Simpson Thacher

# Memorandum

## SEC Signals Willingness to Expand Retail Investor Access to Private Markets Strategies Through Registered Funds of Private Funds

July 29, 2020

In a speech yesterday, Dalia Blass, Director of the SEC's Division of Investment Management, stated her view that it was important to consider ways of enhancing retail investor access to private markets strategies. Notably, she solicited industry feedback on how registered closed-end funds that are structured to invest in private funds can provide access to these types of strategies in a manner consistent with the SEC's investor protection goals. We view Director Blass' comments as an encouraging sign that the SEC may take more concrete steps in this area, which we and others have advocated for consistently over the past few years.[1]

In her remarks at the 2020 Investment Management Institute, hosted by the Practising Law Institute, Director Blass noted that "Main Street investors are on the outside looking in" with respect to private markets strategies, which historically have been reserved for institutional investors. In recent decades, retail investors have experienced reduced access to these strategies, especially as retirement plan structures have shifted from defined benefit plans, which acted as institutional investors on behalf of workers, to defined contribution plans that lack the same institutional quality.

Director Blass' speech built upon comments over the past few years by SEC Chairman Jay Clayton regarding the goal of increasing retail investor access to private markets as public markets have contracted and private markets have expanded. Her comments also echo points raised in in the SEC's Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release") and during meetings of the SEC's Asset Management Advisory Committee and Small Business Capital Formation Advisory Committee.[2] As regulators and industry experts continue to consider the best structures to accomplish this goal, there appears to be a growing consensus that registered closed-end funds of private funds may offer the best combination of diversification, liquidity and investor protections.

In discussing the possible role of registered closed-end funds of private funds in expanding retail access to private markets strategies, Director Blass stated that the Division of Investment Management is reconsidering its position

[1] *See, e.g.*, Our Comment Letter on Ways to Expand Investor Access to Private Company Investments Through Registered Funds (October 2019); SEC Set to Explore Opening Investments in Private Companies to Retail Investors (January 2019); Registered Fund Reforms Could Support the New SEC Chair's Mission to Improve Capital Markets Access (May 2017).

[2] On December 11, 2019, the Small Business Capital Formation Advisory Committee submitted a recommendation to SEC Chairman Jay Clayton that the SEC remove the 15% Limitation (as defined below).

that any closed-end fund that invests more than 15% of its assets in private funds can be offered only to accredited investors (the "15% Limitation"). This limitation, which has no basis in existing statutes or regulations, currently prevents sponsors from launching new registered funds of private funds that can be offered widely to retail investors and also prevents such funds from listing on a national securities exchange (eliminating a key liquidity mechanism for investors). Removing this limitation would be a significant step in offering retail investors more options to invest in private markets strategies.

Director Blass described several of the threshold questions that the staff of the SEC's Division of Investment Management (the "Staff") is considering in order to get comfortable that allowing retail investors access to a registered closed-end fund that invests more than 15% of its assets in private funds is consistent with the SEC's investor protection mandate. She asked industry participants to submit feedback to the Staff on these key questions, which are discussed in more detail below. Based on the questions raised by Director Blass, it appears that the Staff is not considering a full retraction of the 15% Limitation, but rather a more nuanced approach that would permit registered funds of private funds that meet certain criteria to be available to retail investors.

*What criteria would promote access to high quality private market investments? For example, should closed-end funds of private funds invest with fund managers that meet certain experience and scale criteria?*

With this question, Director Blass seems to be looking for characteristics of investment advisers or investment strategies that lend themselves to high-quality management and investments. The Staff likely is leery of inexperienced managers launching registered private markets vehicles and adding an additional layer of risk to the fund of private funds structure. This is a concern that private markets sponsors and industry representatives have shared in comment letters on the Concept Release and in materials presented during meetings of the SEC's Asset Management Advisory Committee and the Small Business Capital Formation Advisory Committee.

*What closed-end fund structures would be most appropriate for Main Street investors? For example, would an interval fund or tender offer fund provide the right mix of liquidity and access? If so, are there any limitations on an interval fund of private funds strategy given the liquidity requirements in the interval fund rule? Should we consider changes to existing rules to make these funds a more viable option in this context?*

