ROPES & GRAY LLP
1211 AVENUE OF THE AMERICAS
NEW YORK, NY 10036-8704
WWW.ROPESGRAY.COM

September 24, 2019

Michael Doherty
[redacted]

SUBMITTED ELECTRONICALLY

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Concept Release on Harmonization of Securities Offering Exemptions (Release No. 33-10649; File No. S7-08-19)

Dear Ms. Countryman:

As a supplement to the Ropes & Gray LLP comment letter submitted separately today in response to Release No. 33-10649 (the "Concept Release"), I am pleased to submit the attached whitepaper we prepared, *Retail Investment In Private Funds: Regulatory Obstacles and Opportunities*.

Section IV of the Concept Release raised various issues for retail investors that seek exposure to growth-stage issuers through a pooled investment fund. The Ropes & Gray whitepaper covers in greater depth some of the topics in our comment letter to the Concept Release. In addition, the whitepaper addresses issues raised in whole or in part by Section IV of the Concept Release, including the regulatory obstacles under the federal securities laws and ERISA that currently limit retail access to growth-stage issuers, the rationale for expanding retail access to such issuers and several potential models for doing so.

Respectfully submitted,

Michael G. Doherty

Attachment

ROPES & GRAY

RETAIL INVESTMENTS IN PRIVATE FUNDS

Regulatory Obstacles and Opportunities

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ABOUT ROPES & GRAY'S ASSET MANAGEMENT PRACTICE

- Ropes & Gray has over 300 lawyers globally dedicated to our asset management practice.
- Ropes & Gray has one of the largest and most sophisticated registered funds and private investment funds practices, advising both fund sponsors and investors. Our clients include the advisers and independent directors of many of the largest and best-known registered funds in the world. Our firm represents all facets of the asset management industry worldwide, including registered funds (and their advisers and directors), private equity fund sponsors, hedge fund sponsors, credit funds, funds of funds, and other types of products, as well as institutional investors.
- We are the only firm ranked nationally by *Chambers USA 2019* in the top three bands for each of private investment funds, hedge funds and registered funds, in addition to receiving the *Chambers USA 2017* Investment Funds Client Service Award. We are also ranked in *The Legal 500 UK, Chambers Global, Chambers UK* and *Chambers Asia* for fund formation.
- There are three former key SEC lawyers who are currently partners at Ropes & Gray.
- Within the SEC Division of Asset Management we have seven alumni serving as attorneys, including Director Dalia Blass.

Introduction

OVER THE PAST SEVERAL YEARS, regulators and market participants increasingly have called for the expansion of investment opportunities for retail investors and retirees. These calls for expanded opportunities have cited market structure changes, the looming retirement crisis and basic fairness to retail investors and retirees who do not meet existing regulatory proxies for investor "sophistication." SEC Chairman Jay Clayton, for example, observed that, in 2018, more capital was raised in the private markets than in the public markets, and that retail investors should (but currently do not) have access to those opportunities.[1]

From 1996 to 2018, according to the World Bank, the number of exchange-listed U.S. companies decreased by approximately half, from 8,090 to 4,397.[2] Consistent with the declining number of U.S. publicly traded companies, many large investors that had previously invested exclusively in public markets are now investing in private markets as well, seeing them as necessary for diversified exposure to global growth.[3] Because retail investors are generally limited to investments in public companies, these market trends suggest that the investment opportunities available to retail investors have correspondingly decreased.[4]

Calls for expansion of retail investment opportunities have also noted that lack of access to investments in private funds[5] is contributing negatively to the retirement savings of many U.S. workers. In 2018, for example, the largest investors in private funds were government and private "defined benefit" retirement plans.[6] However, most private-sector American workers save for retirement through "defined contribution" plans, such as 401(k) plans.[7] For reasons discussed in Section II below, participants in defined contribution plans, both public and private, historically have had very limited access to private funds. Studies suggest that, over the last 25 to 30 years, access to private market investments is contributing to the relative outperformance of defined benefit plans over defined contribution plans.[8]

Expanding retail access to private equity investments, in particular, has drawn support from academics and other non-government commenters in recent months. For example, a November 2018 report published by the Committee on Capital Markets Regulation cited studies demonstrating that private equity buyout funds consistently outperform public market alternatives, and argued that this performance, which appears uncorrelated with the performance of the public securities markets, justifies expanding retail investor access to private equity fund opportunities.[9]

> SEC Chairman Jay Clayton observed that, in 2018, **more capital was raised in the private markets** than in the public markets, and that retail investors should (but currently do not) have access to those opportunities.

Commenters have also noted the direct link between retail investors' access to investment opportunities, on one hand, and private companies' and small businesses' access to investment capital, on the other hand. The SEC, for example, notes that its mission is to "protect investors, maintain fair, orderly, and efficient markets, and *facilitate capital formation.*"[10] In this vein, commenters have noted the importance of the "private offering ecosystem" to the capital-raising efforts of small- and medium-sized businesses, and have suggested that the SEC expand the pool of investors eligible to invest in such offerings.[11]

On June 18, 2019, the SEC published its Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release") to solicit public comment on exemptions from registration under the Securities Act of 1933

(the "Securities Act").[12] Most of the Concept Release describes the requirements and limitations of Securities Act registration exemptions that make up the existing exempt offering framework and solicits responses to a wide range of questions.[13] Commenters' responses are intended to help the SEC assess whether changes to applicable statutes and regulations are necessary or desirable to improve specific exemptions and, more generally, the existing exempt offering framework.

The Concept Release also includes a 20-page section devoted to "pooled investment funds." The inclusion of this discussion suggests the SEC is willing to consider expanding investment opportunities in private funds to "retail investors."[14] Among other things, this "funds" portion of the Concept Release solicits comments on a number of issues that currently limit retail investment (including through defined contribution plans) in private funds, which typically rely on the exemptions from the definition of "investment company" in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act").[15]

The Concept Releases does not telegraph how far the SEC might be willing to expand the scope of these opportunities. That said, it suggests (i) potential avenues for the development of registered "funds of funds" and feeder structures offered to non-accredited investors and (ii) greater flexibility for investor-eligibility requirements to be satisfied through the involvement of an investment adviser (which may include a robo-adviser) or other financial intermediary acting on behalf of non-accredited investors. Any resulting regulatory changes could, for example, allow retail fund complexes to utilize their distribution networks to offer retail products that invest significantly in private funds and/or private companies. This could both expand retail access to private companies and allow private fund sponsors to access new sources of investor capital.

This article surveys the regulatory obstacles under the federal securities laws and the Employee Retirement Income Security Act of 1974 ("ERISA") that currently limit retail access to private funds, discusses the rationale for expanding retail access to private funds, and describes several potential models for doing so.

