Private Investment Sub-Committee Update

SEC Asset Management Advisory Committee - 16th September 2020

Agenda

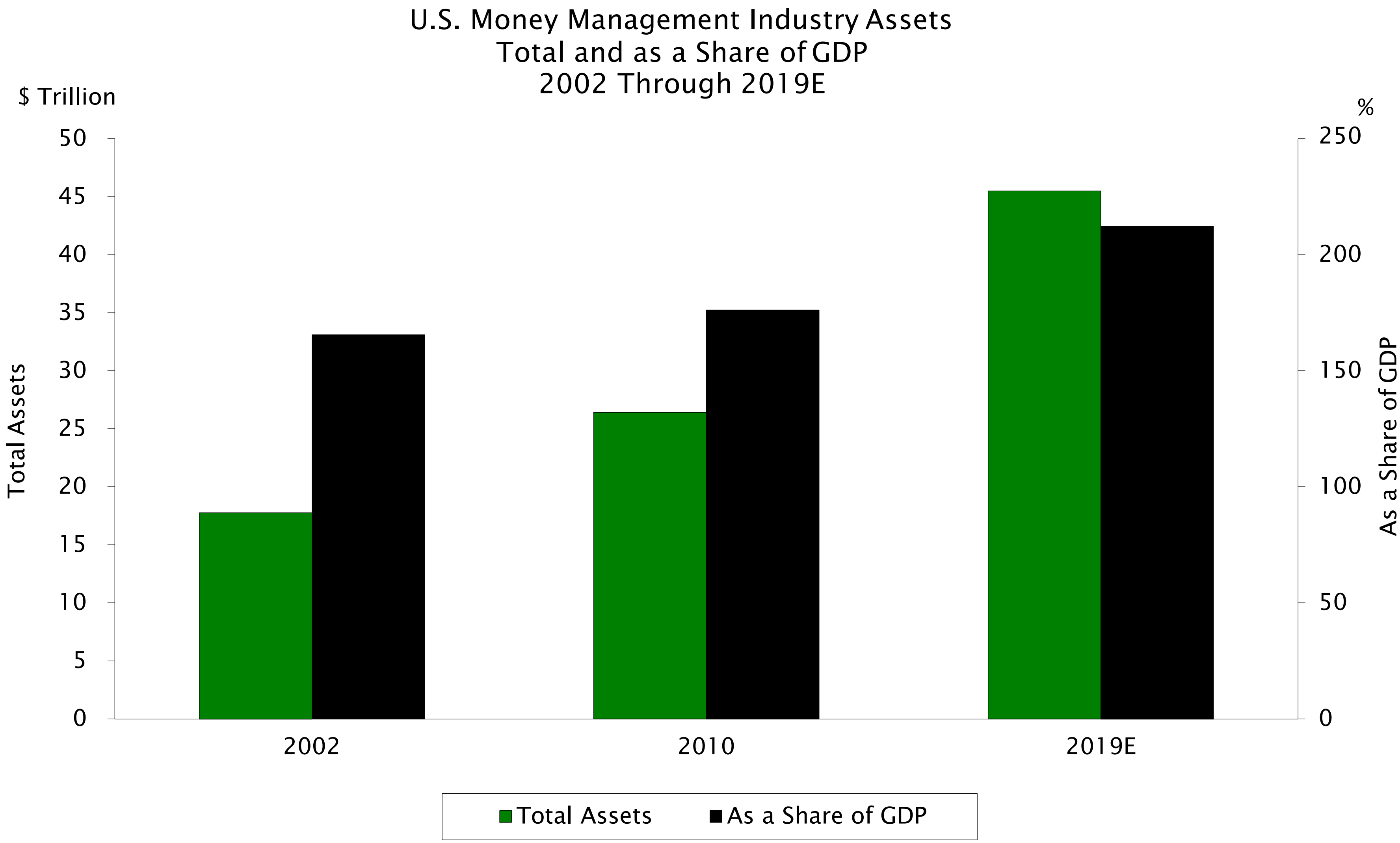
- Recap on why we are focused on potential expansion of access to private investments – Supply and Demand Dynamics in US Asset Management
- Update on two main workstreams
  - Analysis of whether private investments provide better and / or diversifying returns
  - Current regulatory landscape
- Next stage: Design Principles
- Today's panel
  - Some terms defined

