Interim Report of Subcommittee on Private Investments

SEC Asset Management Advisory Committee – 7th July 2021

Agenda

- Asset management and RIC landscape
- Characteristics of private investments
  - Private Equity
  - Private Debt
  - Private Real Estate
- Current regulatory framework for access to private investments
- Design Principles
- Discussion

Asset Management and RIC landscape

Industry Growth

DEMAND SIDE

- U.S. asset management industry AUM has grown faster than either inflation or GDP, rising from $18 trillion in 2002 to $45 trillion at the end of 2019
- At the end of May 2021, RICs held $29.8 trillion
  - Mutual funds: $24.4T
  - ETFs: $5.1T
  - Other RICS: $.33T
- The number of mutual funds has stayed relatively flat over that same period, with around 9,000 funds at the end of 2020
- ETFs have grown explosively over the same period, from around 200 funds managing $0.3Tn in 2005 to around 2,200 funds managing $5.1Tn in 2020
- Mutual funds' and ETFs' primary exposure (by industry AUM) is to US listed equities at approx. 40% and 30%, respectively, at the end of 2020
- Retail investors and self-directed retirement assets have become an increasingly larger part of the overall AUM

Public Market Growth

SUPPLY SIDE

- Total US public equity market capitalization matched the asset management industry AUM growth, rising from approximately $17 trillion in 2005 to $50 trillion at the end of March 2021
- Against this, the number of listed public companies has reduced dramatically from over 8,000 in the mid-1990s to around 4,400 currently
- In addition, there has been a growing concentration of the largest companies, primarily in the tech sector, with the S&P500 index top 10 companies accounting for around a third of the overall value of the index currently

Conclusions

DEMAND SIDE

- *We conclude that there is a growing demand for investment choice from all investors including retail investors as the asset management industry grows more quickly than GDP and inflation*
- *Whilst there is arguably greater choice for retail investors in terms of tailoring exposure particularly via ETFs, exposure is still primarily to the underlying US public equity markets*
- *In turn, this market has grown increasingly concentrated with fewer listed companies and a higher concentration of large tech companies dominating market capitalization weighted indices such as the S&P500 and Nasdaq 100*

Characteristics of Private Investments

Public vs. Private Investments

- The cash flows of private investments are unlike those public equity
  - Private **investments are often made in stages**, with capital calls occurring over multiple years.
  - When distributions occur, these **cash flows cannot be re-invested** in the original project
  - Private investments **do not trade in a secondary market**, and thus have no market price associated with them. Instead, they are usually valued by fund management on a quarterly basis
- This makes the calculation of investment returns difficult to compare to public market returns
- A range of return measures have evolved that attempt to ameliorate these issues, but none are perfect:
  - **IRR**: concerns with cash flow timing, assumes re-investment of returned cash
  - Multiple of Money (**MoM**): ignores duration of investment and timing of cashflows
  - Public market equivalent ("**PME**") matches private market cash flows with investments in the public market index like the S&P500: concerns with project scale, index selection

Private Equity

- There is evidence of private equity ("PE") fund returns being similar to, or better than, returns of public funds with some evidence of diversification
- PE managers tend to display a higher dispersion of returns compared to public market managers
- Compression in spreads more recently between private and public markets potentially driven by lower interest rates and lower illiquidity premium
- High fee product but investors should focus on net after fee returns provided there is adequate and comparable disclosure to allow them to do so
- ***We conclude that PE funds have the potential to offer return and diversification benefits to retail investors. However, the difficulty in measuring and reporting returns on a comparable basis, coupled with the potentially higher fees associated with PE investments, are important considerations in the decision of whether to expand retail access to pooled PE investments***

Private Debt

- Using data provided by consultants to institutional investors, we reviewed asset level and fund level private debt data for periods of 15 – 30 years in relation to:
  - Senior debt
  - Subordinated or mezzanine debt
  - Opportunistic or distressed debt
- As with PE funds, return comparisons to public indices are problematic and require adjustments to reflect cash inflows and outflows from the private debt funds
- ***We conclude that private debt funds appear to outperform public debt indices over medium and longer horizons. Over horizons less than three years, private debt funds underperform public indices***

Private Real Estate

- Real estate is generally classified into the following sub-categories:
  - **Core**
  - **Core plus**
  - **Value-add**
  - **Opportunistic**
- Public REITs can invest in all types of real estate investments across the risk spectrum. However, in order to maintain their REIT tax status under the IRS rules, they must distribute substantially all their income. As a result, they tend to invest in higher-quality cash flow producing assets within core or core plus real estate only
- Unlike Public REITs, private real estate funds tend to invest in value add and opportunistic investment opportunities in addition to core and core plus properties
- REITs can invest in "illiquid" real estate as liquidity for investors is achieved via trading of the REIT security

