September 24, 2019

Vanessa Countryman
Secretary
U.S. Securities & Exchange Commission
100 F Street NE
Washington, D.C. 20549-0609

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

Dear Ms. Countryman:

The Institutional Limited Partners Association ("ILPA")[1], appreciates the opportunity to provide comments to the U.S. Securities & Exchange Commission ("Commission" or "SEC") in response to the Concept Release on Harmonization of Securities Offering Exemptions ("Release").[2] The Release is far ranging, but our comments focus on the accredited investor definition, the Rule 506 exemption under the Securities Act of 1933 ("Securities Act") and the 3(c)(1) and 3(c)(7) registration exemptions under the Investment Company Act of 1940 ("40 Act") and the definitions of qualified client and qualified purchaser. These are the provisions that limit the ability for retail investors to access investments in private equity funds.

More specifically, we will share our views on the retail access to private equity and venture capital funds, given our members' expertise in this area. For this to occur, changes would have to be made to the accredited investor definition and qualified

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[1] ILPA is the voice of the institutional investors invested in private equity, colloquially known as Limited Partners or LPs. Our 520+ member institutions represent over $2 trillion in private equity assets under management globally and include public and private pension funds, insurance companies, university endowments, charitable foundations, family offices and sovereign wealth funds, all of which invest in the U.S. alternative investment market. LPs provide the capital that fuels private equity and venture capital investment, generating economic growth and job creation, across America and around the world.

In addition to providing this critical capital for economic growth, LPs are the trusted financial stewards investing the assets of millions of Americans. Limited partner beneficiaries include teachers, first responders, students receiving university scholarships, charity recipients, and insurance policyholders, among others. ILPA is headquartered in Washington, D.C. with additional offices in Toronto, Ontario. For more information on ILPA's members, please visit: http://www.ilpa.org/members.

[2] Concept Release on Harmonization of Securities Offering Exemptions, SEC Rel. IA-5256, File No. S7-08-19 (Jun. 18, 2019).

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purchaser definitions, as well as the 3(c)(7) exemption to the '40 Act to permit broader retail access. Our comments focus less on the technical aspects of changing the definitions, but instead on the practical impact of opening broader access to retail customers in the private equity and venture capital markets by changing these definitions and exemptions.

I. Returns & Opportunities in Private Equity Are Valuable to Investors

ILPA's members are strong believers in the benefits to investors of investing in private markets. Our members have continued to grow their allocations in private equity because they are seeking, and achieving yields that cannot be attained in the public market.[3]

Investment in private equity and venture capital funds has been strong and growing over the last decade. There currently are 3,874 institutional investors in these funds in the United States, with a median current allocation of 6.1% of the investor's portfolio, while the median target allocation for an investor is 10%.[4] Institutional investors are having difficulty reaching their target allocations to private markets because distributions have been "robust and competition for new allocations is fierce…"[5] The chart below[6] demonstrates the strong demand to deploy more capital in this asset class given the robust returns and distributions from existing funds.

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[3] *See* Kate Rooney, "*Investors, 'starved for returns,' flood private markets in search of high-growth opportunities"*, CNBC, August 12, 2019, *available at:* *https://www.cnbc.com/2019/08/12/investors-starved-for-returns-flood-private-markets.html?__source=sharebar|twitter&par=sharebar*

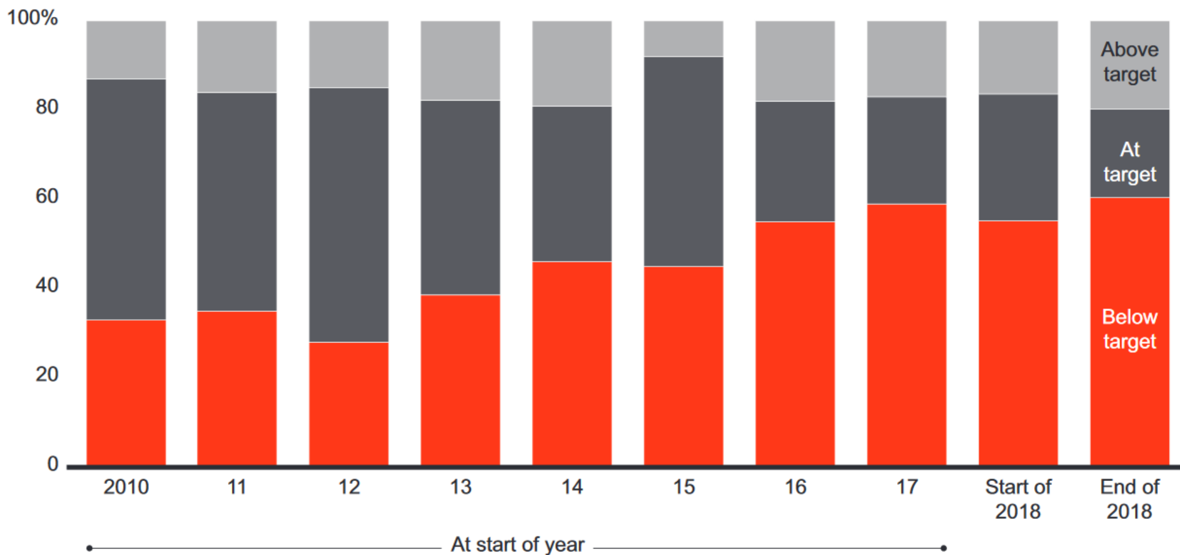
[4] 2019 Preqin Global Private Equity & Venture Capital Report Sample Pages, Preqin, *available at:* *https://docs.preqin.com/samples/2019-Preqin-Global-Alternatives-Reports-Sample-Pages.pdf*