State of the Market

AT A HIGH LEVEL, the federal securities laws and ERISA essentially foreclose significant retail investment in private funds. As described below, direct investment in private funds is generally available only to investors who meet both the "qualified purchaser" and "accredited investor" standards under the 1940 Act and the Securities Act, respectively. While a handful of "registered funds of private funds" currently exist in the marketplace, an SEC staff position requires that these products be sold only to accredited investors, which drastically limits their availability in the marketplace. In addition, practical considerations and legal risks largely deter sponsors of defined contribution plans (including 401(k) sponsors) from offering exposure to private funds to plan participants. This section explores these current obstacles to retail investment in private funds.

FEDERAL SECURITIES LAWS

Private funds generally rely on an exclusion from the definition of "investment company" under Section 3(c)(7) of the 1940 Act to avoid registration as an investment company.[16] To rely on the Section 3(c)(7) exclusion, a private fund's securities must be owned exclusively by persons who, at the time of acquisition of the securities, are "qualified purchasers."[17] Relying on Section 3(c)(7) also permits a private fund to avoid the general prohibition, under the Investment Advisers Act of 1940 (the "Advisers Act"), against investment advisory contracts that provide for compensation to an investment adviser in the form of a performance fee.[18] In our experience, most private funds of any significant size are Section 3(c)(7) funds that accept investments only from qualified purchasers. Approximately 98% of U.S. households are not qualified purchasers.[19]

In addition, private funds usually rely on an exemption from registration under the Securities Act—typically, Rule 506 of Regulation D—to offer their securities in private placements. Rule 506(b) permits an issuer to offer and sell its securities in a private offering to an unlimited number of accredited investors, plus no more than 35 purchasers who are not accredited investors. Rule 506(c) permits an issuer to offer and sell securities in an offering to an unlimited

number of accredited investors, including by means of a public offering, provided that all purchasers of securities are accredited investors.[20] In the Concept Release, the SEC estimates that only 13% percent of all U.S. households currently qualify as accredited investors.[21]

The investor protection policies underlying the definitions of "qualified purchaser" and "accredited investor" have been a key feature of the federal securities laws. In the Concept Release, the SEC states 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."[22] More generally, Regulation D is one of many examples under the federal securities laws in which the applicability of a statutory provision or regulation turns on whether a particular class of persons is deemed to require the protections of the law or, instead, does not require those protections because the class or persons is deemed to be "sophisticated."[23]

> The SEC staff has informally taken a position that securities issued by a closed-end fund that invests more than 15% of its assets in private funds **can be sold only to accredited investors.**

The "accredited investor" standard, however, is only a rough approximation for investor sophistication. The SEC Staff has acknowledged that the definition "as applied to natural persons uses only financial measures to serve as a proxy for financial sophistication and ability to sustain investment losses or fend for one's self,"[24] and that "very well informed investors who are not wealthy may be in a position to take on risks that they understand well, while very wealthy investors may be in a position to take on risks even if they lack financial sophistication."[25] In the Concept Release, the SEC requests comment on whether there are "developments in the market or industry that may assist in potentially identifying new categories of individuals that may qualify as accredited investors."[26]

Likewise, the "sophisticated investor" concept forms the policy basis for the "qualified purchaser" definition in the 1940 Act. A Congressional report underlying the National Securities Markets Improvement Act of 1996[27] – which added "qualified purchaser" and Section 3(c)(7) to the 1940 Act and Section 205(b)(4)'s performance fee exemption to the Advisers Act — stated:

> The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.[28]

Investors who are neither accredited investors nor qualified purchasers — *i.e.,* retail investors — are effectively blocked from investing directly in private funds. In addition, the SEC Staff has informally taken a position that securities issued by a closed-end fund that is registered under the 1940 Act and the Securities Act and that invests more than 15% of its assets in private funds (*i.e.,* a registered closed-end fund of private funds) can be sold only to accredited investors. This SEC Staff position effectively blocks retail investors from investing *indirectly* in private funds through a registered vehicle as well. The SEC Staff's informal position is not published or memorialized in any regulation or SEC guidance but, instead, has been communicated to closed-end fund registrants during the registration comment process.[29]

The Concept Release does not specifically mention the 15% limitation. Instead, while noting that closed-end funds "are better suited" to holding less-liquid securities obtained in exempt offerings,[30] the Concept Release states that "the possibility of offering closed-end funds that make significant investments in private funds to retail investors has histori-

cally raised staff concerns under the Investment Company Act, insofar as these investors could not invest directly in private funds."[31] Nonetheless, the Concept Release requests responses to the following questions:

> What restrictions should there be, if any, on the ability of closed-end funds…to invest in private funds, including private equity funds and hedge funds, and to offer their shares to retail investors? For example, should there be a maximum percentage of assets that closed-end funds…can invest in private funds? Should such closed-end funds be required to diversify their investments across a minimum number of private funds, if they are not restricting their offerings to accredited investors? [32]

ERISA

As noted in the Introduction, defined benefit plans are significant investors in private funds, and there is evidence that exposure to private fund investments is contributing to the outperformance of defined benefit plans compared to defined contribution plans.[33] Over the past few decades, however, employer-sponsored retirement accounts have migrated sharply away from defined benefit plans and toward defined contribution plans as the sole retirement plans for employees. This shift has resulted in increasing numbers of plan participants and their beneficiaries being deprived of the benefits of exposure to alternative asset classes in their retirement plans, despite sponsors and fiduciaries of defined contribution plans having shown interest in hedge funds and private equity investments.[34]

Defined contribution plans, including 401(k) plans, are not technically prohibited from investing in private funds under ERISA; however, the most common plan designs generally preclude or limit private investments. In addition, the rules governing default investments for defined contribution plans and qualified default investment alternatives (each a "QDIA"), such as target date funds, do not preclude the use of alternative investments as part of a QDIA.[35] 401(k) plans will be qualified purchasers (and accredited investors) if they have at least $25 million in investments and the investment decisions are directed by the plan sponsor, not the participants.[36] As a practical matter, relatively few defined contribution plans have their investments directed by plan sponsors.[37] In addition, the SEC has clarified in no-action relief that participant-directed 401(k) plans can invest in private funds without "looking through" to participants under certain conditions (*i.e.,* the relevant investment option was not formed for the purpose of investing in a specific private fund, the participants cannot choose a specific private fund, and at least 50% of the investment option's assets consist of securities other than those of a specific private fund).[38]

> There is evidence that exposure to private fund investments is **contributing to the outperformance of defined benefit plans** compared to defined contribution plans.

Although ERISA does not prohibit defined contribution plans, including 401(k) plans, from investing in private funds or offering private funds as options for participants to select, the fiduciary standard under ERISA requires defined contribution plan fiduciaries to act solely in the best interest of plan participants and their beneficiaries, and to comply with a heightened prudence standard in connection with these types of investments. In addition, ERISA fiduciaries must provide plan participants with the opportunity to diversify among different investment options. The head of the Division of Fiduciary Interpretations of the U.S. Department of Labor ("DOL") has explained that a plan fiduciary can discharge its duty of prudence in selecting plan investments if the plan fiduciary gives appropriate consideration to the plan's diversification, risk, liquidity and other return characteristics, and reviews the methodology for determining fair value of the investments.[39] This explanation also clarified that hedge funds and private equity funds are subject to the same rules as all other plan investments, and the fiduciary should follow the same type of analysis in making any investment decision, regardless of asset class.[40]

> This trend toward conservatism in 401(k) plan menu design has **deprived 401(k) plan participants and their beneficiaries of opportunities** to obtain greater investment diversification and potentially higher-performing investment options.