Supply and Demand Dynamics in US Asset Management - Recap

Demand for Asset Management

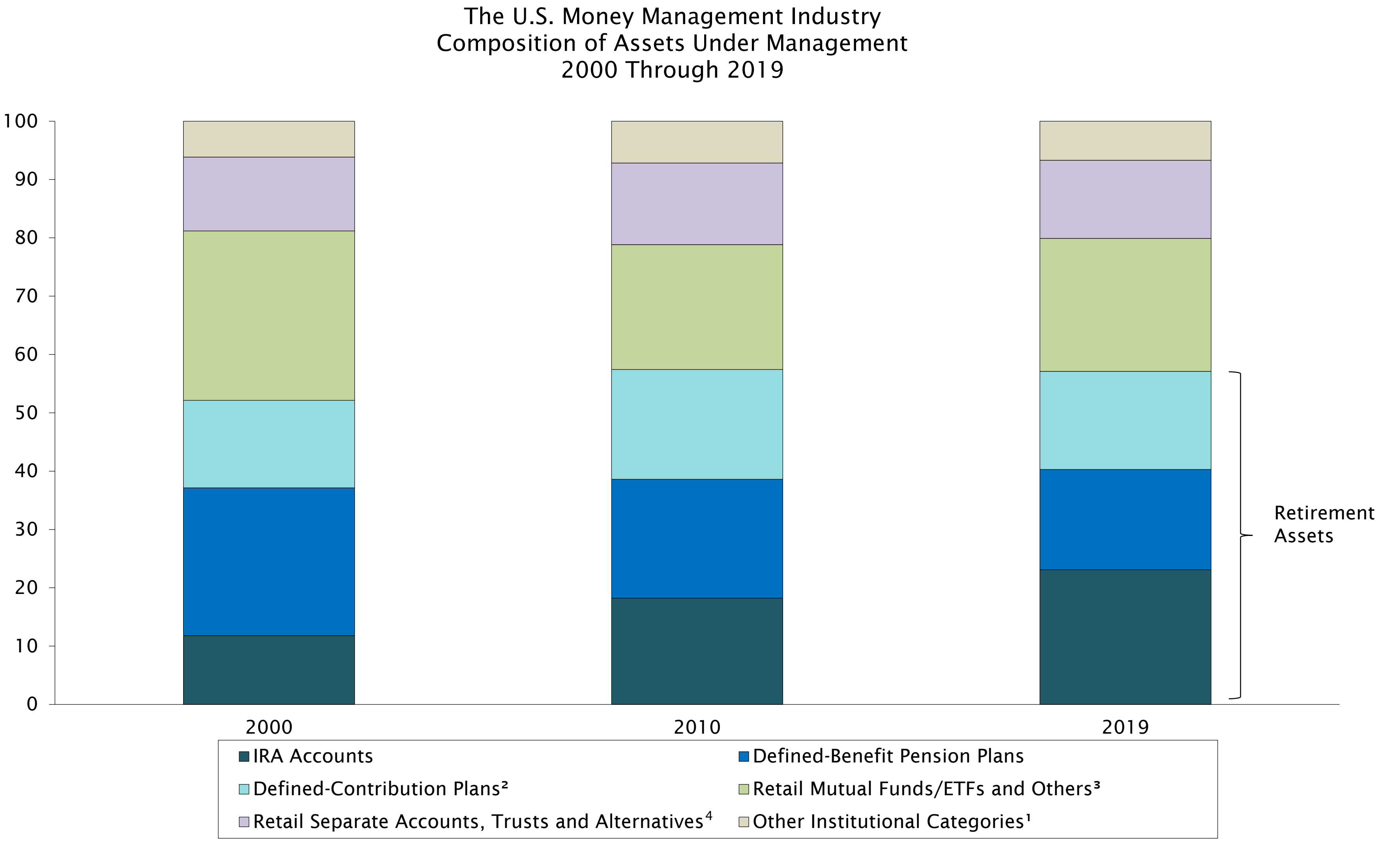
- The pool of investment assets continues to grow due to demographics and macro economic factors
- Retirement savings represent more than half of the AUM of asset management
- IRAs and self directed defined contribution plans (e.g. 401(k)) continue to increase in size and relative share of retirement assets
- Defined benefit plans active participants are reducing sharply and many of the plans are transitioning to the payout phase of their life cycle

The U.S. Industry is Around $45 Trillion in Size



Source: Michael Goldstein, Presentation to AMAC January 2020 - https://www.sec.gov/files/Empirical-Research-Issues-Facing-US-MM.pdf

Retirement Assets make up an increasing share



Source: FMMI Analysis.

[1] Endowments, foundations and outsourced insurance assets.

[2] Includes 401(k), 403(B), 457 and union defined-contribution plans.

[3] Includes variable annuities and college savings plans.

[4] Includes hedge funds and private equity funds.