[5] Bain and Company Global Private Equity Report 2019, p. 22, *available at:* *https://www.bain.com/contentassets/875a49e26e9c4775942ec5b86084df0a/bain_report_private_equity_report_2019.pdf*

[6] Chart sourced from Bain and Company Global Private Equity Report 2019 at 23.

Figure 1.19: Institutional investors cannot pump their PE gains back into the industry fast enough to maintain their target allocations

Distribution of LPs, by fund-raising status



Source: Preqin

Total industry assets as of June 2018 were $3.41 trillion, and 82% of surveyed fund managers predict total private equity assets under management to grow in 2019.[7] Fundraising in 2018 in these asset classes was strong, with $432 billion in total capital secured, and 75% of surveyed fund managers experiencing an increase in investor appetite in 2018.[8] According to Bain & Company, 90% of investors in their sample intend to maintain or increase their allocation to private equity.[9]

Private equity has historically outperformed the public market, including most major public market indices. Cambridge Associates, an investment consultant, measures PE performance through what it calls the modified public market equivalent ("MPME") rating system. Cambridge's MPME replicates the timing and size of private equity cash flows as if they had been invested in public equities, allowing for an effective comparison of PE and public market returns.[10] According to the 1Q 2019 report from Cambridge, fifteen-year returns net of fees in Global Private Equity outperformed most public market

[7] 2019 Preqin Global Private Equity & Venture Capital Report Sample Pages, Preqin, P. 11 *available at:* https://docs.preqin.com/samples/2019-Preqin-Global-Alternatives-Reports-Sample-Pages.pdf .

[8] *Id.*

[9] Bain and Company Global Private Equity Report 2019 at 36.

[10] Cambridge Associates, Q1 2019 Final Report on Global Private Equity, *available at:* https://www.cambridgeassociates.com/private-investment-benchmarks/.

equivalents, even in a bullish public market.[11] As of March 2019, over a 15 year time period, private equity returned 13.69% versus 9.18% for the S&P 500 index or 8.73% for the Russell 2000 index. Over a 20 year horizon, private equity returned 12.44% versus 7.77% for the S&P 500 and 8.94% for the Russell 2000 index.[12] These numbers are net of fees.

Public pension plans, a meaningful part of ILPA's membership base, illustrate the trend towards reallocation of capital to private markets to access these heightened returns. These plans rely heavily on investment gains to meet future benefit payments, and generally seek to meet a 7% annual return to cover their obligations to beneficiaries. According to the Center for Retirement Research at Boston College, most public plans shifted a portion of their assets out of equities and fixed income and into alternatives from 2001-2016.[13] Public pensions have shared in the returns highlighted in the broader public equity market. According to a study of US state pension systems by Cliffwater in March 2019, from 2002-2017, private equity has "produced a significant 4% annualized excess return over public equity of similar geographic composition."[14] Moreover, the study highlighted that private equity performance produces stronger excess returns in both bear and bull market periods than public equities.[15]

In sum, private markets, particularly private equity and venture capital, provide significant opportunities for strong returns for investors, including those in ILPA's membership. Net of fees, these returns on average have outperformed the public markets in both bull and bear periods based on the data available. All of this has resulted in significant and growing allocations to the private equity asset class from a wide spectrum of investors.

II. Sophistication and Additional Transparency & Governance is Required to Achieve Positive Results in Private Market Investing

While private equity and venture capital can generate outsize returns and provide investor access to a wider variety of private companies, a level of sophistication and skill present in the investor is critical. By their nature, private markets and private funds have significantly less disclosure and provide less access to information to evaluate a potential investment. Large institutional investors spend hours of due diligence in

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[11] *Id.*

[12] *Id. at 10.*

[13] Aubry, Chen, Munnell and Wandrei, *What Explains Differences in Public Pension Returns Since 2001,* Center for Retirement Research at Boston College, July 2018, p. 7, *available at:* https://crr.bc.edu/wp-content/uploads/2018/07/slp_60.pdf

[14] Stephen L. Nesbitt, *An Examination of Private Equity Performance Among State Pensions, 2002-2017,* Cliffwater LLC, May 2018, *available at:* https://www.cliffwater.com/Research

[15] *Id.* at 3.