Private Real Estate

Contd…

- We compared fund level data provided by consultants to institutional investors over horizons of up to 10 years to certain public REIT benchmarks
- ***Generally, over a 3, 5 and 10 year period private real estate investments outperformed public REIT indices. However, this information was based on the public REIT indices comparisons and comparison methods***
- ***In looking at the one-year return through September 30, 2020, there was significant over performance from private real estate funds. This may be explained by the difference in secondary market price-based returns for public REITs compared to the underlying asset-based valuations for private funds during the pandemic***

Current Access to Private Investments by Retail Investors

Current Access to Private Investments by Retail Investors

- **Open-end mutual funds** are subject to a general 15% threshold on acquiring illiquid investments
- **Closed-end funds:** Staff in the SEC's Division of Investment Management has historically raised investor protection concerns if closed-end funds that invest more than 15% of their assets in private funds were to be offered to retail investors. As a result, these closed-end funds have limited their offerings to Accredited Investors.
- **Interval and tender offer funds** are closed-end funds subject to the staff position described above. They are designed to offer investors periodic and limited liquidity options.
- **Exempt securities** offered by issuers primarily under certain small offering exemptions (Reg A) and crowdfunding exemptions

Conclusions on Current Access to Private Investments by Retail Investors

- ***We conclude that whilst there are some methods for retail investors to gain access to private investments, these are either in the form of:***
  - ***diluted exposure in a pool of largely liquid assets; or***
  - ***higher exposures to private investments via interval funds and tender offer funds. We note that these have remained a small portion of the mutual fund landscape representing less than 2% of all mutual funds' AUM***
- ***As such broad access to private investments is currently not available to retail investors via existing investment vehicles***

Legal and Regulatory Requirements to Access Private Investments

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Access to private investments for non-retail investors is primarily via "qualification" thresholds. The 3 main "qualifications" are:

- **Accredited Investor** – net worth or income tests, or alternatively certain professional certification or "knowledgeable employees"
- **Qualified Client**- net worth and investor assets under management test (or being a "knowledgeable employee")
- **Qualified Purchaser**- Investments test ($5 million for natural persons) which is significantly higher than the threshold levels in the other two requirements and is required to invest in most private funds (i.e., private funds that rely on an exclusion from the definition of investment company under section 3(c)(7) of the Investment Company Act)

Conclusions on legal and regulatory requirements to access private investments

- *We conclude that the current regulatory landscape, particularly the financial thresholds for Accredited Investors, Qualified Clients and Qualified Purchasers, is such that most retail investors are precluded from the investing in the majority of private investments*
- *In particular, the very high financial threshold for Qualified Purchasers make access to diversified 3(c)(7) private funds virtually impossible for most retail investors*

Overall Conclusions

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Whilst the returns of private investments we looked at are not easily comparable to public markets, we find support for the returns being at least slightly to somewhat better than comparable public market investments

Private investments also offer some diversification benefits to retail investment portfolios

We note that private fund managers tend to exhibit higher dispersion in their returns compared to public fund managers

The current legal and regulatory framework is such that whilst there are some retail investment vehicles that can invest in private investments, these make up a small portion of the AUM in registered investment companies

Given the conclusions and observations above, we recommend widening retail investor access to private investments subject to appropriate <u>Design Principles</u> that strike a balance between wider access and investor protection

Design Principles

Design Principles

Any policy recommendations should be consistent with design principles that seek to balance investor choice, needs, and protection.

- **Liquidity**
  - Direct private investments often involve no secondary market liquidity and few if any redemption rights
  - Investment structures that offer at least limited redemption rights or secondary market trading ought to be encouraged
- **Chaperoned Access**
  - Retail investors require an additional level of protection in accessing private investments which may be achieved via chaperoned access
  - Chaperoned access could be achieved through various methods including using the RIC framework (with some modifications) or allowing retail investments only in funds with significant large institutional investors participation

Design Principles

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- **Diversification**
  - Diversification through a portfolio of investments in different private funds (or a private fund of funds) can help reduce potential performance dispersion and volatility that may occur with more concentrated private investments
  - In addition, retail investors should consider private investments in the context of a diversified overall portfolio that includes more liquid investments
  - Mandating or even monitoring overall portfolio diversification may not be feasible
- **Disclosure**
  - Access to private investments must include standardized disclosure of important information particularly with respect to performance, risks, and fees

Discussion