There is a safe harbor under Section 404(c) of ERISA that insulates fiduciaries from liability for investment losses incurred by plan participants in participant-directed plans, but that safe harbor has two key limitations. First, it does not insulate the fiduciary from liability related to the ongoing monitoring and selection of investment options included on the investment menu. Second, under DOL regulations (which are generally narrower than the statutory language of ERISA), the safe harbor applies only to plans that offer at least three options that permit participants to change their investment elections at least once a quarter and "with respect to *each* investment alternative made available by the plan…permits participants and beneficiaries to give investment instructions with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject." [41]

The DOL has never provided specific guidance on what it considers to be an appropriate liquidity threshold for purposes of satisfying the Section 404(c) safe harbor. Most plan sponsors that rely on this safe harbor currently choose to offer only the most liquid investment options possible, which, in practice, has come to mean daily liquidity provided by mutual funds and collective investment trusts.[42] In addition, over the last several years, class action lawsuits alleging defects in the prudence of menu design and monitoring (including allegations that the investment options were too expensive) have become commonplace, and these cases often settle for large sums.[43] Perhaps, as a result of these cases, many plans offer low-cost passive index and mutual funds as the predominant (or only) investment choices for participants.

This trend toward conservatism in 401(k) plan menu design has had serious and detrimental consequences for defined contribution plan participants because it has deprived 401(k) plan participants and their beneficiaries of opportunities to obtain greater investment diversification and potentially higher-performing investment options.[44] When plan fiduciaries to defined benefit plans are making investment decisions, they generally select a much wider range of investment types than mutual funds and CITs providing daily liquidity. As part of discharging their duties of prudence and diversification, defined benefit plan fiduciaries often include private equity funds, real estate funds, and other alternative asset classes in their plans. While the same overarching standards of fiduciary conduct apply with respect to defined contribution plans, the cost and distraction of defending against class action lawsuits has discouraged sponsors of these plans from offering exposure to alternative asset classes. Putting aside the personal considerations of plan fiduciaries, there is no clear reason why these types of options should be absent from 401(k) plans, since the considerations that a prudent expert should take into account in constructing investment options for long-term retirement planning goals are the same regardless of plan type.

POTENTIAL BENEFITS OF PRIVATE FUNDS

The policy argument for expanding opportunities for retail investors to obtain exposure to private funds is that most such investors are missing out on an increasingly important set of investment opportunities. Some commenters claim that the federal securities laws, by foreclosing most investors from access to private offerings, facilitate wealth inequality in the U.S.[45] Separately, the significant number of households that are not prepared for retirement also supports expanding retail access to private funds.[46] To the extent that the economic evidence supports the argument that long-term retail investors are likely to accrue significant economic benefits through obtaining exposure to private funds, these economic benefits militate in favor of eliminating or significantly reducing the

legal obstacles encountered by retail investors seeking to obtain direct or indirect exposure to private funds.

In the Concept Release, the SEC acknowledges that long-term retail investors "who seek a broadly diversified investment portfolio could benefit from the exposure to issuers making exempt offerings."[47] The SEC's requests for comment in the Concept Release suggest a willingness to explore ways to expand the scope of investment opportunities available to retail investors. Therefore, the next section presents alternative approaches that the SEC could take to expand retail investors' opportunities to obtain exposure to private funds (including registered closed-end funds of private funds). For each alternative, the discussion includes a summary of the regulatory relief that would be required to make the alternative viable.

POSSIBLE ALTERNATIVES

THIS SECTION FOCUSES on three basic approaches to expanding retail access to private funds: (i) direct access, (ii) investment through a registered vehicle organized as a "registered fund of private funds," and (iii) investment through a feeder fund advised by a registered investment adviser ("RIA").

DIRECT ACCESS

In a "direct access" model, retail investors would be permitted to purchase interests directly in private funds. As noted above, most private equity funds and hedge funds with substantial assets rely on the exemption from registration under Section 3(c)(7) of the 1940 Act, which currently limits holders to qualified purchasers. Therefore, a direct access model would require a number of legislative and/or administrative changes to the existing regulatory framework for private funds, including relief from the following statutory provisions:

1. THE 1940 ACT. Relief from Section 3(c)(7) would be required to permit sales of private funds to investors who are not qualified purchasers. Private funds relying on Section 3(c)(7) would also need relief from the "no public offering" requirement to make a public offering of their securities.[48] Because many private funds charge an "incentive fee" or "carried interest," any relief would need to be structured to preserve the exemptions from the Advisers Act's prohibitions on certain forms of incentive compensation currently relied upon by such private funds.

2. SECURITIES ACT. Expansion of existing registration exemptions would be required as a practical matter to permit sales of securities issued by private funds to non-accredited investors. Although Rule 506(b) permits up to 35 non-accredited investors to purchase securities in an offering exempt under that rule, there are information delivery requirements that would discourage reliance on that provision, and the numerical limitation may be unworkable. Another exemption within Regulation D—Rule 504—has a dollar limitation of $5 million. The final exemption within Regulation D—Rule 506(c)—is available only when all sales are made to accredited investors. Accordingly, sales of securities issued by private funds to non-accredited investors would require registration under the Securities Act or expansion of existing exemptions (or the creation of a new exemption) from registration.

3. EXCHANGE ACT. Relief from Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") for issuers with more than $10 million in assets and a class of securities held of record by at least 2,000 persons or 500 persons who are not accredited investors would be required to avoid Exchange Act registration.[49]

To meet investor protection concerns, the SEC could impose restrictions on direct retail access to private funds designed to ensure that the extent of a retail investor's private fund exposure is appropriate for the investor's financial situation. In recognition of the unique risks and issues presented by private fund investments, such restrictions might be based on (i) a limitation of the total dollar amount and/or percentage of an investor's annual income, net worth or investment assets that are invested in private funds, (ii) a requirement that retail investors purchase interests through an investment adviser or other financial intermediary with a duty to act in the investor's best interest or (iii) a requirement that only private funds that meet certain minimum standards be offered to retail investors.[50]

- **DOLLAR AND/OR PERCENTAGE LIMITATIONS.** Such limitations could be based on the total dollar amount and/or percentage of a retail investor's annual income, net worth or investment assets invested in private funds. This approach has been followed in Regulation Crowdfunding[51] and Tier 2 of Regulation A.[52] These restrictions would be premised on the theory that private fund investments may be appropriate for retail investors as part of a diversified investment portfolio.