undergoing their own manager selection processes. Evaluating and considering the potential success of management and teams is critical. Also, given the light regulatory touch under the Investment Advisers Act of 1940, any investor protections must be negotiated into the investment contract or limited partnership agreement ("LPA"). Given the competitive environment for allocations and the heavily negotiated nature of these contracts, it is often difficult, even for institutional investors, to achieve the needed protections and information access. Achieving the same in a traditional private equity fund for individual retail investors who would not be consequential in terms of the amounts invested, would likely be nearly impossible. As a result, the typical retail investor will likely incur higher fees when investing in private markets, have less information about the underlying investments the fund is making, and suffer reduced fiduciary duties in the LPA as compared to institutional investors.

a. The SEC Should Take Action to Implement Minimal Standards of Transparency and Governance in the Private Equity Market, Particularly If Additional Retail Investment is Permitted

ILPA has long asserted that there is a need for further action on basic transparency and governance thresholds required of private equity advisers, areas that are already challenging to sophisticated, institutional investors.[16] These areas would be additionally exacerbated by the lack of sophistication of retail investors in this market, who would be unable to negotiate effectively due to their size, and who lack understanding of the complexity in private equity limited partnership agreements.

A recent academic paper, *A New Approach to Regulating Private Equity by* academics at the Said Business School at Oxford University, enumerates these challenges and suggests the role that a regulator such as the SEC could play in ensuring greater market efficiency for both institutional and retail investors.[17] First, the paper suggests that the complexity in private equity partnership agreements must be addressed. Standardization of contract types, or a creation of standard definitions for key items would be extremely beneficial to both private equity advisers and investors. Second, it suggests there should be regular financial reporting to investors, and the reporting of fees and expenses charged, to ensure efficiency in the market, and that investors know what they are being

[16] ILPA Position Paper: Strengthening the Partnership in Private Equity (May 20, 2019), *available at:* https://ilpa.org/wp-content/uploads/2019/05/ILPA-Position-Paper-on-Improvements-to-Fund-Governance.pdf; Institutional Investor Letter on Proposed Commission Interpretation Regarding Standard of Condcut for Investment Advisers (February 12, 2019), *available at:* https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf

[17] Morris, Peter and Phalippou, Ludovic, *A New Approach to Regulating Private Equity* (February 16, 2011). Available at SSRN: https://ssrn.com/abstract=1762840 or http://dx.doi.org/10.2139/ssrn.1762840

charged to invest. Third, the paper proposes bringing together managers, investors and third parties to set agreed upon quality standards in the market. While ILPA seeks to create standards in the market, a regulator like the SEC could achieve much greater success in encouraging quality standards. All these approaches would benefit both sophisticated and retail investors in the asset class alike.

In addition to pressing for greater transparency in private markets, ILPA has also asked the SEC to take action to address the troubling increase in private equity advisers being permitted by the Commission to disclaim their fiduciary duties in their underlying LPAs, while still being subject to the fiduciary obligations. This loophole contradicts the requirements under the Investment Advisers Act that private equity advisers owe duties of loyalty and care to their investors.[18] Reductions in fiduciary duties would have even more negative impact on retail investors, who would not have the resources or sophistication to adequately negotiate these terms to protect themselves against the downside risk of their investments. The SEC should address these basic transparency and governance issues for current investors in the asset class, but there is even more impetus to act in this area if greater access is granted to retail participation.

b. Sophistication is Required to Source and Evaluate the Best Private Equity Managers in Order to Achieve Strong Returns

A significant component of successful private equity investing is manager selection. This necessitates having a process to evaluate and select top performing managers, many of whom in the current environment are likely to already be oversubscribed. This skill directly correlates to the ability to realize the promise of achieving returns that outperform the public market.

Sourcing and investing with private equity managers that will fall into the top quartile of performance is critical. According to research by Evestment, a provider of private equity analytics, the difference between being invested in a top quartile and bottom quartile private equity fund has a significant impact on returns, "as much as 16.9 percentage points in one study."[19] Further, a 2017 article in the CAIA Alternative Investment Analyst Review stated that, "[e]ffective manager selection is important in any market, but this is especially true within the world of private equity where returns are disproportionately influenced by top tier funds. The impact of positive outliers causes the performance

[18] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Rel. IA-5248, File No. S7-07-18 (July 12, 2019).

[19] Evestment, *Enhancing Private Equity Manager Selection with Deeper Data,* September 2017, *available at:* https://www.evestment.com/wp-content/uploads/2017/09/eVestment-Enhancing-Private-Equity-Manager-Selection-with-Deeper-Data.pdf.

profile for the pool of all funds to have a positive skew."[20] Moreover, this disproportionate impact is magnified by the illiquid nature of private equity, i.e., investors must commit capital without the ability to buy or sell as the investment matures.

