



PHOENIX AMERICAN

FINANCIAL SERVICES, INC.

Regulatory Headwinds Are Subsiding by Ned Montenecourt and David Fisher

It's Not Exactly Morning in America, But the Regulatory Outlook is Brightening

The Trump administration came into office with the promise of breaking down regulatory walls, which was music to the ears of the alternatives industry. While the administration has succeeded to some extent – such as stopping the Fiduciary Rule from being implemented – changing published rules takes time, concerted effort and buy-in from leadership at the relevant agencies.

Just 17 months into the Trump era, it remains too soon to say how much the regulatory rulebook will ultimately be relaxed. But as the dust settles, the alternative investment industry is optimistic that we will see positive results on important issues that will remove the handcuffs from broker-dealers and increase the base of investors with access to alternative products.

Key to these goals includes expanding the definition of an “accredited investor” that can invest in alternatives; loosening the rules on Regulation A+ to enable more funds to raise money without burdensome paperwork hurdles; and making sure that any future Fiduciary Rule doesn't stifle options presented to investors.

IPA Hosts Informational Event

The trade group Institute for Portfolio Alternatives (IPA), a national leader in bringing together the Alternative Investment or Portfolio Diversifying Investments (PDI) industry, recently hosted an event in Washington D.C. The conference brought together more than 200 alternatives industry stakeholders to discuss how the industry should work to facilitate capital formation and devise a more logical approach to expanding the number of investors permitted to participate in the equity portion of capital formation.

Conference attendees – sponsors, broker-dealers, RIAs and investors – discussed how proposed new regulations might change the landscape for sponsors and their distribution partners. The event included “Hill Day,” an opportunity sponsored by IPA for attendees to participate in lobbying relevant lawmakers on proposed changes to regulations.

Phoenix American Financial Services, an active member of IPA and the effort to improve the alternative investment landscape, was among the companies that participated in Hill Day to make the rounds on Capitol Hill to lobby for sensible regulatory changes. We believe that crafting smarter regulations will have a significant impact for both the companies looking to raise capital and investors that deploy capital into these types of investments.

Regulatory Revisions Needed

PAFSI is committed to lobbying for smarter regulations that will facilitate capital formation, broaden the flexibility of fund managers and will not discriminate arbitrarily against investors. In that light, discussions at the IPA event identified three regulatory areas that are critical to industry participants:

- Expanding the definition of an accredited investor, which would enable more investors to participate in the sector.
- Revising Regulation A+, which would make it easier for start-ups to raise capital.
- Ensuring that any future Fiduciary Rule contain reasonable terms and be enacted through the appropriate agency.

Let's take a deeper dive into the issues surrounding each of these issues one-by-one.

Accredited Investor Rules

The requirement that only accredited investors could participate in an alternative investment goes back to the Securities Act of 1933. The current rule defining an accredited investor dates to 1982 and has not undergone any substantial review or revision since then. The rule badly needs to be updated for many reasons, including:

- To help expand the investor pool and facilitates capital formation for companies looking to innovate and expand.
- To bring a logical and updated definition of investors deemed "sophisticated."
- To expand access to an asset class that has long been unfairly restricted to many investors.

The act defines an accredited investor as either: 1) a person with an income of \$200,000 per year (or a couple with a combined income of \$300,000 per year) or 2) a person or couple with a net worth of \$1 million or more. The rule presumes the investment sophistication of an individual based solely on an arbitrary monetary threshold unexamined and unadjusted for over 35 years. Below this threshold, investors do not qualify and are not permitted to invest in Regulation D 506(b) funds (or are at least severely restricted from participating in these products).

There are 12.4 million accredited investors in the U.S. that control three-quarters of the country's wealth, about \$65 trillion, according to Seeking Alpha. The rule, however, excludes a very large population of investors who would be considered "sophisticated" under any probative definition. The alternatives industry contends that expanding the number of investors permitted to invest in these products would benefit investors and sponsors alike.

How do we increase the population of LP investors for sponsors? The IPA proposes to expand the current definition of an accredited investor to include U.S. investors who carry active licenses in financial services industry organizations – such as registered representatives of the Financial Industry Regulatory Authority (FINRA), members of the Chartered Financial Analyst (CFA) Institute, certified public accountants (CPAs), etc. – and to develop a meaningful test of the investment sophistication of those investors who do not meet either the financial threshold or the "Active License" threshold.

Adding professional experts would expand the potential investor pool for alternative investments by nearly 1.4 million. That includes roughly 630,000 FINRA registered representatives, 85,000 U.S. members

of the CFA Institute and 660,000 certified public accountants in the U.S. These financial professionals are sophisticated potential investors but their average salary as a group is well below the \$200,000 threshold of the current accredited investor rule. The investor pool could be expanded further by including other categories of licensed financial professionals, perhaps real estate brokers and attorneys, and creating a reasonable exam to test the investment knowledge of other professionals.

The intent of the securities laws, to protect investors from the financial risks of various investments, is not at issue. The question is whether the definition of a sophisticated investor has been properly addressed and whether the current definition needs to be updated. Phoenix American Financial Services is aligned with the IPA, and we reinforced that view during our recent lobbying efforts on Capitol Hill.

There is movement in Congress on the goal of expanding the definition of an accredited investor. The U.S. House of Representatives recently passed the “Fair Investment Opportunities for Professional Experts Act,” which would enact many of these improvements.