- **ACCESS THROUGH AN INVESTMENT ADVISER OR OTHER FIDUCIARY.** Investor protection concerns could be mitigated by requiring that retail investors purchase interests in private funds only through an investment adviser or other financial intermediary with a duty to act in the investor's best interest, such as a registered investment adviser or a registered broker-dealer subject to Regulation BI. For example, an investment adviser or other intermediary might be permitted to include allocations to private funds as part of a diversified portfolio recommended to a retail investor. The Concept Release notes that "[b]eing advised by a financial professional has not historically been a complete substitute for the protections of the Securities Act registration requirements and, if applicable, the [1940] Act." If the SEC is concerned that not all financial professionals are qualified to give retail investors advice on private fund investing, it could require the financial professional to meet some basic criteria for size and/or experience (*e.g.,* only advisers registered with the SEC under the Advisers Act).

- **"SEASONED" PRIVATE FUNDS.** Alternatively, investor protection concerns could be mitigated by requiring private funds to meet certain threshold requirements to be eligible to sell their securities to retail investors. The requirements could be based on size (*e.g.,* AUM above a certain threshold), manager experience (*e.g.,* managed by an experienced RIA) and/or capital commitment by institutional investors (*e.g.,* held primarily by institutional investors).

Despite the potential benefits of retail access to private funds generally, there are potential drawbacks to a direct access model. The necessary relief could require significant changes to existing regulations, which may be difficult to accomplish. A direct access model also would not necessarily address concerns relating to the liquidity of a retail investor's interest in a private fund. In addition, smaller retail investors may have difficulty building a diversified portfolio of private fund investments or managing cash flows, and may not have the ability to choose among potential private fund investments. Direct access may also be unattractive for 401(k) plan fiduciaries, due to the liquidity considerations described above.

Even if retail investment in private funds becomes legally feasible, direct access may not be attractive to private fund sponsors. Many private fund sponsors do not have distribution networks capable of marketing to retail investors and may not have the operational or administrative capacity to service large numbers of retail investors. For example, many private fund sponsors may be unable or unwilling to process capital calls from and distributions to large numbers of retail investors.[53] For these and other reasons, retail exposure to private funds through a registered investment vehicle may have a number of advantages.

REGISTERED FUND OF PRIVATE FUNDS

In a "registered fund of private funds" model, a fund sponsor would organize a registered investment company that would invest its assets in a number of underlying private funds. The registered fund of private funds would be a closed-end company registered under the 1940 Act, and its shares would be offered to the public in a registered offering under the Securities Act.[54] Like all registered funds, a registered fund of private funds would have a board of directors, a majority of whom would not be "interested persons" of the fund, as defined in Section 2(a)(19) of the 1940 Act ("independent directors"), and would be subject to the disclosure and periodic reporting requirements under the 1940 Act, as well as the same 1940 Act restrictions applicable to all registered closed-end funds.

A registered fund of private funds model would require relief from the following regulatory requirements:

1. **ACCREDITED INVESTORS.** The SEC Staff would have to discard its current position requiring that sales of regis-

tered closed-end funds that invest more than 15% of their assets in private funds be limited to accredited investors.[55]

2. LISTING STANDARDS. Exchange listing could be an important source of liquidity for retail investors. However, for a registered fund of private funds to list its shares on a national securities exchange, the SEC would have to allow listing under current listing standards or permit U.S. securities exchanges to adopt listing standards for registered funds of private funds.[56] Listing standards for registered funds of hedge funds were proposed in 2008 but were not adopted.[57] Absent the development of listing standards for registered funds of private funds, a registered fund of private funds could still be organized and operated as a non-traded closed-end investment company that provides limited liquidity to its investors through periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act (an "interval fund") or tender offers pursuant to Rule 13e-4 under the Exchange Act (a "tender offer fund").[58]

3. AFFILIATED TRANSACTIONS. Relief from Section 17(a) of the 1940 Act would be required to permit a registered closed-end fund to invest in private funds sponsored by the registered closed-end fund's adviser.[59] Retail investors may prefer a registered fund of funds structure in which the fund of funds and the underlying private funds are managed by the same manager, although a registered fund of unaffiliated funds could be offered without the need for relief from Section 17(a).

One concern arising from expanding retail access to private funds is the potential for fraud or abuse of retail investors (*e.g.,* a fund sponsor or distributor that takes advantage of retail investors by offering only underlying funds that are less well known, underperforming and/or in less demand). For several reasons, retail investment through a registered vehicle would mitigate these concerns. Unlike the direct access model described above, investment through a registered vehicle would afford retail investors with the protections provided by the 1940 Act and the Securities Act. A registered investment vehicle would be managed by an RIA with a fiduciary duty and a business motivation to act in the fund's best interest, and would be overseen by a board (a majority of whose members would be independent directors). In addition, as with every publicly offered registered closed-end fund, the civil liability provisions of Sections 11 and 12(a)(2) of the Securities Act would apply to the registration statement and prospectus by which the closed-end fund offers its shares to the public, thereby affording retail investors additional assurance that the fund accurately discloses the specific risks of investing in private funds.

Three possible approaches to expanding retail access to private funds: (i) direct access, (ii) investment through a registered vehicle organized as a "registered fund of private funds," and (iii) investment through a feeder fund advised by a registered investment adviser.

Retail investment in a registered closed-end fund that invests in private funds would involve determinations by two separate fiduciaries—the registered fund's adviser and the private fund's adviser—each with a fiduciary duty to its respective fund. Retail investors in a registered closed-end fund would have the benefit of an RIA with fiduciary duties to the closed-end fund, and the investment adviser managing an underlying private fund would provide a second layer of protection to investors. The RIA of a registered closed-end fund evaluating a potential private fund investment would be in the best position to decide whether an underlying private fund presents an attractive risk/reward and performance-to-cost opportunity. Likewise, the RIA of a registered closed-end fund would be best positioned to evaluate whether an underlying private fund's size, management experience and capital commitment by institutional investors presents an

attractive investment opportunity. That is, to the extent that a registered closed-end fund of private funds raises investor-protection concerns, these concerns are mitigated by the fact that one or two fiduciaries stand between a retail investor and the securities owned by a private fund.

Moreover, the existing disclosure and valuation requirements applicable to registered closed-end funds under the 1940 Act are adequate to address the risks and issues presented by investments in private funds. For example, a registered closed-end fund of private funds must have a prospectus (Form N-2) that requires the fund to disclose material information regarding the specific risks of investing in private funds.[60] Form N-2 also requires disclosure of the aggregate fees paid by a registered closed-end fund to underlying private funds.[61] Similarly, the 1940 Act mandates a framework for valuation of a registered fund's investments that is sufficiently broad to address investments in private funds.[62] For many years, this framework has been utilized by business development companies ("BDCs"), which are closed-end companies registered under the 1940 Act that do not have accredited investor restrictions and invest primarily or exclusively in difficult-to-value securities.[63] Because these types of funds exist, many of these issues have already been considered and addressed thoroughly. In light of these existing protections, a registered fund of funds would require fewer, if any, regulatory changes to ensure that the extent of a retail investor's private fund exposure is appropriate for the investor.