Sourcing these top quartile managers requires a sophisticated skillset. As Institutional Investor magazine highlighted in 2016, "Investing in private equity funds is a skill unto itself."[21] An Ohio State University research paper from 2018 affirmatively stated that "variation in skill is an important driver of institutional investors' returns [in private equity]" and that "[s]ome LPs appear to be better than other LPs at selecting the GPs who will subsequently earn the highest returns."[22] The Ohio State research suggested that "the performance of LPs' private equity investments is not random, and that the ability to identify and invest with private equity partnerships that have the best potential to earn the highest returns is an important skill of institutional investors."[23]

Unfortunately, these skills are unlikely to be innate in the average retail investor investing in the asset class directly, resulting in less than favorable outcomes in manager selection. And as indicated above, poor manager selection results in poorer investment results, thereby diminishing the value of direct access to private equity in a retail investor's portfolio versus the public market investments already available to them. Therefore, we would suggest retail investors invest through a registered fund vehicle that invests directly in private market companies or be required to pass an examination which tests for manager selection and evaluation capabilities.

III. More Capital Entering Private Markets Has the Potential to Produce Adverse Consequences for All Investors

One foundational argument for more retail access to private equity and venture capital investments has been the lack of yield for investors in the public market. Other arguments advanced are to broaden "capital formation" or access to capital from private companies for economic growth. However, dramatically opening private markets to retail access could have detrimental impacts for all investors. First, it would result in less governance and further unfavorable investment terms for all. Second, the private

[20] Chan, Diehl, Gonzalo and True, *Private Equity: Manager Selection, Portfolio Construction, and Outperformance,* CAIA ALTERNATIVE INVESTMENT ANALYST REVIEW, Q4 2017, P. 21, (2017), *available at:* https://caia.org/aiar/archive.

[21] Leanna Orr, *Skill Pays Off When Allocating to Private Equity,* INSTITUTIONAL INVESTOR, November 5, 2016, *available at:* https://www.institutionalinvestor.com/article/b14z9p2mfkkzk8/skill-pays-off-when-allocating-to-private-equity .

[22] Cavagnaro, Sensoy, Wang and Weisbach, *Measuring Institutional Investors' Skill at Making Private Equity Investments,* The Ohio State University - Fisher College of Business Working Paper Series, P. 2, April 17, 2018.

[23] *Id.* at 35.

market is already oversaturated with capital that private equity and venture capital managers are struggling to deploy. This oversaturation has the potential to reduce the returns received from the asset class due to competition for a limited number of deals. The Commission should be aware that opening the market for everyone, while not only undermining the public market, will likely result in an erosion of the standards and benefits of investing (i.e. returns) in private markets in the first place.

a. An Influx of Unsophisticated Retail Investors Will Likely Result in Reduced Governance and Poor Negotiated Terms in Private Equity and Venture Funds

The "sophistication" currently required to invest in the private equity and venture market is premised on being able to "fend for yourself" and to negotiate the rights and protections that you, as the investor, require. A significant element of being able to secure satisfactory terms, given lacking transparency, disclosure and governance noted above, is supply and demand for investor dollars. As the Commission has not yet established minimum standards for transparency and governance in private markets, the ability to secure basic investor protections remains at the whim of the market. These challenges will be exacerbated if an influx of unsophisticated, retail capital enters this market. The oversupply of capital will leave investors in this market even less able to secure adequate investor protections and rights through the contract.

One example is the distressing trend of private equity managers seeking to reduce their fiduciary duties of loyalty and care to investors in the limited partnership agreement. Currently, even sophisticated, reasonably well-resourced institutional investors are not able to adequately retain these rights and still deploy capital in this very competitive market. Another example is the lack of transparency into the fees and expenses investors are charged in the asset class, another area where the Commission has not yet acted, despite well recognized challenges.[24] More capital from individual retail investors, who have limited ability to negotiate these critical protections, will likely lead to an even further backward slide in the contractual protections that all investors, including institutions, will receive.

As was stated in a recent research paper on the difficulties of negotiating private equity contracts for smaller investors, "[t]he world of private equity funds is thus highly

[24] While the Commission has failed to act to require fee and expense reporting, other regulatory bodies have noted and sought to address these challenges, including the FCA in the United Kingdom. *See* Pensions and Lifetime Savings Association, Cost Transparency Initiative, *available at:* https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative; *see also* Institutional Disclosure Working Group Report to the FCA, *available at:* https://www.fca.org.uk/publication/documents/idwg-report-fca.pdf

contractual, and neither state nor federal law provide investors with meaningful back-up protection if the combination of LPA-based protections and reputation-based protections is deficient."[25] A common claim is that robust negotiation between sophisticated parties in private equity funds will result in fair outcomes for the fund, and/or that large investors will greatly benefit smaller investors by negotiating the fund terms thereby "rising tides lifting all investor boats". Recent research indicates that large investors will use their bargaining power to achieve individualized rights and protections, given their fiduciary obligations to their beneficiaries, not necessarily to benefit smaller investors with less bargaining power.[26] This scenario is only natural because larger investors owe fiduciary duties to their beneficiaries to achieve the best possible outcomes for themselves in the side letter agreement and to be efficient in their use of their limited bargaining power during negotiations.[27] This calls into question arguments by some, including a recent Committee on Capital Markets Regulation report, that retail investors would be protected in directly accessing private equity funds by the SEC requiring funds with retail investors in them to have a "material institutional component (e.g. more than 50%)…[which] would enable retail investors to leverage the demands of institutional investors."[28] Given the research and practical reality, it is unlikely such a restriction would be effective in ensuring adequate terms could be negotiated through direct access. Likewise, a retail investment adviser or financial professional would likely lack the knowledge, access or leverage to negotiate any meaningful protections for a retail client, given the complexity and challenges institutional investors already face in this market.

