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September 24, 2019

Ms. Vanessa Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: File No. S7-08-19  
Harmonization of Securities Offering Exemptions  
Release Nos. 33-10649; 34-86129; IA-5256; IC-33512 (the "Concept Release")

Dear Secretary Countryman:

We welcome the opportunity to comment on the questions raised by the U.S. Securities and Exchange Commission (the "Commission") with respect to ways to simplify, harmonize and improve the exempt offering framework to promote capital formation and expand investment opportunities for retail investors while maintaining appropriate investor protections. Simpson Thacher & Bartlett LLP has significant experience representing investment advisory firms, asset managers and other financial institutions that sponsor and advise pooled investment vehicles, including registered investment companies and business development companies (collectively, "regulated funds") and private funds that operate pursuant to an exemption or exclusion from the definition of investment company under the Investment Company Act of 1940, as amended (the "1940 Act"). We submit the following comments on our own behalf and the views contained herein do not necessarily reflect the views of any of our clients.

## *Overview*

We frequently assist alternative asset managers in their development of regulated fund products, from the initial concept phase to negotiations with investors and intermediaries and the ultimate launch of a fund. Many of these alternative asset managers specialize in the types of investment strategies that the Commission in the Concept Release considers making more widely available to investors. These strategies include private equity, private credit, infrastructure and real estate strategies (generally referred to herein as private markets strategies). While there are a variety of reasons that a regulated fund product ultimately may not launch, in our view restrictions based in the 1940 Act and the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that were not designed with private markets strategies in mind too frequently stifle the efforts of our clients to offer these strategies to a broader range of investors through regulated funds.

As Chairman Jay Clayton has suggested, “appropriately structured funds” are one way to “facilitate Main Street investor access to private investments in a manner that ensures incentive alignment with professional investors — similar to our public markets — and otherwise provides appropriate investor protections.”<sup>1</sup> We agree and in this comment letter we wish to share with the Commission our experience regarding the regulatory hurdles that most frequently prevent managers from offering more investors access to investment strategies that are readily available to institutional investors.

The illiquid nature of the investments inherent to most private markets strategies requires any regulated fund pursuing such a strategy to be structured as a closed-end fund. Accordingly, there are two primary structures for regulated funds to offer more investors access to these types of investment strategies: (a) closed-end funds of funds, which invest indirectly through private funds (i.e., funds of private funds); and (b) closed-end funds, or BDCs, each of which invest directly in private markets. We recommend that the Commission consider six regulatory reforms to remove several key impediments that discourage alternative asset managers from offering their strategies to a broader audience:

With respect to closed-end funds of private funds, we recommend that the Commission:

- (i) allow regulated funds to invest in affiliated private funds;
- (ii) allow regulated funds of private funds to list on stock exchanges;

With respect to closed-end funds and BDCs that invest directly in private markets strategies, we recommend that the Commission:

- (iii) allow regulated funds to incentivize managers to produce strong investment performance for the benefit of investors;
- (iv) permit regulated funds to engage in transactions with portfolio companies that may, subsequent to an initial transaction, be deemed to be a portfolio affiliate of an affiliated private fund;
- (v) permit regulated funds additional flexibility in publicly reporting the values of investments in private issuers; and
- (vi) permit tender offer funds to use the interval fund repurchase process and rely on rules that permit automatic effectiveness of registration statement amendments.

### ***Recommendations to promote funds of private funds***

#### **Allow regulated funds to invest in affiliated private funds**

The inability of a regulated fund to invest in affiliated private funds may be the single most significant barrier to offering more investors access to private equity strategies through regulated

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<sup>1</sup> Remarks to the Economic Club of New York, (September 9, 2019), <https://www.sec.gov/news/speech/speech-clayton-2019-09-09>.

funds.<sup>2</sup> The restrictions on principal transactions between a regulated fund and its affiliates in Sections 17 and 57 of the 1940 Act generally prohibit a private fund from selling its securities to an affiliated regulated fund. As a result, regulated funds of private equity funds are only permitted to invest in private funds managed by unaffiliated sponsors. Regulated funds of affiliated private funds may offer investors certain benefits unavailable to a fund that invests in unaffiliated private funds, including better alignment of interests between management of the regulated fund and underlying private funds and enhanced visibility into the value of a position in a private fund. Additionally, a regulated fund that can invest in affiliated funds may be better from an investor's perspective compared to a regulated fund that directly pursues a private markets strategy by co-investing alongside affiliated private funds. Investors in private funds frequently negotiate limitations on the ability of a sponsor to allocate opportunities to other funds. Regulated funds that can invest in affiliated private funds would not be disadvantaged by such limitations.