The Concept Release also requests comment on several issues relating to the operation of interval funds and tender offer funds, which are two types of generally unlisted closed-end fund structures that provide limited liquidity through periodic repurchases. As registered investment vehicles, interval funds and tender offer funds may be open to non-accredited investors (subject to the Staff's current informal position limiting investments in private funds to 15%). The Concept Release notes that the SEC does "not believe these funds currently are used extensively as a means to provide capital to smaller issuers in exempt offerings," which may suggest that the SEC believes these fund structures are currently underutilized as vehicles to provide non-accredited investors with access to private issuers. For many non-accredited investors seeking access to private funds through a registered vehicle, the ability to have the registered fund of private funds listed for trading on a national securities exchange could be a significant advantage over unlisted interval or tender offer structures.

Investment through a registered vehicle managed by a professional manager would make it easier for smaller investors to build a diversified portfolio of private fund investments by relying on professional managers.

In our view, the registered fund of private funds model has certain advantages over the direct access model. First, investment through a registered closed-end fund structure would give investors the protections of the 1940 Act, which may be appealing to regulators as well as investors and other fund advisers. A registered fund of private funds also has the potential to provide better liquidity, depending on whether the registered fund could be listed (and even without listing, an interval fund or tender offer fund structure could provide at least as much liquidity as other products that are currently available). This greater liquidity could also alleviate the ERISA Section 404(c) concerns described above, which could make this model more attractive for ERISA plans under current law than the direct access model. Investment through a registered vehicle managed by a professional manager would make it easier for smaller investors to build a diversified portfolio of private fund investments by relying on professional managers to perform the requisite due diligence and portfolio construction with respect to the underlying private fund investments, which are some of the traditional benefits that registered investment companies have offered to retail investors for nearly 80 years.

FEEDER STRUCTURE

A "feeder" fund model would involve a registered feeder fund sponsored by a wealth manager or other third party (*e.g.,* a broker-dealer with an existing customer base) (each, an "intermediary") that invests substantially all of its assets in a single unaffiliated private fund. The feeder fund would be a closed-end vehicle registered as an investment company under the 1940 Act and would be marketed to an intermediary's existing customers.

A feeder fund model would require relief from the following regulatory requirements:

1. 1940 ACT. Relief from Rule 2a51-3 under the 1940 Act would be required to permit a fund "formed for the specific purpose" of acquiring securities offered by a Section 3(c)(7) fund to count as a single qualified purchaser (*i.e.,* no "look through" to the beneficial owners). This relief could be conditioned, for example, on the feeder being advised by an RIA and/or having a minimum amount (*e.g.,* $25 million) in capital commitments.

2. ACCREDITED INVESTORS. The SEC Staff would have to discard its current position requiring that sales of registered closed-end funds that invest more than 15% of their assets in private funds be limited to accredited investors.

3. RULE 140 Sales of securities issued by a registered closed-end feeder fund would require relief from the definition of "distributor" in Rule 140 under the Securities Act.[64]

4. LISTING STANDARDS. As with a registered fund of private funds, as discussed earlier, for a registered feeder fund to list its shares on a national securities exchange, the SEC would have to allow listing under current listing standards or permit U.S. securities exchanges to adopt listing standards for registered funds of private funds.

A feeder fund model is likely the most quickly scalable of the three options described in this article. Intermediaries have organized feeder funds into hundreds of private funds. These feeder funds are currently offered only to customers who are qualified purchasers. With additional regulatory relief, these feeder funds could be offered to investors who are not qualified purchasers or accredited investors. A registered feeder fund would have many of the same advantages as a registered fund of private funds, including giving investors the protections of the 1940 Act, the involvement of a registered investment adviser at the feeder fund level, having the potential to provide better liquidity (depending on whether the registered feeder fund could be listed), and requiring fewer regulatory changes as compared to the direct access model; however, the feeder fund may be less attractive than the registered fund of private funds for ERISA plans due to the lack of diversification.[65]

RETIREMENT INVESTORS AND DEFINED CONTRIBUTION PLANS

As noted above, employer-sponsored 401(k) plans largely avoid investing in private funds, despite the prevalence of these funds in defined benefit plans operated by fiduciaries who are held to the same standard of care, because their limited liquidity and relatively expensive fees (as compared to index funds, for example) create fiduciary litigation risk. Although some courts have pushed back against fiduciary breach claims,[66] the inconsistency among courts, the prevalence of class action lawsuits and the lack of guidance from the DOL threaten to undermine any increased SEC flexibility.[67] The DOL could address these issues by providing formal guidance that (i) reaffirms the long-standing principle that a 401(k) fiduciary must consider the totality of factors related to investment options as opposed to just focusing on liquidity and fees and (ii) expands the safe harbor for plan fiduciaries who are making good faith

> DOL can take big steps toward expanding 401(k) plan access to alternative investments, which should **help level the playing field for plan participants** in defined benefit plans and 401(k) plans.

efforts, well informed by expertise on long-term retirement investing, to provide participants with access to alternative asset classes that offer the potential for attractive gains and greater diversification to hedge risk. We believe such guidance should be provided in a regulation (*i.e.*, as part of the Section 404(c) regulations, and not in a speech, website publication or other informal guidance), to give plan fiduciaries confidence that the guidance will not change again in a few years. Conforming updates should also be made to the Section 404(c)(5) regulations to make clear how investment options that include private funds can satisfy QDIA criteria in the absence of participant direction.

With some clarifications to the existing regulatory framework, the DOL can take big steps toward expanding 401(k) plan access to alternative investments, which should, in turn, help level the playing field for plan participants in defined benefit plans and 401(k) plans and facilitate greater retirement savings. Making changes of this type would also be in keeping with the DOL and SEC's stated goals of harmonizing rulemaking.[68] While expanded access to private funds will not solve the retirement crisis facing America on its own, we believe that it could be a key step towards solving the problems facing current retirement savers.

Conclusion

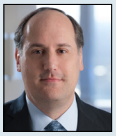
IT IS FAR TOO EARLY TO PREDICT whether the Concept Release will lead to changes in the regulatory landscape. However, at the very least, the Concept Release indicates that the SEC is willing to consider expanding retail access to private funds. This could afford non-accredited investors the opportunity to more broadly diversify their investment portfolios and otherwise benefit from investments that may have returns with less correlation to the public markets.

From the perspective of a private fund sponsor, an expansion of investment opportunities in private funds to non-accredited investors could result in substantial new sources of investor capital. Similarly, traditional retail fund complexes might be able to utilize their existing distribution networks and operational capabilities to offer alternative strategies to a much wider section of the investing public, either on their own or in partnership with private fund sponsors. And, most importantly, allowing retail investors to diversify their investments to include private funds will provide them with wealth-building opportunities that currently are available only to wealthier investors.