Self directed Defined Contribution plans growth

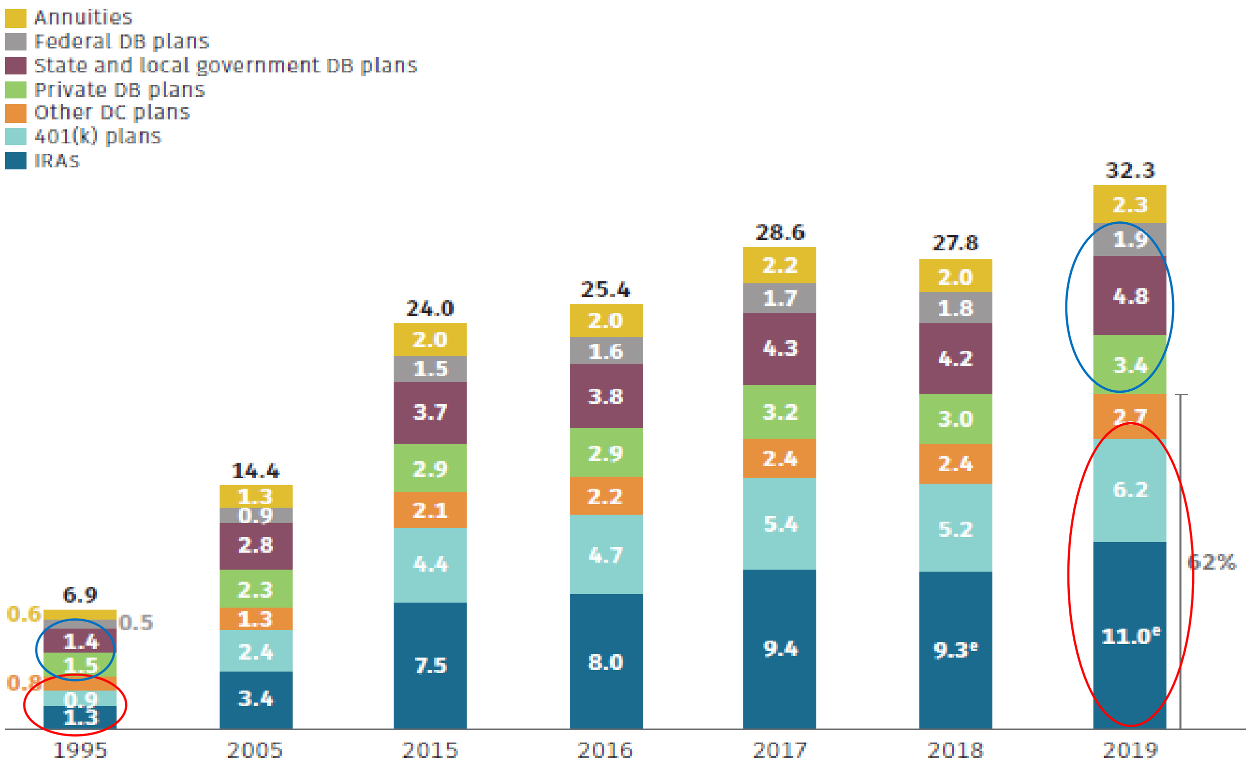
IRAs + 401(K) plans have grown from $2.2tn to $17.2tn since 1995 and from 33% to over 53% of total retirement assets .

In the same period DB plans grew from $3.4tn to $10.1tn but as a percentage of total retirement assets decreased from 49% to 31% of total retirement assets.

FIGURE 8.5

US Retirement Market Assets Surpass $30 Trillion

Trillions of dollars, year-end



ᵉ Data are estimated.

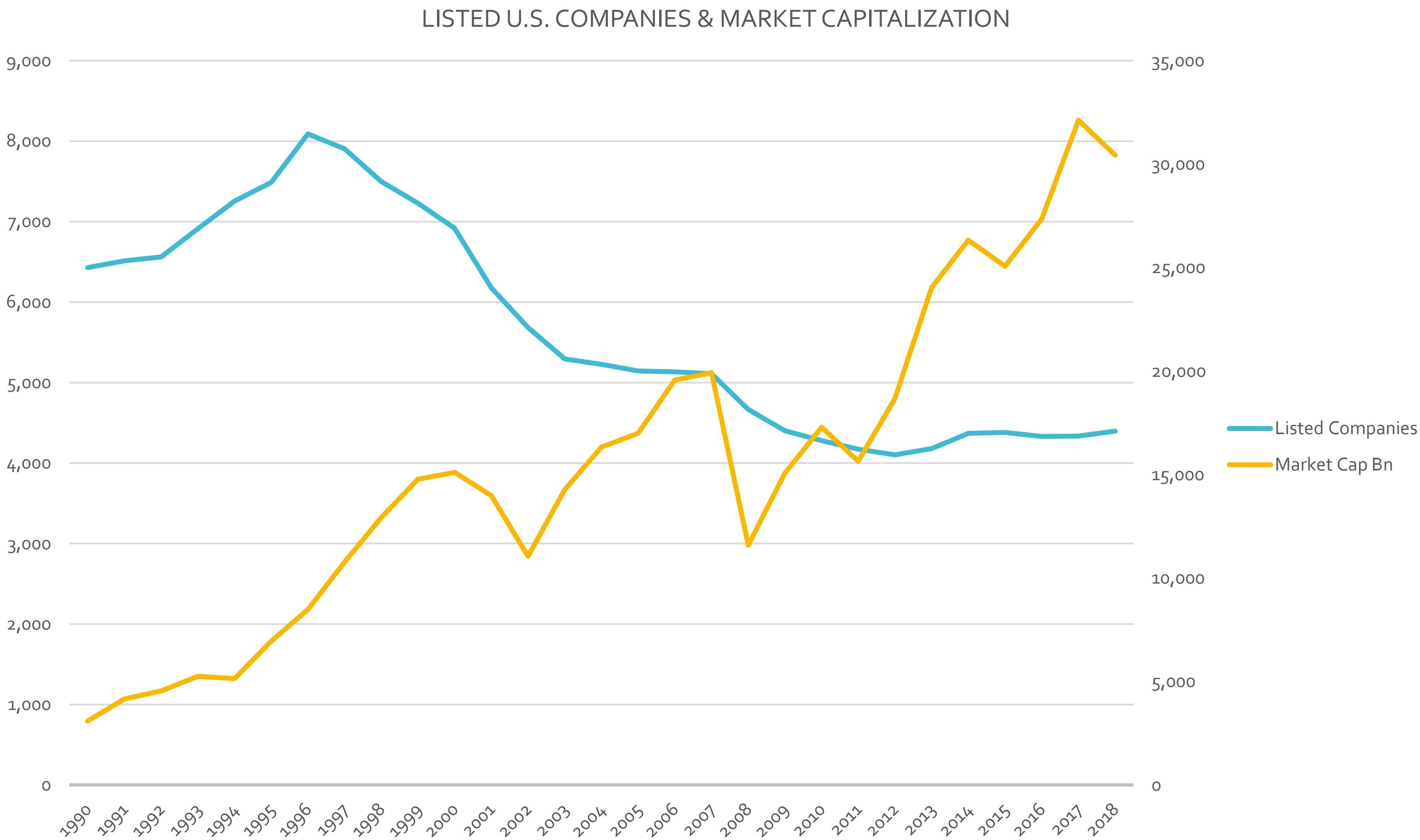
Source: Investment Company Institute. For a complete list of sources, see Investment Company Institute, "The US Retirement Market, Fourth Quarter 2019."