Regulated funds are already permitted to invest in affiliated mutual funds under Section 12(d)(1)(G) of the 1940 Act. We appreciate that the Staff historically may have had different conflict of interest concerns when the underlying funds are private funds. However, we believe the Commission could impose reasonable restrictions on a fund of affiliated private funds structure to mitigate these concerns. For example, below are several potential limitations that would mitigate the risk of overreaching by a manager:<sup>3</sup>

- i. To avoid impermissible layering of fees, the regulated fund's board of directors will only approve fund-level fees for services that are in addition to and not duplicative of services at the underlying affiliated private fund level;
- ii. To avoid the concern that retail investor money will be used to "seed" funds with untested or potentially unattractive strategies, the regulated fund cannot own more than 25% of any affiliated closed-end private funds;
- iii. To address similar seeding concerns, the regulated fund cannot own more than 25% of any affiliated open-end private funds and will be restricted from seeding affiliated open-end private funds;
- iv. To avoid being deemed to be formed for the purpose of investing in a particular private fund, the regulated fund will not invest more than 40% of its assets in a single affiliated private fund;
- v. To avoid complex control structures, the regulated fund will vote its interests in any affiliated private fund in the same proportion as the vote of all other shareholders in a particular affiliated private fund or seek instructions from its shareholders; and
- vi. To ensure that the terms of the affiliated transaction with the affiliated private fund are not disadvantageous to the regulated fund, the regulated fund will receive substantially similar treatment with respect to all investments in affiliated private funds as the treatment received by similar investors.

If the Commission were to permit regulated funds to invest in affiliated private funds, with appropriate limitations, such as those set forth above, it would remove one of the key deterrents

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<sup>2</sup> See Concept Release at 190-191, Question 120.

<sup>3</sup> See Concept Release at 188, Question 115.

that prevents alternative asset managers from making their strategies available to more investors.

#### Allow regulated funds of private funds to list on stock exchanges

The staff of the Commission's Division of Investment Management (the "Staff") has taken a position in the disclosure review process and related comment letters<sup>4</sup> that a regulated fund that invests a significant portion (more than 15%) of its assets in private funds can only be offered to accredited investors.<sup>5</sup> To our knowledge, the Staff has never fully explained the legal or policy basis for its position, and there is no statute, rule or regulation imposing this limitation.

We understand that initial and continuing listing standards for major national securities exchanges do not restrict regulated funds of private funds from listing and trading on exchanges, as they are generally agnostic as to a listed fund's investment strategy.<sup>6</sup> Therefore, the only reason regulated funds of private funds are unable to list on an exchange is the Staff's position that limits these funds to accredited investors. This deprives shareholders of a regulated fund of private funds of one of the primary liquidity options that would normally exist for a closed-end fund, and readily available, frequent liquidity should be viewed as an enhancement to investor protection.<sup>7</sup> Currently, because funds of private funds are unable to list on a stock exchange, they are forced to find alternative means to provide liquidity to investors, typically through periodic share repurchases. This places artificial constraints on a closed-end fund's ability to pursue an investment strategy focused on less liquid investments, as managers must source liquidity for investors through sales of portfolio holdings, which can disadvantage investors and would be unnecessary for listed funds whose investors can trade shares on an exchange. We urge the Staff to revise its position and permit funds of private funds to be accessible to all investors, and allow such funds to list on national securities exchanges.

#### ***Recommendations to promote funds that invest directly in private markets strategies***

##### Allow regulated funds to incentivize managers to produce strong investment performance for the benefit of investors

Section 205(a)(1) of the Advisers Act generally prohibits a manager from receiving compensation based on a share of capital gains upon, or capital appreciation of, the assets of a registered closed-end fund unless the offering of the fund is limited to "qualified clients."<sup>8</sup> BDCs, on the other hand, are permitted to pay a manager an incentive fee on capital gains

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<sup>4</sup> See, e.g., Sierra Total Return Fund, SEC Comment Letter (Mar. 11, 2016); Wildermuth Endowment Strategy Fund, SEC Comment Letter (Oct. 11, 2013); Resource Real Estate Diversified Income Fund, SEC Comment Letter (Oct. 19, 2012).

<sup>5</sup> See Concept Release at 188, Question 114.

<sup>6</sup> We note that the Committee on Capital Markets Regulation also has submitted comments agreeing with this analysis.

<sup>7</sup> See Concept Release at 192-193, Questions 128-129.