The limited nature of bargaining power for investors in alternative investment funds was highlighted in a 2014 paper by the Chief Justice of the Delaware Supreme Court, Leo Strine, who stated that:

> [b]ased on cases we have decided and our reading of many other cases by our judicial colleagues, we do not discern evidence of arms-length bargaining between the sponsors of the alternative entities that raise capital from diverse investors. Rather these governing instruments seems to be

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[25] William W. Clayton, *The Private Equity Negotiation Myth,* YALE JOURNAL ON REGULATION, Forthcoming; BYU Law Research Paper No. 19-01, July 31, 2019, P. 11, *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3335656&download=yes

[26] *Id. at* 25.

[27] *Id.*

[28] Committee on Capital Markets Regulation, *Expanding Opportunities for Investors and Retirees: Private Equity,* November 2018, P. 36, *available at:* https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf

drafted unilaterally by the sponsors and proposed on a take-it-or-leave-it basis to the investors.[29]

Further, Chief Justice Strine noted that "[a]mong the hallmarks of these agreements are broad waivers of all fiduciary duties, including the duty of loyalty. Traditionally, the duty of loyalty provided the most meaningful protection to passive investors in corporations and partnerships."[30] This dynamic results in a difficult choice, according to the Chief Justice, "the practical alternatives for a skeptical investor are often stark: invest without adequate protection against self-dealing or avoid the asset class altogether."[31]

In sum, given the challenges for even large institutional investors to negotiate basic protections, like fiduciary duties, in private equity funds, and the even further reduced negotiating power of smaller investors, it is unlikely that retail investors will be able to achieve the contractual protections they need. Moreover, their entrance into this market will likely leave smaller institutional investors, such as family offices, endowments, foundations and city and municipal pension funds with even less leverage to achieve the protections they need.

b. An Influx of Additional Capital from Retail Investors Will Result in Lower Returns for all Investors in the Market

Unleashing a flood of new retail capital into the private market to seek yield will likely result in reduced returns for everyone in the marketplace. As Rick Fleming, the SEC's own Investor Advocate, indicated in his recent comment letter on this rule proposal[32], private equity firms have a surplus of capital waiting to be deployed, otherwise known as "dry powder." This "dry powder" (i.e., capital that is not earning returns for investors) is at all-time highs, setting a new record of $2 trillion in December 2018, according to the chart below from Bain & Company.[33] A growth in "dry powder" indicates increased competition for investment opportunities in the private market, which has the potential to bid up prices for assets, thereby lowering potential returns at exit.[34]

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[29] Leo Strine & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom,* Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations (Robert W. Hillman and Mark J. Loewenstein eds.) (Edward Elgar Publishing 2015, Forthcoming), Harvard Law School John M. Olin Center Discussion Paper No. 789, August 2014, P. 2., *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2481039

[30] *Id.*

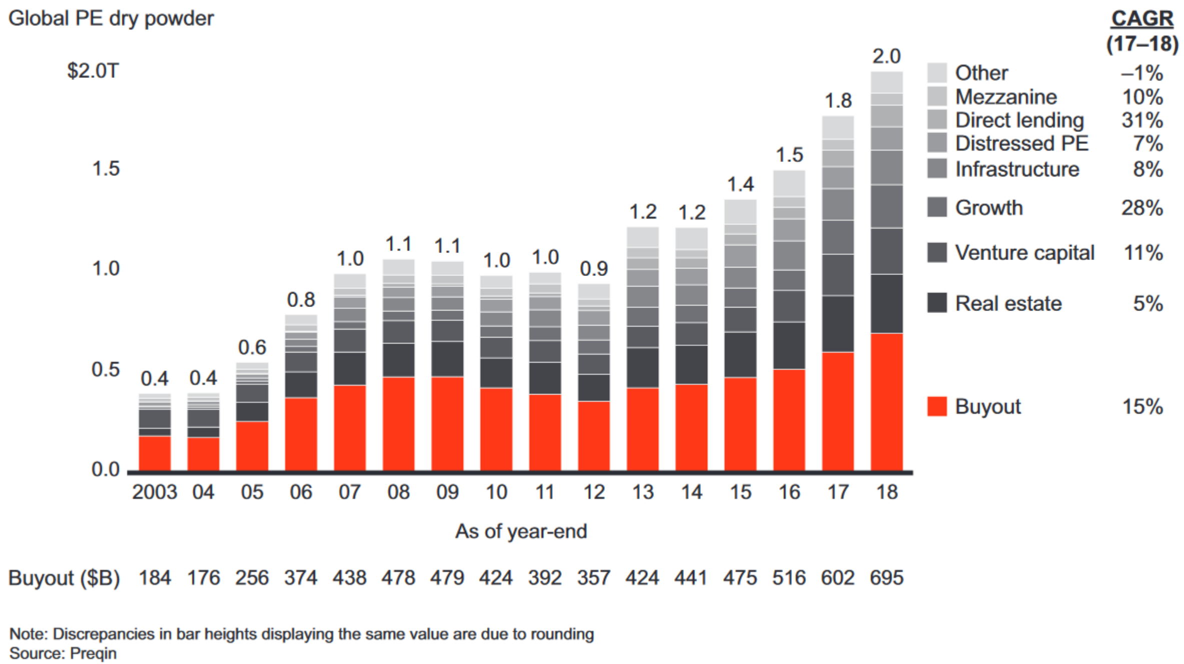
[31] *Id* at 4.

