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March 16, 2020

Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: RIN 3235-AM19 Amending the "Accredited Investor" Definition

Ladies and Gentlemen:

Morningstar, Inc. appreciates the opportunity to comment on the SEC's proposed rule "Amending the 'Accredited Investor'" Definition.

In general, we support the direction of the rule. Putting an emphasis on allowing investors with knowledge and expertise to participate in private capital markets is sensible. These investors, by definition, should be better able to cope with the opacity and limited availability of comparable measures in our private markets. However, we believe the SEC should focus less on examinations and certifications that mostly cover the public markets. Rather, certifications should demonstrate potential accredited investors understand the unique liquidity and valuation issues in the private markets.

More importantly, as others have observed, the current income and wealth thresholds are a poor proxy for investor knowledge and expertise. In fact, the form of our retirement system makes such wealth thresholds a poor way of determining who is qualified to invest in private markets. As the defined-contribution retirement system has replaced the defined-benefit pension system, millions of workers stand to accumulate more than $1 million. Many of these investors will have little or no investment expertise. A majority will have simply been automatically enrolled in a target-date fund or managed account and accumulated wealth over time without learning the basics of the public securities markets.

At our request, the Employee Benefits Research Institute, or EBRI, provided additional analysis of how rapidly the U.S. retirement system will begin to produce accredited investors as it matures. Using a microsimulation model, EBRI examined current retirement accounts in the United States and concluded that just among people with retirement accounts today, 8.8% will have over $1 million in 10 years and 21.8% will have over $1 million in 20 years, making more than one in five Americans with a retirement account today an accredited investor.[1]

[1] This simulation uses standard assumptions and includes participants aged 26-64. The assumptions assume an increasingly conservative asset allocation over time, stochastic rates of return based on Ibbotson/Morningstar data, and inflation expecations from the Social Security Trustees annual reports, among other parameters.

This microsimulation model provides a more-sophisticated estimate to supplement the analysis Commissioner Lee presented in her statement on Dec. 18.[2] It provides a better estimate of the number of 401(k) millionaires because it accounts for leakage, spending in retirement, and individuals' contribution patterns. However, this estimate is an understatement of the total number of people that would be eligible because it does not include couples combining their assets to qualify nor spouses of those with account balances of more than $1 million, nor does it include other qualifying assets. It also does not include people without accounts today who may hit the $1 million threshold in coming years. Despite these limitations, the simulation paints a clear picture of, at minimum, more than 14.6 million individuals crossing an arbitrary threshold to become eligible accredited investors in the coming years. This would put many of these investors potentially at risk.

As we wrote in response to the concept release in the fall of 2019, high levels of knowledge are very important for those investing in private markets. Private pooled investments tend to have a large performance variance compared with other pooled investments. In contrast, even if an investor chooses a worse-performing mutual fund, he or she is likely to lag a benchmark by a small amount—it won't be a critical error that could unravel a retirement plan. As we argued then, these characteristics of private investments—a wide variance in outcomes and incomplete information—are intrinsic to them. That means they should not be available to people who cannot evaluate the investments and bear the risks inherent in them.

Further, private investments are highly illiquid. Individuals need to demonstrate an understanding of any lock-up provisions that would affect their investments. To the extent that such liquidity risk is absorbed by investment vehicles, e.g. target-date funds, this concern will not be as relevant to the end-client. However, to the extent they are impacted, clients should be provided with disclosures and even questioned regarding their knowledge in a manner similar to the approach the Commission has taken in its recent proposal regarding leveraged ETFs.[3] We believe that a laissez-faire approach to private vehicles based simply on a wealth standard is inconsistent with the more prudent approach the Commission has taken regarding leveraged ETFs where individual accounts must be approved for investment by brokers based on a number of criteria.

Some have argued that an inflation indicator should be added to the income and asset thresholds to qualify as an accredited investor, but we disagree. There is no reason to conflate wealth with knowledge in a country with a robust defined-contribution system and millions of workers saving for retirement. Unless the threshold were dramatically raised, we think the Commission should focus on requirements for accredited investors, like the ones proposed, that are more likely aligned with their actual knowledge and expertise. Whether or not an investor

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[2] https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor

[3] Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customer's Transactions in Certain Leveraged/Inverse Investment Vehicles (Securities and Exchange Commission). https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf.

has $1 million in assets in coming decades will simply be a given for many people lucky enough to have defined-contribution plans at work.

Sincerely yours,

Aron Szapiro
Head of Policy Research
Morningstar, Inc.