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THE CASE FOR PRIVATE MARKET CERTIFICATION

WHY THE LACK OF OF EXAMS PUTS INVESTORS AT RISK

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Abstract

Exams for certification play a crucial role in ensuring that professionals in the financial industry have the knowledge and skills necessary to do their work successfully and responsibly. However, there are no analogous exams or certifications in the private markets, which exposes investors to many hazards. Without a standard of competence, it is difficult for investors to evaluate the expertise of the individuals they engage with. Without a common method of measuring knowledge, behaviors, ethics, and financial skills, investors remain exceedingly susceptible. Exams for certification also assure ethical conduct based on honesty, integrity, competence, and diligence. Without certification, investors may lack a comprehensive understanding of the risks and opportunities connected with private market investment. The SEC's Rule for Accredited Investors is an inadequate indicator of financial acumen. To address these oversights, it is time to establish a private market certification program that will provide a standard of competence and accountability for professionals in the private markets, deter fraudulent or unethical behavior, and equip investors with the knowledge and best practices they need to make informed investment decisions.

The Case for Private Market Certification: Why the Lack of Exams Puts Investors at Risk

Certification exams play a critical role in ensuring that professionals in the financial industry have the requisite knowledge and expertise to conduct their work effectively and ethically. Exams such as Series 7 and Series 63 are mandatory for individuals working in the public markets and serve as a standard of competence and accountability. However, when it comes to the private markets, there are no equivalent exams or certifications. Private markets are not required to file periodic reports or make the disclosures required in proxy statements. Furthermore, they are not required to obtain, much less distribute, audited financial statements, which has severe consequences for investors.[1] These are significant oversights, as private markets have become increasingly popular among investors seeking higher returns and greater diversification.

The lack of certification in the private markets presents several risks to investors. Firstly, without a standard of competence, it is difficult for investors to assess the expertise of the professionals they work with, such as private equity and venture capital firms. Investors are left to rely on reputation and word-of-mouth, which can be unreliable indicators of expertise.

40%

A study by Preqin found that 40% of investors, such as limited partners, family offices, and high-net-worth individuals, cite the investment team's expertise as a key factor in their investment decision-making process.[2] Investment teams need to be conversant and proficient in order to identify investment opportunities, conduct due diligence on potential targets, negotiate and structure deals, manage portfolio companies, and ultimately, generating returns for the fund's investors.

Additionally, certification dictates ethics in the financial sector. Without being at risk of losing their certification, some even engage in fraudulent practices. Furthermore, certification exams standardize the knowledge in investing, a prerequisite for informed decisions. Investors remain extremely vulnerable without a uniform way to accurately measure knowledge, behaviors, ethics, and financial abilities.

Exams Ensure Ethical Behavior

The lack of certification makes it easier for unscrupulous individuals to operate in private markets. Without the threat of losing their certification, individuals who engage in fraudulent or unethical behavior have fewer disincentives to do so. Ethical behavior goes beyond simply following laws and established rules. It is about knowing how to navigate ambiguous ethical situations and putting the interests of investors first when the rules are unclear. Certification exams dictate financial practices hinged upon honesty, integrity, competence, and diligence. For example, a report by the SEC found that private equity firms frequently engage in fraudulent practices such as overvaluing assets and charging undisclosed fees.[3] Additionally, the Securities and Exchange Commission (SEC) has filed over 100 cases since 2010 surrounding misconduct involving private firms, including misusing investor assets, dishonesty about investment strategies or performance, charging exorbitant fees, and failing to disclose conflicts of interest.[4] **The certification process ensures that professionals have the pertinent knowledge and skills that can better protect investors from fraudulent and unethical behaviors.**

Exams Standardize Knowledge

Thirdly, without a standard of knowledge and best practices, investors may not be fully aware of the risks and opportunities associated with private market investing. This can lead to poor investment decisions and missed opportunities. Certification profoundly impacts decision-making, including standardized knowledge, practices, and guidelines. Lack thereof breeds nonconformity to widely accepted methodologies in the financial sector. For instance, a survey by Deloitte found that only **18%** of limited partners in private equity funds are highly satisfied with their ability to access the best deals and co-investment opportunities.[5] **Standardized knowledge that comes from passing certification exams could improve both confidence and skills leading to better investment outcomes.**

The SEC's Accreditation is a Poor Proxy for Exams

In contrast to a well-designed certification program, the SEC's Accredited Investor rule is an inferior measure of an individual's financial sophistication. The rule sets income and net worth thresholds for individuals to qualify as accredited investors, which indicates their financial sophistication and ability to bear the risks of private market investing. However, this measure is criticized for being a blunt instrument that fails to assess an individual's financial sophistication accurately. An SEC's Investor Advisory Committee report found that the Accredited Investor rule "is a poor proxy for investor protection, has contributed to the expanding wealth gap, and imposes unjustified costs and burdens" (SEC, 2020).

Standardizing Private Market Certification

Given the risks associated with the lack of certification in the private markets, it is time to establish a private market certification program. Such a program would provide a standard of competence and accountability for professionals in the private markets. In addition, it would help investors to assess the expertise of the individuals they work with. It would also serve as a deterrent to fraudulent or unethical behavior and provide investors with the knowledge and best practices needed to make informed investment decisions. Ultimately, a private market certification program would benefit everyone involved in the private markets, from investors to professionals, and would help to ensure the long-term health and sustainability of this important and growing segment of the financial industry.

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