Source: Investment Company Institute. 2020. 2020 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry. Washington, DC: Investment Company Institute. Available at www.icifactbook.org.

Supply Side for Asset Management

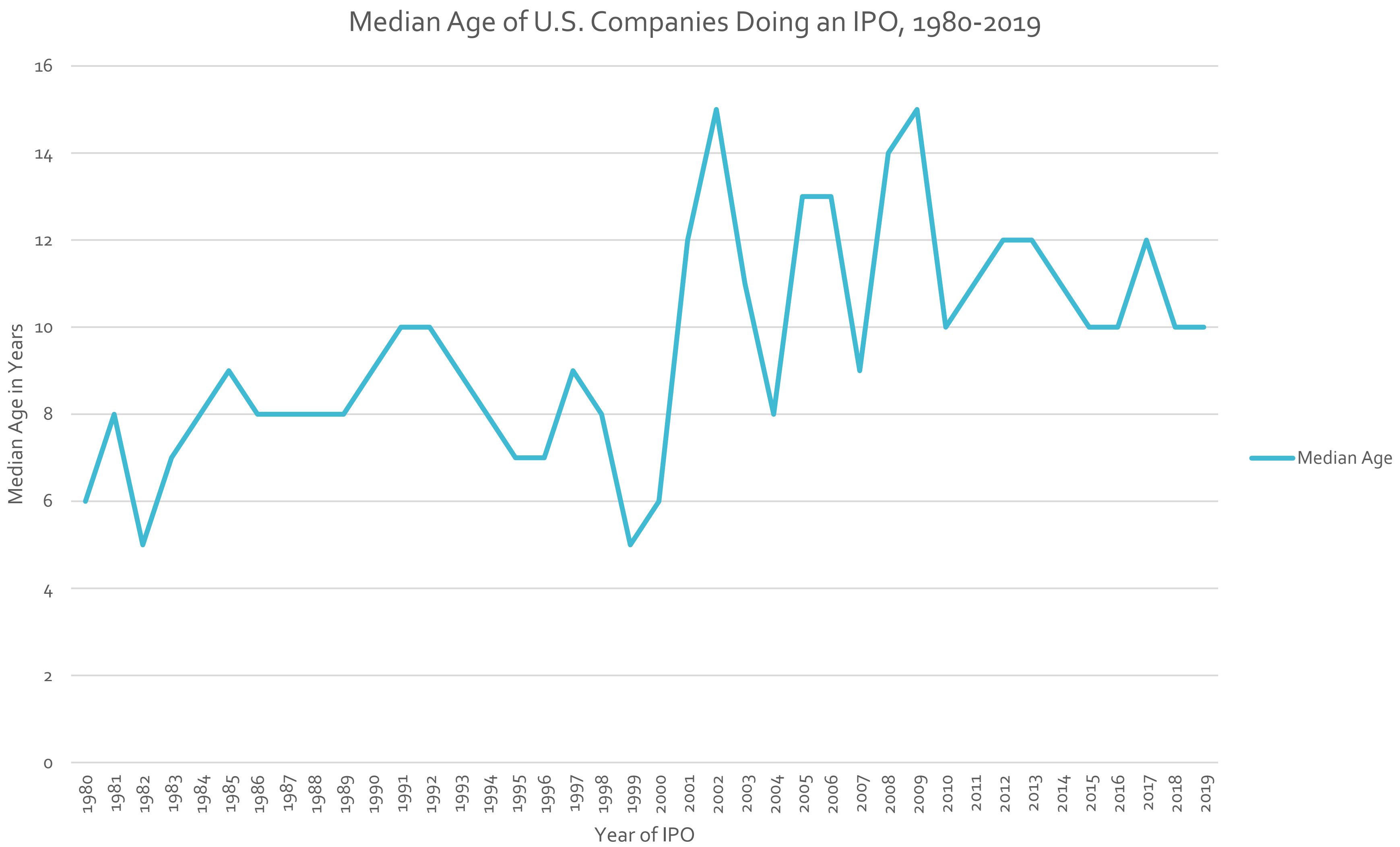
- The public equity market, whilst larger is more concentrated and with fewer listed companies
- Companies are staying private for longer and getting larger while private
- Private fundraising easily surpasses public fundraising

