

## MEMORANDUM

TO: File No. S7-08-19 – Concept Release on Harmonization of Securities Offering Exemptions

FROM: Mark T. Uyeda  
Division of Investment Management

RE: Meeting with Ropes & Gray LLP

DATE: July 23, 2019

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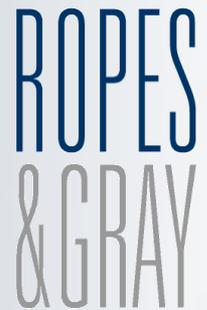
On July 22, 2019, Sarah ten Seithoff, Mark Uyeda, Jennifer Songer, Daniele Marchesani, Christian Sandoe, and John Ganley from the Division of Investment Management, Elizabeth Murphy, Jennifer Zepalka, Amy Reischauer, and Jennifer Riegel from the Division of Corporation Finance, and Anzhela Knyazeva from the Division of Economic and Risk Analysis met with the following partners from the law firm of Ropes & Gray LLP:

- John B. Ayer
- Michael G. Doherty
- Keith F. Higgins
- David Tittsworth

The participants discussed the SEC's concept release relating on the harmonization of securities offering exemptions using the attached slides prepared by Ropes & Gray LLP.

# Retail Investments in Private Funds: Potential Approaches

July 22, 2019



# Introduction

Public comments from regulators and market participants increasingly call for the expansion of opportunities for retail investors and retirees

*“Private equity. . . for the most part they focus on mid-sized companies . . . that they are going to run. . . . I want individual investors to have access to those growth opportunities.”*

- SEC Chairman Jay Clayton (April 2018)

*“Investment opportunities in private companies and private equity funds are growing. However, the vast majority of U.S. investors are missing out as they are excluded from private markets. We therefore believe that now is the right time to examine how to safely expand access to private markets.”*

- Committee on Capital Markets Regulation, Expanding Opportunities for Investors and Retirees: Private Equity (Nov. 2018) (CCMR Report)

# SEC Concept Release

June 2019, the SEC published its Concept Release on Harmonization of Securities Offering Exemptions to solicit public comment on exemptions from registration under the Securities Act

- The Release includes a section that suggests the SEC is willing to consider expanding investment opportunities in private funds to “retail investors”
- This portion of the Release solicits comments on a number of issues that limit retail investment in private funds

# Goals for this Discussion

- Impediments to broadening retail access
- Possible approaches
- Concerns and areas for further analysis

# Retail Investor Access

As an exemption from Securities Act registration, private funds usually rely on Rule 506 of Regulation D

- Sales to accredited investors
- About 13% percent of all U.S. households are accredited investors
  - Source: SEC Concept Release

Vast majority of institutional-quality private funds rely on the 3(c)(7) exemption from the definition of “investment company” in the 1940 Act

- Investors must be qualified purchasers
- Approximately 2% of U.S. households are qualified purchasers
  - Source: CCMR Report

# Retail Investor Access

## There are a few registered closed-end funds with private equity exposure

- The Staff's current position is that sales of registered closed-end funds that invest more than 15% of their assets in private funds must be limited to accredited investors
- This position is not currently in SEC rules or guidance, but has been communicated in the registration comment process

# Retail Investor Access

Both the “accredited investor” and “qualified purchaser” requirements reflect the concept that there are a class of persons who can fend for themselves and, therefore, do not require the protections of the federal securities laws

- In the Concept Release, the SEC stated that the accredited investor concept is *“intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.”*
- A Senate report underlying the 1940 Act amendment adding the qualified purchaser definition states that the *“qualified purchaser pool reflects the . . . recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the [1940 Act’s] protections.”*

# Retail Investor Access

## There are practical limitations on access to private funds by defined contribution plans

- Defined benefit plans are significant investors in private funds, and there is evidence that exposure to private funds is contributing to the outperformance of defined benefit (DB) plans compared to defined contribution (DC) plans
- Over the past 30 years, employer-sponsored retirement assets have migrated sharply away from DB plans towards DC plans, such as 401(k) plans
- Investments in individual private funds by individual DC plan participants are limited by AI/QP requirements
- Although investments through a pooled option are possible, litigation risks largely deter DC plan sponsors from offering exposure to private funds

