Guest Snapshot:

The Evolving Regulatory Context of Private Markets

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ESG and impact investing advisory with the goals of value enhancement and risk management.

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In our Guest Snapshot series, the Blue Dot Capital team, in collaboration with guest experts, unpacks topics such as regulations, geopolitics, and energy policy, and their ramifications for how investment managers design and execute their sustainable investment strategies and programs.

Snapshot: The Evolving Regulatory Context of Private Markets

For this Snapshot, we are joined by Troy A. Paredes, former Commissioner at the U.S. Securities and Exchange Commission (SEC) and advisor and expert commentator on financial regulation to discuss the evolving private markets regulatory landscape.

Background

Private markets investments have grown to represent a significant part of global capital markets. According to Preqin, private markets assets are poised to grow to $18.3 trillion in 2027 from $11.7 trillion in 2022. Within private markets, private credit too has been growing rapidly and total assets stood at $1.9 trillion at the end of 2022[1].

Private markets now command a sizeable portion of institutional investor allocation. According to BlackRock's Global Private Markets Survey 2023, private markets assets represented an average 24% of institutional portfolios[2].

In recent years, private markets investment firms have made a major push towards diversifying their client base beyond institutional investors and have ramped up their product offerings for wealth distribution channels.

As private markets have grown in scale and influence, regulatory attention has increased too.

Q&A

Q: How would you chart the evolution of the regulatory stance and parameters governing private markets?

A: Since their inception, the federal securities laws have set the stage for private markets. The statutory cornerstone of private markets is section 4(a)(2) of the Securities Act of 1933 (long known as section 4(2) until it was renumbered), which affords private offerings of securities an exemption from the mandatory disclosure requirements that public offerings must follow under the registration requirements of section 5 of the Securities Act. The size private markets have grown to signals the contributions private markets have made to economic enterprise and entrepreneurism.

Notwithstanding that a company's private offering of securities may be exempt from the mandatory disclosure that a company engaging in a public offering must make, private offerings are still subject to antifraud

1. Preqin
2. Survey respondents included 200+ institutions across 22 countries

regulation. You can't commit fraud in a public offering; nor can you commit fraud in a private offering. In addition, although private offerings are exempt from section 5, companies raising money privately still typically provide investors with a great deal of informative disclosure, demonstrating how market discipline and accountability can elicit information aside from what the government mandates. Mandatory disclosure is not the only way investors are provided information to make informed investment decisions; transparency is not entirely dependent on SEC mandates.

Q: What have been the regulatory milestones as private markets have grown and matured?

A: For me, two stand out.

Actually, the first one is jurisprudential: the Supreme Court's 1953 decision in SEC v. Ralston Purina. In that case, the Court considered what constitutes a private offering under section 4(2) (now 4(a)(2)) of the Securities Act. The Court decided that a private offering is one in which investors are able to "fend for themselves," to quote the Court. On the one hand, this was helpful in establishing a standard to evaluate if a securities offering is or is not exempt from section 5's registration requirements for public offerings. On the other hand, "fend for themselves" is not especially illuminating. What does this mean practically? Also, not all investors are equally situated.

Lower courts and others struggled with this for years. Some courts emphasized the information investors had access to – for example, how did it compare to the information investors would have in a public offering? The number of investors and the manner of the securities offering also factored in sometimes. Other courts focused on whether investors were, as the courts put it, "sophisticated" in financial, investing, or business matters so that they could evaluate the merits of the offering, including, presumably, the risk of not being provided certain information about the issuer. Since "sophistication" is difficult to pin down, the financial wherewithal of investors became a consideration, the thought being that some investors may be more able to bear the risk of financial loss if things didn't turn out well when buying privately-placed securities. Needless to say, this was all highly uncertain, setting the stage for the second milestone.

The second milestone is squarely regulatory: the SEC's adoption of Regulation D in 1982, nearly 30 years after Ralston Purina. The uncertainty of "fend for themselves" frustrated the private offering exemption's usefulness because uncertainty creates the risk of being second-guessed even when you act in good faith. In particular, if an issuer did not register its securities offering under section 5 of the Securities Act genuinely believing that section 4(2) was available, yet a court decided that the investors could not in fact "fend for themselves," the issuer could be found in violation of the federal securities laws. The SEC decided it was appropriate to fashion a test with brighter lines, through the adoption of a safe harbor, as an alternative to the ill-defined jurisprudential test of "fend for themselves." To this day, that safe harbor takes the form of Regulation D.

Regulation D offers clear, understandable criteria that are relatively easy to apply and that, if met, allow an issuer to raise capital in a private offering of securities that the issuer does not have to register with the SEC. For all intents and purposes, the distinguishing feature of Regulation D is that the offer and sale of securities must be to "accredited investors," with some exceptions; individuals generally qualify as "accredited" if they meet certain net worth or income thresholds.