[32] https://www.sec.gov/comments/s7-08-19/s70819-5800855-187067.pdf

[33] Chart sourced from Bain and Company Global Private Equity Report 2019 at 8.

[34] "Chronically heavy competition has driven deal multiples to historic highs, and growing jitters about an eventual economic downturn are affecting decision making from diligence to exit planning. For [GPs], putting record amounts of capital to work means getting comfortable with a certain level of discomfort

Figure 1.6: Dry powder continues to pile up globally, setting a new record in 2018



Note: Discrepancies in bar heights displaying the same value are due to rounding
Source: Preqin

The flow of capital into the asset class is already contracting returns for the increasing number of institutional and high net worth investors in the private equity market. While buyout funds have still continued to outperform public equity markets over the long-term, returns have fallen from the last investment cycle before the global financial crisis.[35] Our members are projecting lower returns due to the already massive amount of capital flows into the asset class, with a recent article indicating that "[i]nvestors and their consultants now expect annualized returns in the high single digits over the long term," versus double digit returns that previously were the case.[36] Several large Californian public institutions have cut return expectations in the past 12-18 months in the asset class, although all anticipate outperformance versus the public market.[37] In sum, adding a massive inflow of retail investor capital will only result in significantly more dry powder for private equity and venture capital funds, resulting in diminished returns for the entire market. As a result, we encourage the Commission to be targeted and thoughtful when

when investing. They are paying prices they swore they would never pay and looking to capture value that may prove elusive post-close." MacArthur, Burack, De Vusser, Yang and Rainey, *Private Equity: Still Booming, but Is the Cycle Near Its End?,* Bain & Company, February 25, 2019, *available at:* https://www.bain.com/insights/year-in-review-global-private-equity-report-2019/

[35] *Bain and Company Global Private Equity Report* at 33.

[36] Arleen Jacobius, *Funds dial back expectations for returns,* Pensions & Investments, August 5, 2019, *available at:* https://www.pionline.com/private-equity/funds-dial-back-expectations-returns

[37] *Id.*

evaluating how much and how quickly to widen access to retail investors given the potential higher risk and likely reduced rewards.

c. Retail Investors Are More Likely to Default on Capital Commitments, Posing Harm to Themselves, other Investors and the Fund

Allowing direct access by retail investors into the private equity market will also present the risk of their default in a private equity fund. This scenario poses significant risk for the fund, particularly during a market shock, as well as to the retail investors themselves. A default occurs in a private equity fund when an investor is not able to meet a capital call in accordance with the terms of the investment contract.[38] "Many fund managers have strict rules in their Limited Partnership Agreements in the case of a defaulting investor…[i]n such a case, the investor might lose the entire investment and all the capital which they have already paid into the fund."[39] Selling this illiquid investment on the secondary market often requires the approval of the manager of the fund, as well as often resulting in a significant price discount. Given that retail investors typically are unlikely to have the reserves of an institutional or even high net worth investor, there is a significant risk that retail investors could sustain massive losses if they default in this asset class. As such, we encourage the Commission to consider carefully whether direct access would be the most appropriate approach for these investors.

IV. Investing Through a Registered Fund Vehicle Would be Preferable for Most Retail Investors & the Commission Should Consider This Model

As highlighted above, ILPA's members believe in the returns that can be achieved in the private equity market, particularly given the search for yield beyond the public markets. We believe that there is no reason that retail investors should not also be able to access the private markets. However, we assert that investing through a registered closed-end fund or business development company (BDC)-type vehicle under the Investment Company Act of 1940 could provide the necessary additional protections that would make the model viable. These protections include that of an independent board of directors, restrictions on transactions with affiliates and other protections against conflicts of interest, enhanced transparency around pricing and valuation of assets, and certain limitations on the use of leverage, among others.[40]

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[38] Christian Diller and Christoph Jackel, *Risk in Private Equity: New Insights into the risk of a portfolio of private equity funds,* British Private Equity & Venture Capital Association, October 2015, P. 3, *available at:* https://www.bvca.co.uk/Portals/0/library/documents/Guide%20to%20Risk/Risk%20in%20Private%20Equity%20-%20Oct%202015.pdf