Both private fund sponsors and traditional fund complexes should consider how they might create and offer products that could take advantage of any new regulatory flexibility. For example, private fund sponsors without an established retail distribution network may want to look for potential distribution partners, just as retail fund sponsors without established alternatives capabilities may wish to either build that capability or partner with a private fund sponsor that already has this capability.

PRINCIPAL CONTRIBUTORS

Michael Doherty
Partner, New York
michael.doherty@ropesgray.com
+1 212 497 3612



David M. Geffen
Senior Attorney, Boston
david.geffen@ropesgray.com
+1 617 951 7244

Joshua Lichtenstein
Partner, New York
joshua.lichtenstein@ropesgray.com
+1 212 841 5788

Nathan Somogie
Associate, Boston
nathan.somogie@ropesgray.com
+1 617 951 7326

ENDNOTES

[1] Interview with Jay Clayton, SEC Chairman, in Washington (April 9, 2019), The David Rubenstein Show (Bloomberg May 8, 2019) *available at* https://www.bloomberg.com/news/videos/2019-05-08/the-david-rubenstein-show-sec-chairman-jay-clayton-video?srnd=peer-to-peer. In August 2019, Chairman Clayton stated that "[p]rivate capital raising is now outpacing capital raising in our public markets, yet our Main Street investors have no effective access to investments in private capital offerings." Remarks at SEC's Small Business Capital Formation Advisory Committee Meeting (Aug. 13, 2019) *available at* https://www.sec.gov/news/public-statement/statement-clayton-081319.

[2] *See* The World Bank, Listed Public Companies *available at* https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US&view=chart.

[3] McKinsey & Company, *Private Markets Come of Age* 2 (Feb. 2019).

[4] Although retail investors can, to a certain extent, invest in private companies indirectly through registered investment funds such as mutual funds and closed-end funds, as Part II of this article discusses, such access is limited.

[5] This article uses the term "private fund" to refer broadly to funds that are sold in exempt offerings, including private equity buyout funds, private credit funds, hedge funds and venture capital funds.

[6] Preqin, *Global Private Equity and Venture Capital Report* 38, 42 (2019). Family offices, insurance companies, foundations and endowments are other significant investors.

[7] According to Department of Labor data, as of 2016, the number of U.S. workers with access to private defined contribution plans (such as 401(k) plans) was more than 2.75 times the number of U.S. workers with access to private defined benefit plans. U.S. Dept. of Labor, Employee Benefits Security Admin., Private Pension Plan Bulletin Historical Tables and Graphs 1975-2015 at 5 (Dec. 2018) *available at* https://www.dol.gov/sites/dolgov/files/EBSA/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf.

[8] *See* Partners Group, *Adding private markets to DC pension plan portfolios—a case study* (Jan. 2017) *available at* https://www.partnersgroup.com/fileadmin/user_upload/Documents/Research_PDF/20170123_Adding_private_markets_to_DC_pension_plan_portfolios.pdf.

[9] Committee on Capital Markets Regulation, *Expanding Opportunities for Investors and Retirees: Private Equity* 13-20 (Nov. 2018) ("CCMR Report").

[10] SEC, What We Do *available at* https://www.sec.gov/Article/whatwedo.html (emphasis added). *Accord* SEC Commissioner Hester Peirce, *Regulation: A View from Inside the Machine,* Remarks at Protecting the Public While Fostering Innovation and Entrepreneurship: First Principles for Optimal Regulation (Feb. 8, 2019) ("Because of the central role the markets we regulate play in ensuring that the rest of the economy is funded, we need to be open to innovations that will make the capital markets function better and serve parts of the population that were previously not able to access those markets. Can we, for example, look for ways for unaccredited investors to pool their resources to invest in private companies?") *available at* https://www.sec.gov/news/speech/peirce-regulation-view-inside-machine.

[11] *See Final Report of the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies* (Sept. 2019) at 12 *available at* https://www.sec.gov/info/smallbus/acsec/acsec-final-report-2017-09.pdf. *See also Final Report, SEC Government-Business Forum on Small Business Capital Formation* 17-22 (June 2019) *available at* https://www.sec.gov/info/smallbus/gbfor37.pdf.

[12] Rel. No. 33-10649 (June 18, 2019) *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[13] The Concept Release discusses and solicits comments on the conditions and requirements for the following exempt offerings: Regulation D offerings pursuant to Rules 504, 506(b), and 506(c); Regulation A offerings by Tier 1 and Tier 2 issuers; intrastate offerings pursuant to Section 3(a)(11) and Rules 147 and 147A; and certain crowdfunding transactions under Section 4(a)(6). Comments on the Concept Release must be submitted to the SEC no later than September 24, 2019.

[14] There is no universal definition of "retail investor." This article uses the term to refer to investors who are neither "accredited investors" as defined in Regulation D under the Securities Act nor "qualified purchasers" as defined for purposes of the Investment Company Act of 1940, and includes persons investing through their 401(k) or other defined contribution retirement plans.

[15] *See* Concept Release at 172-192.

[16] Although a private fund seeking investments from non-qualified purchasers can instead rely on the exclusion from the definition of investment company under Section 3(c)(1) of the 1940 Act, such funds are limited to no more than 100 beneficial owners. We believe that this limitation would be a substantial impediment to widespread access by retail investors.

[17] Section 2(a)(51)(A) of the 1940 Act generally defines the term "qualified purchaser" to include (i) a natural person who owns at least $5 million in investments, (ii) a family-owned company that owns at least $5 million in investments, (iii) a person, acting for its own account or the accounts of other qualified purchasers, who, in the aggregate, owns and invests, on a discretionary basis, at least $25 million in investments, and (iv) a trust with respect to which the trustee and each person who has contributed assets to the trust is a person described in (i), (ii) or (iii).

[18] *See* Section 205(a) of the Advisers Act. A performance fee is a fee based upon a share of the capital appreciation of the account/fund.

[19] *See* CCMR Report at 26.

[20] An issuer relying upon Rule 506(b) must provide the non-accredited investors with extensive disclosure, *see* 17 C.F.R. § 230.502(b), and the non-accredited investors each must satisfy so-called sophistication requirements. *see* 17 C.F.R. § 230.506(b)(2)(ii). Consequently, as the SEC notes in the Concept Release, issuers reported non-accredited investors as participating

in only 6% of Rule 506(b) offerings in each of 2015, 2016, 2017 and 2018.

[21] Concept Release at 36.

[22] Concept Release at 32 *quoting* Rel. No. 33-6683 (Jan. 16, 1987).

[23] *See, e.g., SEC v. Ralston Purina Co.,* 346 U.S. 119, 125 (1953) ("the applicability of § 4(1) [now § 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[24] *See* SEC Staff, *Report on the Review of the Definition of "Accredited Investor"* 93 (Dec. 2015) available at https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

[25] *Id.* at 94.

[26] Concept Release at 54-55.