Growing Concentration of US Listed Companies



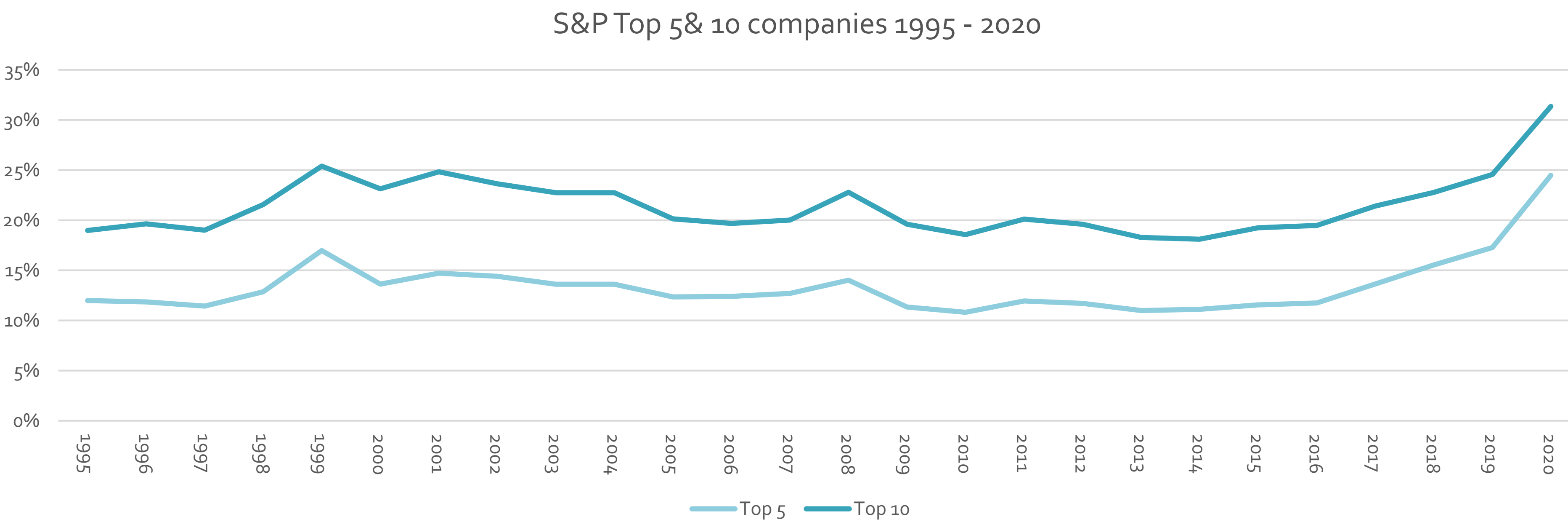
Source: The World Bank https://data.worldbank.org/indicator/CM.MKT.LDOM.NO