[39] *Id.*

[40] Morrison Foerster, *Frequently Asked Questions About Closed-End Funds, available at:* https://media2.mofo.com/documents/faqs-closed-end-funds.pdf.

a. The Commission Should Permit Retail Closed-End Funds to Invest in Private Funds with Additional Investor Safeguards

The Committee on Capital Markets Regulation highlighted that public closed-end funds are not subject to redemption requirements and therefore may be better suited as a vehicle to permit greater retail access to private market investments which are long-term and illiquid in nature.[41] According to the Committee, the Commission has restricted the ability for closed-end funds to invest as a "fund of funds" into private equity funds.[42] We believe that the Commission should reconsider this proposal by relaxing the requirement to allow closed-end funds with retail investors to invest more than 15% of their assets in private equity funds. However, we suggest imposing additional restrictions on the management fees that may be charged by these types of funds, in addition to any fees charged by the underlying funds themselves. We also recommend proscriptions for closed-end fund managers against entering into side letter agreements with private fund managers and requiring that such funds must negotiate the terms of the LPA to ensure the best outcomes for all investors.

b. The Commission Should Evaluate Changes to the BDC Regulations Which Could Encourage its Use for Equity Investment.

When evaluating the closed-end fund model, the Commission could look to the Business Development Company ("BDC") structure, created in 1980 to permit retail investors to access investment returns from small and medium sized private companies.[43] The BDC model is better structured to allow retail investors to receive returns from private companies directly without the additional layer of fees that is charged by investing through a true "fund of funds." A BDC has some of the same protections of a traditional closed-end fund with the additional benefit of flexibility to invest directly in private companies and take on a modest and limited level of 2:1 leverage, while also providing "management expertise" to the companies.

Most BDCs are focused on investment in the debt of small and mid-size companies and have moved away from equity investment as most retail investors invest in them for the high dividends generated by debt investing. The lumpiness of capital gains and

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[41] Committee on Capital Markets Regulation, *Expanding Opportunities for Investors and Retirees: Private Equity* at 3, 38.

[42] *Id.* "However, the SEC has issued comment letters to closed-end funds indicating that only accredited investors may invest in a public closed-end fund that invests more than 15% of its assets in Section 3(c)(7) funds."

[43] Morrison Foerster, Frequently Asked Questions About Business Development Companies, *available at:* https://media2.mofo.com/documents/faq-business-development-companies.pdf

dividend payments in equity-oriented BDCs have made them less attractive in the marketplace.

The Commission should study ways in which greater equity investment by the BDC industry can be encouraged in privately held companies through amended regulations applied to the BDC industry. However, the SEC should also ensure that this updated BDC structure that preferences equity is required to be “internally managed” rather than “externally managed” as externally managed BDCs have been found to have much higher expense ratios for investors and tend to trade below net asset value.[44] ILPA believes that investing through a product registered under the ‘40 Act, such as a BDC-like vehicle, strikes the right balance of investor protection and access to private market investment opportunities for retail clients.

V. Investing in Private 3(c)(1) and 3(c)(7) Funds Should be Limited to Those Who Can Establish Sophistication via an Examination & Require Funds Accepting Retail Investment to Have Enhanced Investor Protections

While the solution of investing through a registered fund is preferable, if the Commission is inclined to grant direct access to private 3(c)(7) and 3(c)(1) funds, ILPA encourages the agency to provide the option of an investor examination in addition to the wealth requirements to invest. This examination should be rigorous in establishing sophistication and test the retail investor’s knowledge about private funds. The examination should include significant coverage of illiquidity risk, the skills needed to evaluate private equity teams, track record and performance, and the importance of fee and expense reporting/transparency. ILPA would recommend the fundamentals of our recently released Principles 3.0[45] as an ideal component for investor testing and training for the examination.

In addition to an examination, there should be additional requirements for private fund managers that accept retail investors in their funds to: (1) provide full fee and expense disclosure in a retail format, including the fees and expenses offset or charged to portfolio companies; (2) ban the contracting away of fiduciary duties in the investment contract; and, (3) require the fund to have a limited partnership advisory committee (LPAC) with an appointed independent member of the LPAC designated to represent the interests of retail investors in the fund and keep them informed.

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[44] William Packer, *The Future of Externally-Managed BDCs,* SEEKING ALPHA, June 1. 2017, *available at:* https://seekingalpha.com/instablog/5056551-william-packer/4994716-future-externally-managed-bdcs

[45] The ILPA Principles, including the most recent version, Principles 3.0, set forth a guide of best practice standards in the private equity industry. The Principles are available here: https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf

VI. The SEC Should Provide More Options for Direct Contribution Plans to Access Private Markets

ILPA's members include not only operators of defined benefit plans, but also operators of defined contribution plans, particularly corporate pension plans. Given the long-term nature of investing in private funds, we would support additional opportunities for such institutional investors to offer these types of investments in their defined contribution plans. While our understanding is that many of the barriers to providing these opportunities in defined contribution plans are due to regulatory requirements under ERISA and Department of Labor requirements, we encourage the Commission to coordinate and work with the DOL to provide additional guidance to ERISA defined contribution plans regarding investments in these types of assets.