<sup>8</sup> The qualified client standard is a higher threshold than the accredited investor standard, requiring a natural person to have a net worth of at least \$2.1 million (excluding the value of a primary residence).

without the qualified client limitation.

The 1940 Act's restrictions on a BDC's investment strategy prevent some funds from using a BDC structure. For example, a BDC must invest at least 70% of its assets in U.S. issuers, so a global private equity strategy would not fit a BDC structure.<sup>9</sup> In addition, that 70% requirement also excludes investments in investment companies (or certain exempt investment companies), and thus indirect equity investments through co-investments offered by third-party sponsors may also be ineligible when made through funds created for the benefit of deal-specific co-investors.

The Commission should consider adopting an exemptive rule that would permit registered closed-end funds to pay a similar incentive fee on capital gains.<sup>10</sup> In our view, the justification for treating BDCs and closed-end funds differently in this respect has eroded over time. Congress adopted the BDC structure in 1980 to promote investment in private U.S. issuers by facilitating venture capital-type strategies where a fund's gains are based on capital appreciation.<sup>11</sup> However, the BDC structure has not led to widespread investment in equity strategies, for the reasons noted above and others (such as the lack of exemption from state securities laws for unlisted BDCs, unlike for closed-end funds). Closed-end funds, because they are more flexible, are more likely vehicles for investments in private markets than BDCs. Thus, nearly 40 years later, as policymakers find themselves again looking for ways to facilitate investments in private companies, we suggest that fee parity between registered closed-end funds BDCs is one way to facilitate such investment. The Commission has significant discretion under Section 205(e) of the Advisers Act to adopt exemptions to Section 205(a)(1), and we believe it would be appropriate to permit registered closed-end investment companies that pursue private markets strategies to pay their managers an incentive fee based on capital gains.

Fulcrum fees, permitted for registered investment companies under Section 205(b)(2) of the Advisers Act, provide a poor substitute for traditional incentive fees. The mandated symmetry of fulcrum fees, where a base fee must increase or decrease in equal increments based on performance, results in a manager being paid a relatively high fee for poor performance. A traditional incentive fee provides a more market-tested (and investor friendly) approach and incentivizes a manager to produce strong long-term returns. Decades of market practice in the private fund space have resulted in sophisticated institutional investors negotiating standard concepts that are frequently incorporated into BDC incentive fees. Two features in particular, "hurdles" and "lookbacks," are common devices in BDC performance fee structures that are derived from similar concepts used by private funds to create incentive alignment between a sponsor and investors, and could be implemented for closed-end funds that invest in private markets.

A hurdle helps to ensure that no performance fee is paid unless a fund beats a specified

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<sup>9</sup> See 15 U.S.C. 80a-54.

<sup>10</sup> See Concept Release at 191, Question 123.

<sup>11</sup> See H.R. Rep No. 96-1341, at 19 ("[the bill] was designed to provide exemptions . . . for certain qualified venture capital companies in certain circumstances."), and at 27 (1980) (" . . . registered investment advisers to business development companies would in certain instances be permitted to receive 'performance fees,' geared to appreciation of the companies' portfolios."); S. Rep No. 96-958, at 42 (1980) (noting that performance fees for BDC managers are subject to scrutiny under Section 36(b) of the 1940 Act).

performance threshold for a specific period. Many BDCs have hurdles that are based on longer term lookback periods, sometimes going back to the fund's inception. This essentially means that if the fund fails to achieve strong performance continually, the fund will have to make up for any underperformance during the lookback period before the manager will be entitled to receive additional incentive fees. The hurdle and lookback structure is a significant deterrent to speculative short-term risk taking by a manager, and effectively mitigates the investor protection concerns that a fulcrum fee structure was designed to address. We believe that a traditional incentive fee structure offers benefits to both investors and managers when compared to fulcrum fees, and urge the Commission to allow closed-end investment companies to adopt fee structures similar to BDCs.

Permit regulated funds to engage in transactions with portfolio companies that may, subsequent to an initial transaction, be deemed to be a portfolio affiliate of an affiliated private fund

Regulated funds pursuing a direct private equity strategy face two affiliated transaction issues under Sections 17 and 57 of the 1940 Act. First, these funds often plan to co-invest alongside a manager's affiliated private funds, which generally would be prohibited under the 1940 Act's proscription on an affiliated person of a regulated fund, and affiliated persons of such persons, acting jointly with the fund. Fortunately, the Commission has streamlined the co-investment exemptive relief application process in recent years, removing co-investments as a major gating item in the product development process. Co-investment exemptive orders still take months to receive, and the conditions historically imposed on managers create a significant administrative burden, but the Commission's flexibility in these exemptive orders has removed what previously was the single largest gating item to pursuing a private markets regulated fund.<sup>12</sup>