[27] Pub. L. No. 104–290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[28] Senate Comm. on Banking, Hous., and Urban Affairs, The Securities Investment Promotion Act of 1996, S. Rep. No. 104-293, 104th Cong., 2d Sess. (Jun. 26, 1996) at 10. Similarly, in adopting Rule 205-3, the SEC stated:

> The Commission has concluded that it is consistent with the protection of investors and the purposes of the [Advisers] Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate.

Rel. No. IA-996 (Nov. 14, 1985) at Section I.C.

[29] *See, e.g.,* Wildermuth Endowment Strategy Fund, SEC Comment Response Letter (Dec. 17, 2014) *available at* https://www.sec.gov/Archives/edgar/data/1586009/000114420414074464/filename1.htm. In the Concept Release, the SEC states its "understanding" that "all closed-end funds that invest primarily in private funds are offered only to investors who meet certain wealth requirements (*e.g.,* the tests for accredited investor), and require significant minimum initial investments," but did not identify how closed-end funds came to adopt the described practice or the 15% limitation.

[30] Concept Release at 174.

[31] Concept Release at 186-87. On this point, the SEC cited a portion of Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003), which discussed SEC concerns about the "retail-ization" of private funds. *Id.*

[32] Concept Release at 188.

[33] *See* CCMR Report at 49-52 (noting that studies examining the performance of defined benefit plans and defined contribution plans show that defined benefit plans outperform defined contribution plans).

[34] *See* Advisory Council Report on Employee Welfare and Pension Benefit Plans, *Report to the U.S. Secretary of Labor: Hedge Funds and Private Equity Investments* (Nov. 2011) *available at* https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2011-hedge-funds-and-private-equity-investments.pdf ("DOL Advisory Council Report").

[35] A QDIA is an investment alternative that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy or that are consistent with a target level of risk appropriate for participants of the plan as a whole. *See* 29 C.F.R. § 2550.404c-5(e).

[36] *See* Section 2(a)(51)(A)(iv) of the 1940 Act.

[37] According to DOL data on all defined contribution plans which filed Form 5500 for plan years ending in 2016, less than 20% of defined contributions were partially or fully plan sponsor-directed, and approximately 10% of 401(k) plans were partially or fully plan sponsor-directed. *See* DOL Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2016 Form 5500 Annual Reports Data Extracted 7/10/2018 available at* https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2016.pdf.

[38] *See H.E.B. Investment and Retirement Plan,* SEC No-Action Letter (pub. avail. May 18, 2001).

[39] *See* DOL Advisory Council Report at 27.

[40] *Id.*

[41] 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C) (emphasis added).

[42] While some alternative investment strategies provide for some degree of liquidity, in general, "unlike registered investments, hedge funds and private equity funds do not have a secondary market and are not redeemable at will, and ownership cannot be terminated unless agreed upon with the investment manager. Furthermore, most funds have lock-up provisions, gates, early termination rights, and pre-determined payment restrictions, any of which could delay [one's] ability to move out of the fund." DOL Advisory Council Report at 3.

[43] *See* José M. Jara, *ERISA: Thou Shall Not Pay Excessive Fees!* (2019 Winter Issue) *available at* https://www.americanbar.org/groups/real_property_trust_estate/publications/ereport/rpte-ereport-winter-2019/erisa--thou-shall-not-pay-excessive-fees-/.

[44] *See* CCMR Report at 57-59.

[45] *See, e.g.,* Kevin G. Bender, *Giving the Average Investor the Keys to the Kingdom: How the Federal Securities Laws Facilitate Wealth Inequality,* 15 J. BUS. & SEC. L. 1, 2 (2016); Usha Rodrigues, *Securities Law's Dirty Little Secret,* 81 FORDHAM L. REV. 3389 (2013).

[46] *See, generally,* James M. Poterba, *Saver Heterogeneity and the Challenge of Assessing Retirement Saving Adequacy,* 68 NAT. TAX J. 377 (2015).

[47] Concept Release at 173. *See also* CCMR Report at 13-15, 17-20 (private equity funds offer enhanced returns that are uncorrelated with public markets).

[48] Section 3(c)(7) provides an exemption for "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making, and does not at that time propose to make, a public offering of such securities."

[49] Such an exemption might borrow from Rule 12g-6 under the Exchange Act, which excludes from the definition of "held of record" securities issued pursuant to the offering exemption under Section 4(a)(6) of the Securities Act (*i.e.,* securities issued in a "crowdfunding" offering). For example, such an exemption might exclude from the definition of "held of record" securities issued pursuant to any access restrictions made applicable to retail investors purchasing securities issued by private funds.

[50] These standards could be based on, for example, size, sponsor experience or institutional investor participation.

[51] *See* Rule 100(a)(2) of Regulation Crowdfunding, 17 C.F.R. § 230.100(a)(2).

[52] *See* Rule 251(d)(2)(i)(C) of Regulation A. 17 C.F.R. § 230.251(d)(2)(i)(C) (limiting the amount of securities that a non-accredited investor can purchase in a Tier 2 offering to no more than 10% of the greater of annual income or net worth).

[53] A potential solution to these operational and administrative challenges might involve an unregistered "feeder" fund sponsored by a wealth manager or other third party (*e.g.,* a broker-dealer with an existing customer base) that invests substantially all of its assets in a single unaffiliated private fund. An unregistered feeder fund structure would require legal and regulatory changes similar to those discussed above. Section III.C discusses a *registered* feeder fund model, which would require fewer legal and regulatory changes.

[54] Unlike a registered open-end investment company, a registered closed-end fund does not need to satisfy redemption requests and is not subject to the 15% limitation on "illiquid investments" imposed by Rule 22e-4 under the 1940 Act. Accordingly, a registered closed-end structure is better suited to an investment strategy that involves significant exposure to illiquid private funds.

[55] To our knowledge, the Staff has not formally articulated a legal basis for its informal limit on registered closed-end fund investments in Section 3(c)(7) funds. It is possible that the Staff would defend its informal position under Section 48(a) of the 1940 Act as a means of preventing a circumvention of Section 3(c)(7) through the interposition of a registered fund between a private fund and non-accredited investors. However, if that is the justification, it is applied selectively. For example, many high yield funds invest significant portions of their assets in Rule 144A securities, notwithstanding the fact that retail investors in the funds are not "qualified institutional buyers" eligible to purchase Rule 144A securities.

[56] The Staff has informally taken the position that a national securities exchange cannot list shares of a registered closed-end fund that exceeds the 15% limit on investments in Section 3(c)(7) funds, and U.S. securities will not adopt listing standards without permission from the SEC. Although we do not believe that any special listing requirements would need to apply to a registered closed-end fund that invests in private funds, to the extent the exchanges view such listing standards as necessary, the SEC should approve any changes to generic listing standards required by exchanges to list these closed-end funds for trading.

[57] *See Notice of Filing of Proposed Rule Change Relating to Closed-End Fund of Hedge Fund Listing Requirements,* Rel. No. 34-58067 (June 30, 2008). The proposed listing standards would have required the registered closed-end fund of hedge funds to calculate its net asset value at least weekly and to contractually agree to publicly disseminate any material information that the underlying hedge fund made available to its investors.