Regulation D – and especially Rule 506 of Regulation D – has enabled the growth of private markets. Robust private markets provide a way for companies – whether early-stage, well-established, or in between – to raise needed funds when a public offering isn't doable or preferable. But private markets do more than facilitate capital formation, as important as that is to business, enterprise, and innovation and as foundational as that is to the SEC's mission. The other side of raising capital is providing capital. Thriving private markets afford investors more opportunities to invest in entrepreneurs and businesses they want to back, the chance to further diversify their portfolios, and additional choices when seeking to earn income and build wealth, although, of course, nothing is a sure thing.

Q: As private markets investing continues to grow and private markets firms continue to attract individual investors, how do you anticipate the regulatory reference points to evolve?

A: For decades, the reference points primarily have been statutory: the private offering exemption discussed above, along with the definition of "private fund" under the Investment Advisers Act of 1940. The structure of the federal securities laws remains vital, as it incorporates the tenet that not all aspects of the U.S. capital markets should be subject to the same degree and nature of government regulation – in other words, that there's value in allowing companies to issue securities privately and in allowing investors to buy securities by organizing themselves in private investment vehicles. However, private markets have grown several times over in recent years. That kind of growth has attracted regulatory interest and media attention, and it has accentuated as a reference point the economic impact of private markets, with assets and investments now well into the trillions.

I hope the scrutiny that private markets are under these days doesn't result in unduly burdensome and restrictive regulation that stifles them. Candidly, if the SEC's recently-adopted private funds rule – in which the SEC, on a 3-to-2 vote, imposed far-reaching regulations on private funds, going well beyond anything the SEC had seen fit to do previously – is any indication, I'm uneasy.

There's no disputing that markets of all types thrive on accurate information, and that market participants need to be confident that the markets they participate in have integrity. These basic principles are the backbone of the federal securities laws.

But as the SEC itself has acknowledged, regulation has its costs, too, such as out-of-pocket compliance costs, the opportunity cost of people's time and effort, the potential chilling of new products and services, squeezing smaller businesses, and so on. The question is how the benefits of regulation compare to the costs. When the SEC balances costs and benefits in deciding how private markets should be regulated, the value creation and economic activity that private markets have fueled should weigh considerably. The combination of private offerings and private funds has been instrumental in funding startups and entrepreneurs, mid-size companies looking to compete more aggressively, cutting-edge technologies, and business expansion. Capital formation is not an esoteric idea, but a concrete dynamic that helps grow the economy, expand opportunity, and create jobs.

In 2012, the JOBS Act was enacted with Republican and Democratic support. The legislation centered on making it easier for companies to raise capital to finance their prospects and operations, without compromising essential investor protections. Indeed, elements of the JOBS Act were meant to foster

investment opportunities for investors, both institutional and retail. At the time, I spoke favorably about the reforms the JOBS Act ushered in.

What strikes me today is the bipartisan message that the JOBS Act continues to send – namely, that facilitating capital formation and protecting investors are not necessarily in tension. We can ensure that investors have the material information that matters through a combination of mandatory disclosure together with market discipline and accountability that induces issuers to disclose more than the government requires; we can bolster the integrity of – and trust in – securities markets with effective enforcement of antifraud provisions against abuses and misconduct; and we can avoid overburdening capital formation and, as the JOBS Act did, look for opportunities to spur the process of raising capital in both private markets and public markets and to broaden the choices investors get to choose from when investing. If we have these as reference points as well, we can continue to produce a sound regulatory environment that is conducive to the consequential role private markets play.

Guest Author

Troy A. Paredes, Founder, Paredes Strategies LLC

Troy A. Paredes is the founder of Paredes Strategies LLC. From 2008-2013, Paredes was a Commissioner at the U.S. Securities and Exchange Commission.

Paredes advises on financial regulation, compliance, risk management, corporate governance, and regulatory strategy. He also serves as an expert and advisor in regulatory enforcement investigations and in private litigation involving securities law and corporate law. Paredes has brought his extensive government, compliance, enforcement, and regulatory experience to bear in serving as an independent compliance consultant/corporate monitor. He also has considerable experience sitting on boards of directors and as a member of advisory boards.

Paredes was a professor of law at Washington University in St. Louis before joining the SEC. In addition, he has been a Lecturer on Law at Harvard Law School, a Distinguished Scholar in Residence at NYU School of Law, and a Distinguished Policy Fellow and Lecturer at the University of Pennsylvania Law School.

Paredes is the author of numerous academic articles on financial regulation, corporate governance, innovation, behavioral economics, and administrative agencies. And he is a co-author (beginning with the 4th edition) of a multi-volume securities regulation treatise with Louis Loss and Joel Seligman entitled Securities Regulation.

Paredes holds a bachelor's degree in economics from UC Berkeley and earned his J.D. from Yale Law School.

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