offers and Sales, Release No. 33-6863 (April 24, 1990) ("With respect to fiduciary accounts (other than trusts and estates), the definition generally treats the person with the investment discretion as the buyer; therefore the status of that person governs. Thus, where a U.S. person has discretion to make investment decisions for the account of a non-U.S. person, the account is treated as a U.S. person. Conversely, where a non-U.S. person makes investment decisions for the account of a U.S. person, that account is not treated as a U.S. person. Several exceptions from that general principle, however, are established in the definition."); *see also* Goodwin, Procter & Hoar LLP, SEC No-Action Letter (Feb. 28, 1997) ("The release adopting Reg. S also stated that when a foreign fiduciary or other entity has full investment discretion for the account of a U.S. person, that account is not treated as a U.S. person.").

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

[22] *See* Comment Letter on Commission Report on the Review of the Definition of "Accredited Investor" from the Investment Adviser Association (June 29, 2016).

[23] *See* Comment Letter on Commission Report on the Review of the Definition of "Accredited Investor" from the Consumer Federation of America and Americans for Financial Reform (April 27, 2016) (noting that if certain changes were adopted to the purchaser representative framework, "it might be possible for the Commission to consider expanding the definition of accredited investor to include individuals who rely on an independent, fiduciary adviser in making their investment decisions.").

## IV. Potential Means of Implementation of our Recommendation

As discussed above, the Commission should revise the definition of "qualified purchaser" for purposes of Section 3(c)(7) under the 1940 Act to include, in the case of a private equity fund, any investor who invests in the fund at the direction of, or based on the advice of, a fiduciary that is a Commission-registered or state-registered investment adviser or bank (as defined in the Advisers Act) and that has at least $50 million in assets under management or advisement. To implement our recommendation, the Commission could use its authority under Section 2(a)(51)(A)(i) to define the term "investment" in Rule 2a51-1, for purposes of the definition of "qualified purchaser" in Section 2(a)(51) with respect to a prospective qualified purchaser investing in a private equity fund, to include all investments managed or advised by such a fiduciary advising the prospective qualified purchaser on the investment in the fund. Alternatively, the Commission could use its rulemaking authority under Section 6(c) of the 1940 Act to exempt any private equity fund that would be able to rely on Section 3(c)(7) but for the fact that it has non-qualified purchaser investors that were advised by such a fiduciary when they acquired interests in the fund. In addition, the Commission should revise the definition of "accredited investor" under Rule 501(a) of Regulation D to include any such investor. To implement our recommendations with respect to the definition of accredited investor, the Commission could use its rulemaking authority under Section 2(a)(15)(ii) of the Securities Act.

## V. Conclusion

In closing, we would like to thank the Commission for the opportunity to comment on this important issue. We believe that making our suggested changes to the definitions of qualified purchaser and accredited investor would help more investors access attractive private equity investments, which are an important tool to help generate savings for retirement. At the same time, we believe that the regulatory framework currently in place provides sufficient protection to warrant the extension of these opportunities to investors advised by sophisticated fiduciaries. If you have any questions with respect to the matters raised in this letter, please contact Nora Jordan at [redacted], Gregory Rowland at [redacted], or Aaron Gilbride at [redacted].

Very truly yours,

Davis Polk & Wardwell LLP

Davis Polk & Wardwell LLP