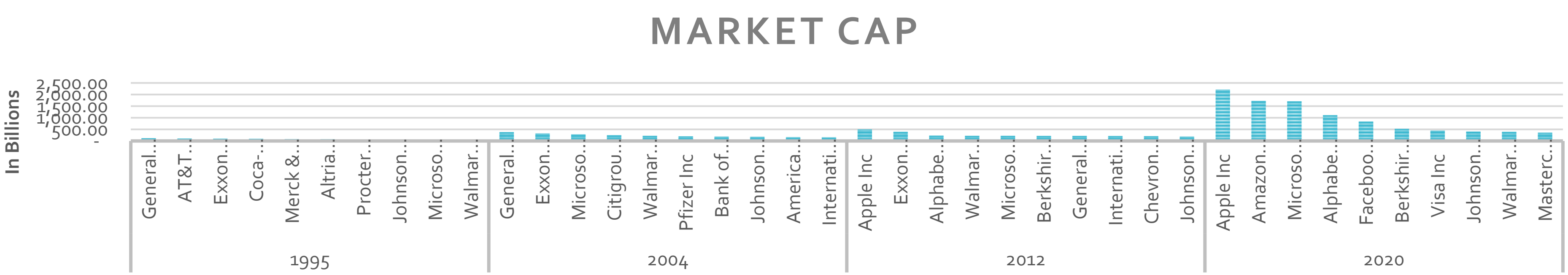
Start-Ups Have Stayed Private Longer



Source: https://site.warrington.ufl.edu/ritter/files/IPOs2019VC-backed.pdf

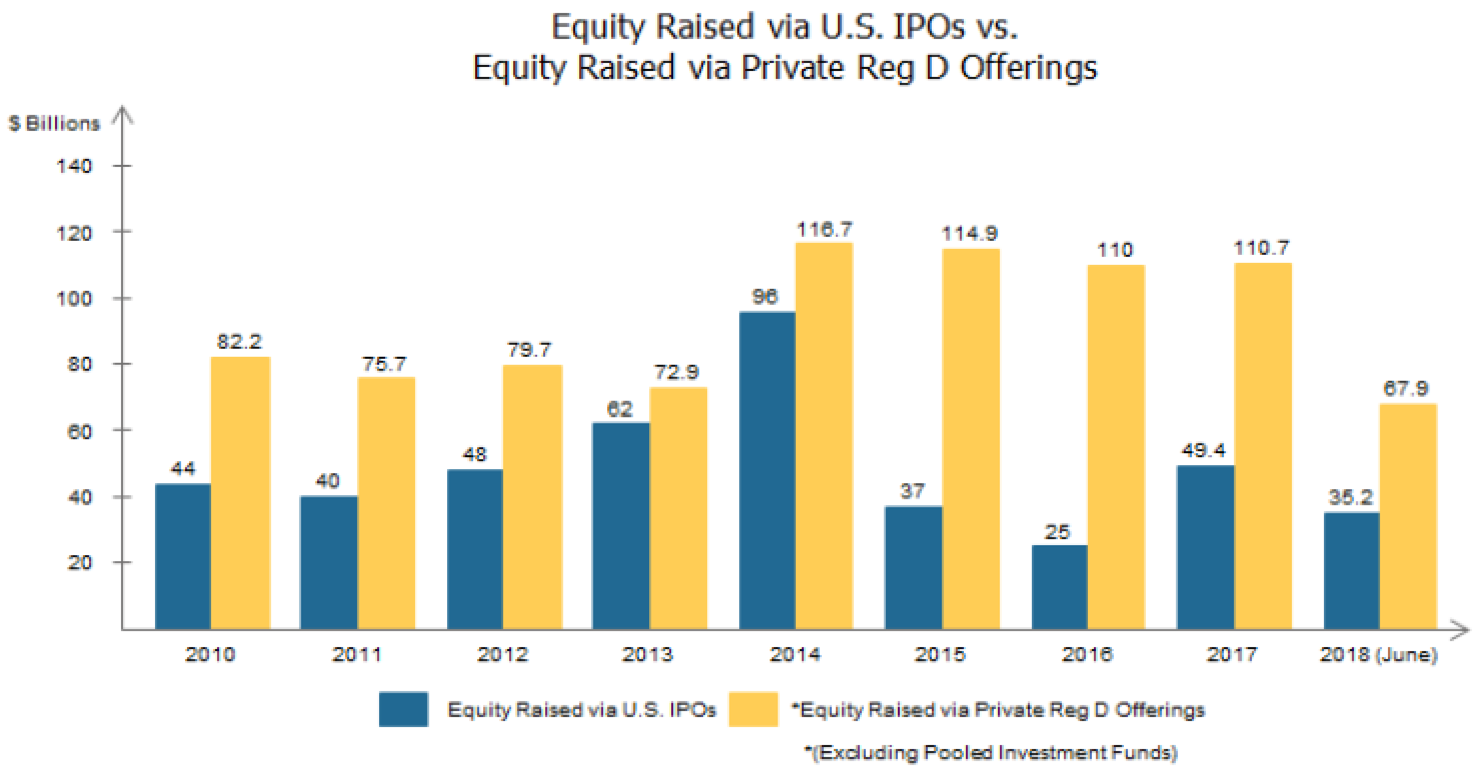
Growing concentration of Top 5 and 10 Companies in S&P 500





Source: Bloomberg + GTS analysis. Market Cap measured 12/31 other than 2020 when it was measured 8/31

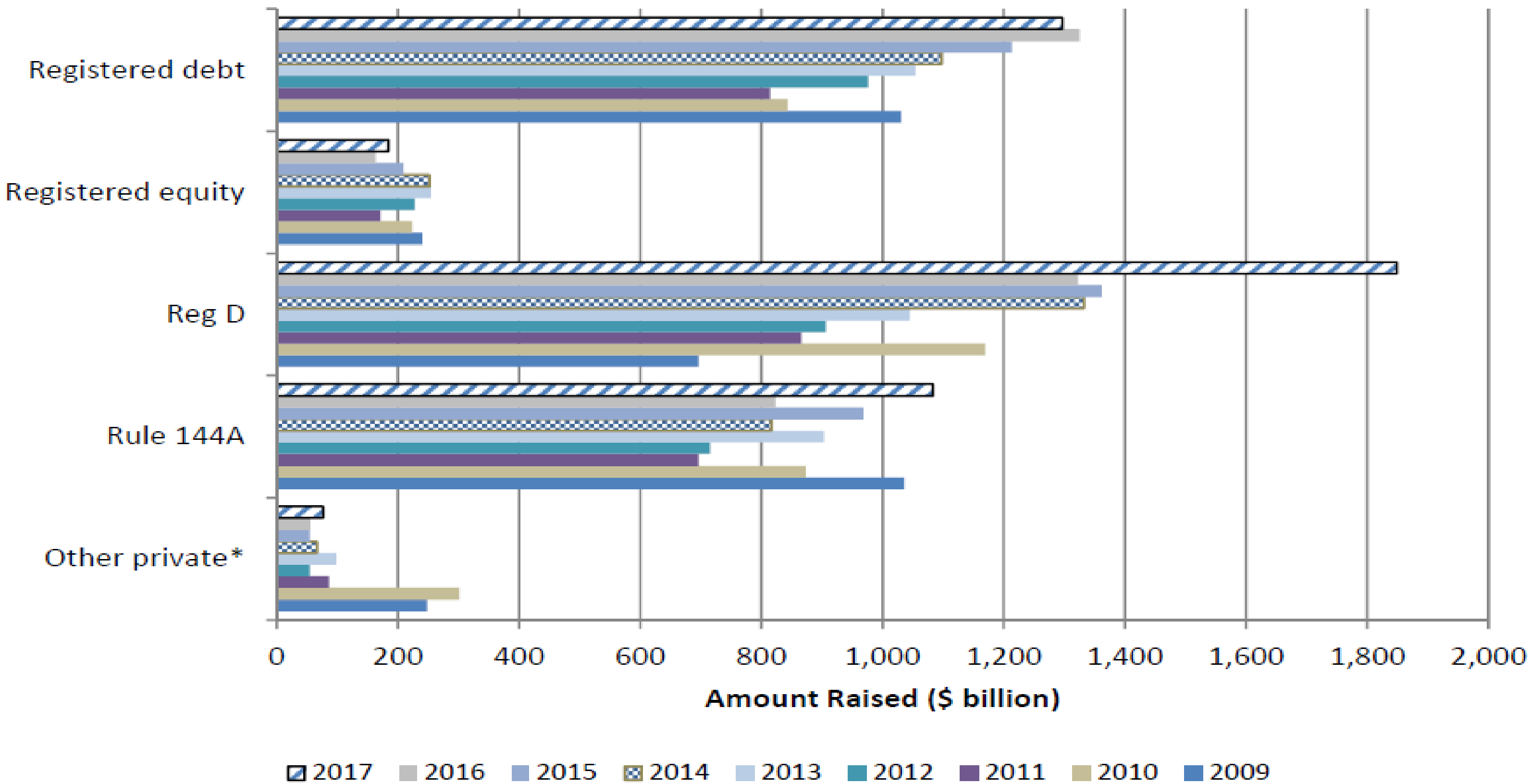
Private Reg D offerings are a larger proportion of equity raising