# Possible Approaches

We discuss 3 basic approaches to expanding retail access to private funds

- Access Through a Registered or Unregistered Fund of Funds
- Access through a Feeder Vehicle
- Limited Direct Access

This is not to suggest that there aren't other possible approaches or that more analysis isn't required

# Possible Approaches – Fund of Funds

## **Possible variations: registered and unregistered funds**

Registered fund of private funds – a closed-end fund offered to the public pursuant to Securities Act registration

This approach has the benefit of already being in use, at least for accredited investors

- Registered fund of private funds exist and sponsors have analyzed and addressed issues such as valuation, disclosure and reporting, affiliated transactions, etc.

### Relief needed:

- Requires relaxation of the Staff's 15% restriction (discussed above)
- Listing: requires expansion of applicable listing standards to allow registered funds of private funds to list on U.S. stock exchanges
- Affiliated fund of funds relief from Section 17(a) of the 1940 Act to permit a registered fund to invest in private funds sponsored by an affiliated adviser

# Possible Approaches – Fund of Funds

## Unregistered fund of private funds

- Would limit investors to accredited investors
- Would not be subject to qualified purchaser requirement, but otherwise would rely on the Section 3(c)(7) 1940 Act exemption
- Would not list

### Relief needed:

- Relaxation of qualified purchaser requirement, possibly by permitting qualification if advised by a financial professional
- Exchange Act Section 12(g) (500 persons who are not accredited investors)

# Possible Approaches – Feeder Funds

A feeder fund sponsored by a third party that invests substantially all of its assets in a single unaffiliated private fund

Infrastructure exists for this structure, as financial intermediaries already offer such feeder fund products to “high net worth” investors who are AIs and QPs

- Able to facilitate diligence, monitoring, reporting, etc.
- Many private fund sponsors would likely prefer feeder approach over offering to and servicing many individual investors

As with fund of funds, could be registered or unregistered

# Possible Approaches – Feeder Funds

## Relief needed:

- In addition to the relief described above, a feeder structure would require relief from Rule 2a51-3 under the 1940 Act (a company is not a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a Section 3(c)(7) fund)
- Comfort that feeder would not be a co-issuer with underlying fund or otherwise impact underlying fund's private placement

# Possible Approaches – Limited Direct Investment

Permit retail investors to purchase *direct* interests in private funds, subject to potential restrictions designed to ensure requisite sophistication and limit the risk of “over-exposure” to the asset class

- Requires relief under the Securities Act to permit sales to non-accredited investors
- Requires relief from Section 3(c)(7) qualified purchaser requirement
- Need to consider Exchange Act Section 12(g) (500 persons who are not accredited investors)

# Possible Approaches – Limited Direct Investment

Restrictions might be based either on:

- The aggregate value and/or percentage of an investor's annual income/net worth invested in private funds, or
- A requirement that retail investors purchase interests through an RIA or other financial intermediary with a duty to act in the investor's best interest

Possibly enhance protections by limiting to private funds with a significant institutional investor base

Unclear how many sponsors would utilize a direct access model

- Distribution, administration and other potential challenges

Presence of an intermediary could deter unscrupulous actors

# Possible Approaches – ERISA DC Plans

As noted above, 401(k) plans largely avoid private investments because their limited liquidity and relatively expensive fees create fiduciary litigation risk

- Ideally, the DOL would clarify that private funds can be included in the range of investment options eligible for the Section 404(c) safe harbor for participant-directed plans
- Section 404(c) provides that a plan fiduciary is not liable under ERISA for any losses that result from a plan participant's exercise of investment control

DOL already has provided special ERISA status to registered funds, which should logically apply to a registered fund of private funds

401(k) plan participants have access to advice (record keeper call centers, third-party platforms), and many plan options (e.g., target date funds) are already professionally managed

# Goals for this Discussion

Concerns and next steps?

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