[58] Some increased flexibility for interval funds could be helpful, such as a longer initial investment term before periodic repurchase offers must commence. In the Concept Release, the SEC requests comments regarding increased flexibility for interval funds to invest in exempt offerings. *See* Concept Release at 188. Even with such increased flexibility, however, this type of product would be unlikely to be offered within a 401(k) plan other than through a brokerage window.

[59] In general, Section 17(a) prohibits an affiliated person (or an affiliated person of such a person) of a registered fund, acting as principal (*e.g.,* a private fund advised by the registered fund's adviser) from engaging in transactions (including purchases/sales of securities or other property) with the registered fund.

[60] Form N-2 is the disclosure form that the SEC has prescribed for closed-end investment companies to use when registering under the 1940 Act and when registering their securities under the Securities Act. Form N-2 requires disclosure of material information about a registered closed-end fund, including the principal risk factors associated with an investment in the fund, as well as certain undertakings by the fund (*i.e.,* agreements as a condition to effectiveness of the fund's registration statement). For example, Form N-2 requires a description of the types of securities in which a registered closed-end fund will principally invest (*e.g.,* private funds), as well as the principal risk factors associated with an investment in the fund specifically and the risks generally associated with an investment in a fund with similar investment objectives, capital structure or trading markets.

[61] Item 3 of Form N-2 requires a registered closed-end fund to disclose the fees that investors will indirectly bear as a result of investments in any underlying private funds. Although investors would be paying fees at both levels of a registered fund of private funds, products with two levels of fees already exist in the market. Concerns about fee levels are addressed through disclosure and the annual contract renewal process under Section 15 of the 1940 Act.

[62] For many years, registered funds (including registered funds of private funds) have made investments in difficult-to-value assets. The 1940 Act mandates the framework to determine the fair value of those assets, rather than prohibiting registered funds from holding difficult-to-value assets.

[63] Like other registered closed-end funds, BDCs may be listed for trading on a national securities exchange, or may provide limited liquidity to investors through periodic tender offers for a percentage of their shares.

[64] Rule 140 under the Securities Act provides that "[a] person, the chief part of whose business consists of the purchase of the securities of one issuer …and the sale of its own securities…to furnish the proceeds with which to acquire the securities of such issuer…is to be regarded as engaged in the distribution of the securities of such issuer…within the meaning of Section 2(11) of the Act." It is likely that many underlying private fund sponsors will be disinclined to have a feeder fund be treated as a distributor. For example, such treatment could require the underlying private fund to sign the feeder fund's registration statement.

[65] A registered feeder fund could be structured for tax purposes as either a partnership or a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended. Although registered funds of private funds are often structured as RICs, investing in a single underlying fund could raise additional difficulties in complying with Subchapter M's requirements. The degree of difficulty and the measures that might be necessary to structure around any issues would depend upon, among other things, the investment strategy of the underlying fund.

[66] In 2009, the Seventh Circuit found that "nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." *Hecker v. Deere & Co.,* 556 F.3d 575, 586 (7th Cir. 2009). *See also Renfro v. UNISYS Corp.,* 2010 WL 1688540 *6 (E.D. Penn. Apr. 26, 2010) ("ERISA does not require fiduciaries to get the best deal imaginable for the Plan; it requires them to act carefully, skillfully, prudently, diligently, and solely in the interest of participants and beneficiaries and while this is not a light duty, it does not support a lawsuit that simply claims the fiduciaries could have done better had they worked harder to leverage their market power.").

[67] Based on Ropes & Gray's analysis of class action law suits brought against 401(k) plan sponsors based on investment menu design decisions, fees charged to participants and other related claims, there have been approximately 219 such complaints alleged between 2007 and September 2019. The average settlement amount in these cases is approximately $17 million.

[68] *See* SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions, June 18, 2019 *available at* https://www.sec.gov/news/press-release/2019-97 (*quoting* SEC Chairman Jay Clayton: "We are taking a critical look at our exemptions from registration to ensure that our multifaceted private offering framework works for investors and entrepreneurs alike, no matter where they are located in the United States"); Chairman Clayton's remarks at the SEC's June 5, 2019 open meeting approving Regulation Best Interest (available at https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd):

> The recommendations today reflect a careful study of the DOL Fiduciary Rule, incorporating certain aspects of the rule that will enhance the broker-dealer standard of conduct in line with reasonable investor expectations, while avoiding other aspects of the rule that appear to have been primary drivers of the rule's unintended consequences…Our senior staff and DERA economists have met with staff at the Department of Labor on many occasions, both during and after the development of the DOL Fiduciary Rule and during the development of our standards of conduct rulemaking, to discuss the approaches taken by our respective staffs.

See also Melanie Waddell, *DOL to Issue New Rules on Fiduciary Duties: Acosta,* THINKADVISOR (May 1, 2019) ("Acosta replied: 'The Department of Labor is working with the SEC; the SEC was asked by Congress to come up with appropriate responses to protect these individuals; we are communicating with them [the SEC] and based on our collaborative work, we will be issuing new rules in this area.'").

OUR OFFICES WORLDWIDE

NEW YORK
1211 Avenue of the Americas
New York, NY 10036

T +1 212 596 9000
F +1 212 596 9090

CHICAGO
191 North Wacker Drive
32nd Floor
Chicago, IL 60606

T +1 312 845 1200
F +1 312 845 5500

HONG KONG
One Exchange Square
44th Floor
8 Connaught Place
Central, Hong Kong

T +852 3664 6488
F +852 3664 6588

WASHINGTON, D.C.
2099 Pennsylvania Avenue, NW
Washington, DC 20006

T +1 202 508 4600
F +1 202 508 4650

SAN FRANCISCO
Three Embarcadero Center
San Francisco, CA 94111

T +1 415 315 6300
F +1 415 315 6350

SHANGHAI
36F, Park Place
1601 Nanjing Road West
Shanghai 200040

T +86 21 6157 5200
F +86 21 6157 5299

BOSTON
Prudential Tower
800 Boylston Street
Boston, MA 02199

T +1 617 951 7000
F +1 617 951 7050

SILICON VALLEY
1900 University Avenue
6th Floor
East Palo Alto, CA 94303

T +1 650 617 4000
F +1 650 617 4090

SEOUL
POSCO Tower Yeoksam, 21F
134 Teheran-ro, Gangnam-gu
Seoul 06235

T +82 2 2141 5900
F +82 2 2141 5950

LONDON
60 Ludgate Hill
London EC4M 7AW

T +44 20 3201 1500
F +44 20 3201 1501

TOKYO
JP Tower 30F
2-7-2, Marunouchi
Chiyoda-ku, Tokyo 100-7030

T +81 3 6259 3500
F +81 3 6259 3501

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NEW YORK | WASHINGTON, D.C. | BOSTON | LONDON
CHICAGO | SAN FRANCISCO | SILICON VALLEY
HONG KONG | SEOUL | SHANGHAI | TOKYO

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