Source: Committee on Capital Markets Regulation - Expanding Opportunities for Investors and Retirees: Private Equity at Pg 5
Equity raised via U.S. IPOs is derived from Dealogic. Equity raised via private offerings is derived from Regulation D filings available on the SEC's EDGAR database and excludes pooled investment vehicles and real estate investment trusts.

SEC data shows a similar trend across a wider universe

Figure 1. Aggregate capital raised in 2009-2017 by offering method ($billions)



* Other private includes Regulation S offerings, Section 4(a)(2) offerings, Regulation Crowdfunding offerings, and Regulation A offerings.

Source: https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf Pg 8
Registered equity includes initial and follow on public offerings and all numbers include corporate and non-corporate issuers

Regulatory Landscape

Summary

- The Securities Act provides for various exemptions from registration for issuers of securities, but Reg D offerings to **Accredited Investors** are the most widely used

- Any investment in a private fund will likely also require consideration of the Investment Company Act – for example, the **Qualified Purchaser** definition is a much higher threshold relative to the Accredited Investor

- With 401(k) investors additional ERISA requirements also need to be considered

Regulatory Landscape

- **Securities Act 1933** - a company that offers or sells its securities must register such securities with the SEC unless an exemption from registration is available
- Section 4(a)(2) - exempts from registration transactions not involving a public offering – *SEC v Ralston Purina Co* – US Supreme Court decision – "sophisticated investors"
- Various other safe harbors. Exempt offerings are more than 2x larger than registered offerings*. Summary of exemptions can be found in links at the end of the presentation
- Rule 506(b) of Reg D is by far the largest exempt offering used by private funds
  - Accredited Investors and up to 35 non-accredited investors
  - No general solicitation
- **Accredited Investor** definition
  - Income/net worth financial requirements for natural persons (income in excess of $200k (or $300k joint income with spouse) in each of the last 2 years or a net worth in excess of $1m (excluding value of primary residence). Also includes other categories with different thresholds.
  - Recently extended to specified people based on professional certifications, designations or credentials

*2019 –SEC Proposed Rule - Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets Pg 8-9

Regulatory Landscape

- **<u>Investment Company Act of 1940</u>** - Section 3(c) exempts from the definition of investment company many types of entities, including most PE funds, that would otherwise be subject to the significant regulatory requirements of the Act. Most PE funds use one of two exemptions
  - Section 3(c)(1) – non-public offering and fewer than 100 investors
  - Section 3(c)(7) – non-public offering and investors limited Qualified Purchasers. Qualified Purchaser requirements are primarily financial and much higher than Accredited Investor requirements, generally more than $5m in investments for individuals
- Most common types of registered investment companies ("**RICs**"):
  - Open end – eg: mutual funds
  - Closed end – eg: Interval funds
  - ETFs – open end or UITs
- Main requirements / restrictions of RICs
  - Investment advisory contract and corporate governance requirements
  - Limitations on affiliated transactions, use of leverage, among others

Regulatory Landscape

- Standards affecting RIC's private investments:
  - Open-end funds are subject to a general 15% threshold on acquiring illiquid investments
  - 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, although Division staff has indicated that they are re-examining this staff position*
- **Investment Advisers Act of 1940** has a separate requirement prohibiting an investment adviser from charging a performance fee unless the client is a **Qualified Client**:
  - $1m under the management of the investment adviser; or
  - Reasonable belief client had a net worth of more than $2.1m, excluding the value of the client's primary residence (solely or jointly)
- Generally 401(k) plans, like all employer sponsored plans are administered by a fiduciary, are also subject to ERISA rules (sections 403 and 404 primarily) – including to prudently select and monitor any designated investment alternatives under the plan

Source: Dalia Blass, Director of the Division of Investment Management, Speech: PLI Investment Management Institute (July 28, 2020)

Regulatory Landscape

- DOL recently issued an information letter setting out a framework with multiple issues that plan fiduciaries must consider in addition to the appropriate level of liquidity
- It is estimated around 13% of households meet the Accredited Investor definition and around 2% or even less meet the Qualified Purchaser threshold*
- The average Fidelity 401(k) balance was around $112k at the end of 2019 with around 233k accounts out of 17.3m (1.35%) having balances in excess of $1m^.