A second 1940 Act affiliated transaction restriction, however, will also need to be addressed to encourage investment in private markets by regulated funds. In addition to joint transactions with affiliates, Sections 17 and 57 of the 1940 Act prohibit principal transactions between a regulated fund and its first- and second-tier affiliated persons. While co-investment exemptive relief may permit a regulated fund to initially make a co-investment with affiliated funds, there currently is no explicit relief that allows a regulated fund to engage in subsequent transactions with a portfolio company that (by virtue of the initial co-investment) became an affiliated person of an affiliated private fund. Rule 17a-6 permits two affiliated regulated funds to transact with a jointly-affiliated portfolio company but this exemption may not be available if an affiliated private fund is involved. We recommend that the Commission either amend Rule 17a-6 to fix this disparity, authorize the Staff to incorporate similar relief into co-investment exemptive orders or to issue similar interpretive guidance, or confirm that such relief is implicit in existing co-investment orders.

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<sup>12</sup> We urge the Commission and its Staff to grant the new form of co-investment exemptive relief sought by FS Global Advisors, LLC (File No. 812-15016), as it would further significantly reduce unnecessary burdens on managers while retaining the core investor protections of previously granted co-investment orders.

Permit regulated funds additional flexibility in publicly reporting the values of investments in private issuers<sup>13</sup>

In addition to representing alternative asset managers, we have significant experience representing private operating companies who have considered accepting capital from regulated funds. From the perspective of private operating companies, the requirement that a regulated fund must publicly report the value of its investment in each portfolio company makes an investment by a regulated fund unattractive.<sup>14</sup> To facilitate regulated fund investment in private issuers, we believe the Commission should consider narrowly tailored exceptions to reporting individual portfolio values in private portfolio companies. For example, we recommend that a regulated fund be permitted to report an aggregate value for small positions in multiple private companies, such as those where the regulated fund and its affiliates hold less than 5% of the issuer's equity securities. This would address a particular concern of private issuers that the public may see a regulated fund report a valuation that differs from the private issuer's own valuation, even though the regulated fund, as a minority investor, may be missing critical information about the issuer's business. Alternatively, the Commission could consider permitting a regulated fund to publish the private issuer's own valuation alongside the fund's reported value, or the ability for the private issuer to note its disagreement with the valuation. In the event a private issuer disagrees with the fund's valuation, this would provide private issuers with a mechanism to attempt to correct the public record regarding the issuer's valuation. We encourage the Commission to seek public comment on potential other solutions to this limitation on the attractiveness of regulated fund investment in private markets, from the perspective of the private operating companies.

Permit tender offer funds to use the interval fund repurchase process and rely on rules that permit automatic effectiveness of registration statement amendments

Tender offer funds have more flexibility than interval funds to determine the timing and extent of repurchases, but must adhere to tender offer rules under the Securities Exchange Act of 1934 while interval funds have a streamlined process under Rule 23c-3 of the 1940 Act.<sup>15</sup> This added flexibility has led funds that pursue a private markets strategy to choose the tender offer fund structure, but the inefficiencies of this structure create unnecessary costs for shareholders. The Commission should allow tender offer funds to utilize the same streamlined repurchase process that interval funds can use, thereby reducing costs for tender offer funds without sacrificing investor protections.<sup>16</sup> We recommend that the Commission allowing tender offer funds to rely on Rule 486 under the Securities Act of 1933, which allows interval funds to file certain updates to their registration statements that become effective automatically. Providing this parity with interval funds may also make a wholesale revision of Rule 23c-3 under the 1940 Act, applicable

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<sup>13</sup> See Concept Release at 187, Question 111.

<sup>14</sup> See generally, Article 6 of Regulation S-X.

<sup>15</sup> See Concept Release at 177.

<sup>16</sup> See Concept Release at 191, Question 121.

to interval funds, unnecessary.<sup>17</sup>

*Conclusion*

The Commission's openness to consider these important issues has the potential to lead to significant innovation in the regulated funds space and provide corresponding benefits to retail investors. We appreciate the opportunity to submit, and the Commission's consideration of, our comments. Should the Commission have any questions regarding these comments, please feel free to contact Rajib Chanda at [REDACTED] or [REDACTED], Christopher Healey at [REDACTED] or [REDACTED] or Katherine O'Neil at [REDACTED] or [REDACTED].

Sincerely,

SIMPSON THACHER & BARTLETT LLP

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<sup>17</sup> See Concept Release at 188-191, Questions 116-120.