We also encourage the SEC to consider the following changes to the securities laws to allow greater flexibility for defined contribution plans to invest in alternative investments, including private equity funds. The SEC should reconsider the various no-action letters[46] that create a requirement to "look through" 401(k) plans to each individual plan participant for evaluation under the accredited investor definition. Given the protection provided by a defined contribution plan fiduciary, the plan itself should qualify as an accredited investor and qualified purchaser, so long as the decisions regarding the retirement plan are made by the fiduciary. Second, the Commission should permit target date open-end funds to have a greater concentration of illiquid investments, including private equity funds. Section 22e-4 of the '40 Act, [47]otherwise known as the mutual fund liquidity rule, generally prevents funds from investing more than 15% of assets in illiquid investments. Updating these rules would encourage more exposure to private equity and other alternatives in target date mutual funds, which make up many defined contribution plans.

We believe that these changes would allow greater retail access to private company returns in retirement accounts.

VII. Family Offices Should Receive Additional Flexibility from the Accredited Investor and 40 Act Exemptions

ILPA's membership includes over 80 single family offices that invest in private funds on behalf of family clients. The Commission and Congress correctly recognized that family

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[46] The Standish, Ayer & Wood, Inc. Stable Value Grp. Tr., SEC No-Action Letter, 1995 (Dec. 28, 1995); The H.E.B. Inv. & Ret. Plan, SEC No-Action Letter, 2001 (May 18, 2001).
[47] 17 C.F.R. § 270.22e-4.

clients did not require the protection of the Investment Advisers Act by crafting the family office rule[48] after the passage of Section 409 of the Dodd Frank Act, thereby exempting single family offices from the registration requirements of the act. The view in Congress was that members of a family office will understandably act on behalf of other family members to ensure they have the best advice possible in their investment activities.

Unfortunately, the family office rule does not apply beyond the Investment Advisers Act. ILPA and our members believe that the same public policy principles that supported the family office rule under the Advisers Act should also be extended to the Securities Act and the Investment Company Act of 1940.

First, the SEC should apply this same principle to the accredited investor and qualified purchaser definitions, by permitting any "family client of a family office" to qualify for accredited investor status so long as they are relying on the advice and sophistication of the family office. The current restriction prevents family clients receiving expert investment advice from a dedicated family office from accessing the same investments in the private market that the SEC is contemplating retail clients should receive. In particular, the qualified purchaser threshold of $5 million is difficult for certain family clients to meet, given that their assets often are structured within a trust vehicle and therefore are not reflected in the net worth of individual family members. We encourage the SEC to amend the accredited investor and qualified purchaser definition to ensure it is in line with the principles represented by the family office rule.

Second, the SEC should support the creation of a new exemption from the Investment Company Act for single family offices. There are currently fourteen categories of companies that buy, hold, and trade securities, but have an exemption from registration. Similar to the policy reasoning in the family office rule, the protections in the Investment Company Act aren't necessary for family investments when the family is managing family money for its own family members. Family offices often must structure various investment vehicles to invest family member assets and the lack of an exemption from the investment company act imposes unnecessary burdens that cannot be addressed using the existing 3(c)(1) or 3(c)(7) exemptions. Some family offices acquire securities for their own account, and some family offices have holdings of a prior operating company that was once the source of the wealth enjoyed by the members of the family offices. Family offices also set up investment vehicles to acquire interests in private equity funds, hedge funds and venture capital funds, as well as family-owned operating companies. Structuring these vehicles within 3(c)(1) or 3(c)(7) can often be difficult given the requirements of the accredited investor and qualified purchaser definitions. For the

[48] 17 C.F.R. § 275.202(a)(11)(G)-1.

sponsors of private funds, due diligence processes would be streamlined when offering securities to family office members or family clients. Given there is no public interest in the registration and regulation of family offices, we encourage the Commission to support extending that treatment to the Investment Company Act and the Securities Act.

Given our significant experience in the private fund marketplace and our commitment to our membership which comprises key stakeholders in the ecosystem, ILPA appreciates the opportunity to share our views on this important concept release. We look forward to working with the Commission to ensure the right balance is struck between access to investment opportunities and corresponding investor protections.

Sincerely,

Steve Nelson
Chief Executive Officer
Institutional Limited Partners Association (ILPA)

cc. Honorable Jay Clayton, Chairman
Honorable Robert J. Jackson Jr., Commissioner
Honorable Hester M. Peirce, Commissioner
Honorable Elad L. Roisman, Commissioner
Honorable Allison Herren Lee, Commissioner

Rick Fleming, SEC Investor Advocate
Dalia Blass, Director, Division of Investment Management
William Hinman, Director, Division of Corporation Finance