** Committee on Capital Markets Regulation - Expanding Opportunities for Investors and Retirees: Private Equity – Pg 2 and footnote 107 comparing IRS data with SCF data*
^ *https://s2.q4cdn.com/997146844/files/doc_news/archive/quarterly-retirement-trends-021320.pdf* , *https://www.benefitspro.com/2020/02/13/record-number-of-millionaires-in-fidelity-401k-plans-iras/?slreturn=20200814102918#:~:text=Fidelity%E2%80%99s%20401%20%28k%29%20data%20comes%20from%2023%2C000%20plans,years%20had%20an%20average%20account%20balance%20of%20%24421%2C700.*

Design Principles

Summary

- Do not want to pre-empt conclusions from the analysis of private investment returns
- Guiding principles will be useful in helping us come up with potential recommendations
- **A working group within the PI sub-committee will focus on this – led by Joe Savage**

Design Principles

- Should access only be via a diversified pool (fund of funds)?
- Should access be via an intermediary and should they act in a fiduciary capacity?
- What disclosure should investors be provided?
- Should there be restrictions on underlying investments?
  - Asset class
  - Only other PE funds
  - Minimum size requirements
  - Minimum % held by "qualified" or "large" investors
- Should there be differentiated access
  - Retail v "super" retail
- Should there be an incentive for funds that can show true market pricing and secondary trading
- Who are "main street" or "retail investors"
  - Individuals
  - IRAS
  - 401(k)s

Panel Discussion – Key Terms

Internal Rate of Return ("IRR")

- IRR solves for the discount rate that makes the net present value ("NPV") of cashflows equal zero
- Favors early cashflows and is sensitive to timing
- Assumes reinvestment rate that might not be achievable
- Consider 3 alternative investments with equivalent NPV, similar multiple of invested capital but substantially different IRRs due to the timing of cashflows

Year	0	1	2	3	4	5	IRR	MOIC	NPV 8%
Investment 1	-10.00	5.00	5.00	5.00	5.00	5.00	41%	2.50	9.23
Investment 2	-10.00	0.00	0.00	0.00	14.10	14.10	26%	2.82	9.23
Investment 3	-10.00	11.19	11.19	0.00	0.00	0.00	76%	2.24	9.23

Public Market Equivalent (“PME”)

- PME compares the returns of a private investment to a public market benchmark
- There are several variants
  - Long-Nickels PME
  - PME+
  - KS-PME
  - Direct Alpha
  - *m*PME (Cambridge Associates)
- L-N compares a fund’s IRR with a theoretical benchmark’s IRR which mirror the cashflows of the fund with the index NAV at the end of a period being the future value of the index investment less cashflows. PME+ addresses a shortfall of L-N PME which can result in a negative index NAV if there are substantial early cashflows in the private investment comparison by applying a constant scaling factor to ensure the index FV is equal to the private investment FV
- K-S PME compounds a private investment cashflow (both capital calls and distributions) based on a public market index performance. The fund’s actual NAV + compounded distributions is then divided by the compounded capital calls to produce a simple ratio. A ratio greater than 1 indicates the private investment outperforms the public index

Public Market Equivalent ("PME")

- Direct Alpha quantifies out/underperformance by calculating the IRR of the compounded cash flows plus fund NAV, rather than a multiple of performance
- *m*PME is analogous to PME+ in that it uses a scaling factor but the scaling factor is dynamic rather than static
- We have provided some links at the end for further reading

Year	Capital call	Cashflow +NAV	Index value	Future value		L-N PME NAV	
0	-25		100	-33	(A)		
1		15	115	17	(B)		
2		20	130	20	(C)	16	-[(A)+(B)]

K-S PME = FV Cashflow + NAV / FV Capital call = [(B)+(C)] / (A) =	**1.14**
IRR (using actual cashflows and NAV)	**24%**
L-N PME	**14%**
Direct Alpha (using FV cashflows)	**9%**

Questions and Comments

References and Materials

- Michael Goldstein, FMMI - Issues Facing the US Money Management Industry - Presentation to the SEC Asset Management Advisory Committee January 2020
- Investment Company Institute Factbook 2020
- Other ICI research
- SEC Summary of Exempt Offerings
- Committee on Capital Markets Regulation - Expanding Opportunities for Investors and Retirees: Private Equity
- SEC Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017- DERA White Paper
- SEC Proposed Rule, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Market (March 2020)
- SEC - Final Rule: Amending *the Accredited Investor Definition*
- Accredited Investor statutory definition
- Qualified Purchaser statutory definition at para 51
- Dalia Blass, Director of the Division of Investment Management, Speech: PLI Investment Management Institute (July 28, 2020)
- SEC Final Rule on Investment Advisers charging Incentive Fees
- US Department of Labor - Information Letter 06-03-2020: Use of Private Equity investments in 401(k) plans
- Insead: Measuring Private Equity Fund Performance
- An ABC of PME: Landmark Private Equity Brief- March 2014
- Evaluating Private Equity Performance: PME v Direct Alpha