Closed-end funds for retail investors generally have three different liquidity structures: (i) listing on a national securities exchange (a listed closed-end fund); (ii) periodic discretionary tenders (a tender offer fund); and (iii) periodic mandatory repurchase offers (an interval fund). If the 15% Limitation is removed, all three of these liquidity structures theoretically could be utilized by a closed-end fund of private funds. Each structure has key benefits and drawbacks. Listed fund shares often trade at a discount to net asset value per share, but provide constant (secondary market) liquidity. Tender offer funds allow a fund to sync tender offers to match the receipt of proceeds from prior investments but the tender offer process can be expensive and investors have no guarantee of liquidity. Interval funds provide more certainty regarding liquidity opportunities but current rules require at least annual repurchase offers and shareholder approval to change the frequency, which can reduce flexibility in portfolio management and generally does not align with the time horizons for realizing many types of private markets investments. The SEC solicited comments on similar questions in the Concept Release, and commenters raised a variety of suggestions, including amendments to the interval fund rules that would allow for less frequent repurchases and to permit tender offer funds to utilize the more streamlined interval fund repurchase mechanism to reduce unnecessary costs.

*What types of advisory compensation arrangements would result in the most optimal alignment of economic interests between Main Street investors and the fund adviser? For example, would performance-based compensation better serve this goal? Or perhaps compensation in the form of fund shares? If so, how should we structure such relief?*

Several industry advocates have suggested that allowing a registered fund of private funds to have carried interest-like features would incentivize higher-quality managers to develop products for retail investors. It would also potentially prevent bottom-feeding on retail investors, reducing the risk of a situation where only those sponsors that could not attract institutional capital would serve as sponsors of registered funds.

Certain types of funds available to retail investors, specifically business development companies, already are permitted to pay advisers incentive fees based on capital gains so long as the fee structure meets certain requirements. For funds with investment strategies that focus on illiquid investments, the ability to pay an adviser in fund shares would allow the fund to avoid selling assets in order to generate money to pay an advisory fee in cash, and at least one private market sponsor recently has sought such exemptive relief. The SEC is likely to impose restrictions on any compensation structure that includes these features, so industry participants should consider what limitations would further the SEC's investor protection goals while still serving the purpose of aligning the economic interests of retail investors and sponsors.

*Should registered funds limit exposure to private funds that are sponsored or advised by a single adviser? Would allocating assets across multiple advisers promote competition and minimize the risk of unattractive or unsuitable investments? What other risk measures could be put in place by closed-end funds of private funds that would diminish incentives for advisers to take undue risks?*

Currently, there are a number of registered closed-end funds of private funds that invest in private funds sponsored by a single manager, and others that invest in funds managed by a variety of managers. It would seem that Director Blass is again looking for industry input on the criteria that will determine whether a fund of funds should be eligible to be offered to retail investors. It would seem that, depending on the breadth of a sponsor's business, a fund that focuses on a single sponsor could provide similar diversification and risk mitigation benefits to a fund that invests in funds of multiple sponsors. Limitations on how much a fund of funds can invest in a single underlying private fund, and a potential minimum institutional ownership threshold for each underlying private fund also may be considered in this context on the theory that retail investors will benefit from the diligence and negotiations that institutional investors engage in with respect to private fund investments.

*Finally, how can the structure be shaped in a manner that would not involve an extra layer of fees and expenses?*

The affiliated transaction restrictions in the Investment Company Act of 1940 currently prohibit a registered closed-end fund from investing in affiliated private funds managed by the same sponsor. Providing an exemption from this restriction would be the ideal way to mitigate fee-layering concerns, as the sponsor could waive fees either at the retail fund or private fund level. Absent such an exemption, a third-party adviser is required for the retail fund, and that adviser needs to be compensated for their services. Promoting competition in the registered closed-end fund of private funds space would help limit the fees charged by these third-party advisers, but otherwise this fund structure faces the same fee-layering issues as existing retail fund of funds that do not invest in private funds. It is important for third-party advisers to be fairly compensated for the services that they provide, so long as those services are not duplicative of the services provided by the managers of the underlying private funds.

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Director Blass called on the industry to reach out to the Staff with thoughts on any of the above questions. Based on Director Blass' remarks, we view this as a significant opportunity for the industry to provide the Staff with the information it needs to make progress on these issues and remove significant roadblocks to offering private markets strategies to retail investors.

For further information regarding this memorandum, please contact one of the following:

WASHINGTON D.C.

**Rajib Chanda**
+1-202-636-5543
rajib.chanda@stblaw.com

**Ryan Brizek**
+1-202-636-5806
ryan.brizek@stblaw.com

**Christopher P. Healey**
+1-202-636-5879
christopher.healey@stblaw.com

**Katherine O'Neil**
+1-202-636-5840
kate.oneil@stblaw.com

**Debra Wong Sutter**
+1-202-636-5508
debra.sutter@stblaw.com

NEW YORK

**Benjamin Wells**
+1-212-455-2516
bwells@stblaw.com