Regulation A+: Help for Small Business

Regulation A+ is about not overburdening small start-up companies with paperwork. It has two tiers:

- The original Regulation A is Tier 1, which enables funds to raise up to \$20 million without providing audited financial statements to the Securities and Exchange Commission. There is no limit on the proportion of total capital raised from the general public, and continuous reporting to the SEC is not required. Tier 1 does require that a fund ensure compliance with blue sky laws in each state it receives funding.
- The A+ is Tier 2, is the newer regulation. Tier 2 allows a startup fund to raise up to \$50 million without the need to comply with blue sky laws in states where investments are received. So private companies can raise up to \$50 from accredited and non-accredited investors and conduct a “mini-IPO” subject to prior SEC review. Tier 2 does require funds to submit two years of audited financial statements to the SEC.

Regulation A+ success stories include Brew Dog, a Scottish craft beer company, which used Regulation A+ to raise \$25 million in its Equity for Punks IV crowdfunding campaign in 2016. The proceeds were to fund the brand’s expansion into the American market. Elio Motors, makers of high-mileage three-wheeled automobiles, raised \$17 million from over 6000 non-accredited investors through CrowdfundX.

What these success stories have in common is they are innovative products with a compelling story appealing to the average non-accredited investor. They are also relatively small in scale. Real estate projects and other more traditional fund offerings are deterred by the \$50 million limit of Regulation A+.

The industry believes, a stance reflected at the IPA summit, that Regulation A+ is too restrictive and the amount of capital companies can raise and should be expanded. This is another area in which there is legislative action. The House passed on a bipartisan basis the “Regulation A+ Improvement Act,” which would increase to \$75 million (up from \$50 million) the amount that companies can offer and raise under Regulation A. The bill would also allow that amount to be adjusted for inflation every two years.

The IPA supports the proposed expansion of Regulation A+ and is actively seeking a Senate companion bill to go with the recently passed House version to move the measure toward enactment. Phoenix

American Financial Services, having relationships with many funds using Regulation A+, also strongly supports this legislative effort and was happy to lobby for its improvement on Capitol Hill.

Fiduciary Rule – Not Quite Dead

Since its introduction in 2010, the Department of Labor’s (DOL) Fiduciary Rule has been on a wild ride. That ride may finally have come to an end.

The rule requires those who advise investors – such as broker-dealers, investment advisors, insurance agents – to act in the best interests of their clients when providing investment advice for a fee or other compensation. The intent was to ensure that financial advisors for retirement funds were motivated by the welfare of their clients rather than by attractive commissions associated with some investment products.

The DOL Rule requires advisors to act as fiduciaries. Legally, a person acting in a fiduciary capacity is held to a high standard of honesty and full disclosure and must not obtain a personal benefit at the expense of the client. Any perceived conflict of interest in recommending an investment product could potentially be grounds for legal action, creating a prohibitive liability for advisors selling investment products with sales commissions for retirement accounts.

The fiduciary rule was published in the Federal Register on April 8, 2016, and made effective June 7, 2016. The applicability date was delayed to April 10, 2017 to give financial services companies time to prepare. During that time the rule was challenged in court, and in Congress. Ultimately, the rule went into partial effect in 2017, though the DOL announced it would not enforce it pending review.

A panel of the 5th Circuit Court of Appeals struck down the regulation on March 15, 2018 calling it an “arbitrary and capricious exercises of administrative power.” The Department of Labor had until April 30 to file an appeal to be heard by the full 5th Circuit Court. Likely because of the strength of the chief judge’s dissent and because the current administration opposes the rule, this appeal was not filed. Unless the DOL petitions the Supreme Court to take up the case or a third-party plaintiff takes up the appeal, the DOL Fiduciary Rule is dead. However, the SEC has promised to write its own fiduciary rule later this year. SEC Chairman Jay Clayton said he wants the his agency to govern the relationship between clients and financial professionals.

The alternatives industry believes that the fiduciary rule was never in the purview of the DOL and that the appropriate forum for such rule making is the SEC. The sensible next step – should the SEC choose to act – would be for the commission to propose practical rules that would clarify the financial advisor-retirement investor relationship. DOL, as recently as May 7th, 2018 that it will continue to rely on the regulation for now to govern advice in retirement accounts.

Conclusion

The IPA Summit successfully demonstrated the leadership that the group is providing to bring smarter policies that will benefit the alternative investment industry and the investors that would benefit from participation in the sector. Phoenix American Financial Services is proud to be actively involved with the IPA in helping to improve the efficiency and integrity of the alternatives industry and to advocate for constructive cooperation with lawmakers in Congress. SEC Commissioner Michael Piwowar recently

announced to President Trump that he is stepping down effective July 7th, 2018. More change afoot for the alternative industry for sure.

Stay tuned for more thoughts from Phoenix American Financial Services, Inc. (“PAFSI”) on how these regulations might impact sponsors, Broker-Dealers, RIAs and other industry participants.

About Phoenix American Financial Services

Founded in 1972, Phoenix American Financial Services, Inc. (PAFS) is a leading provider of fund administration, fund accounting and transfer agent services for the alternative investment industry. PAFS's Aircraft Group, which includes its major operational facilities in Shannon Ireland, is the leading provider of administration and accounting services for asset backed securitizations specializing in the commercial aircraft and engine leasing industry. The company was founded in 1972 and is headquartered in San Rafael, CA.