March 10, 2021

Senator Sherrod Brown
Chairman
Senator Patrick J. Toomey
Ranking Member
United States Senate Committee on Banking, Housing, and Urban Affairs

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RE: On Reforms to SEC Interval Funds Rules

Dear Chairman Brown, Ranking Member Toomey, and the members of the Banking, Housing, and Urban Affairs Committee:

Private markets have become the dominant driver of growth and yield. And yet, we only allow access for the rich, while the poorest 90% of Americans are barred from these wealth-creating assets. This is unjust: one should not have to *be* wealthy to *become* wealthy. While regulators have introduced a new vehicle – the interval fund – to help retail investors access private markets, a single regulatory limitation is preventing them from properly functioning. We encourage the SEC to change its position and allow retail investors to invest in interval funds that run fund-of-funds strategies.

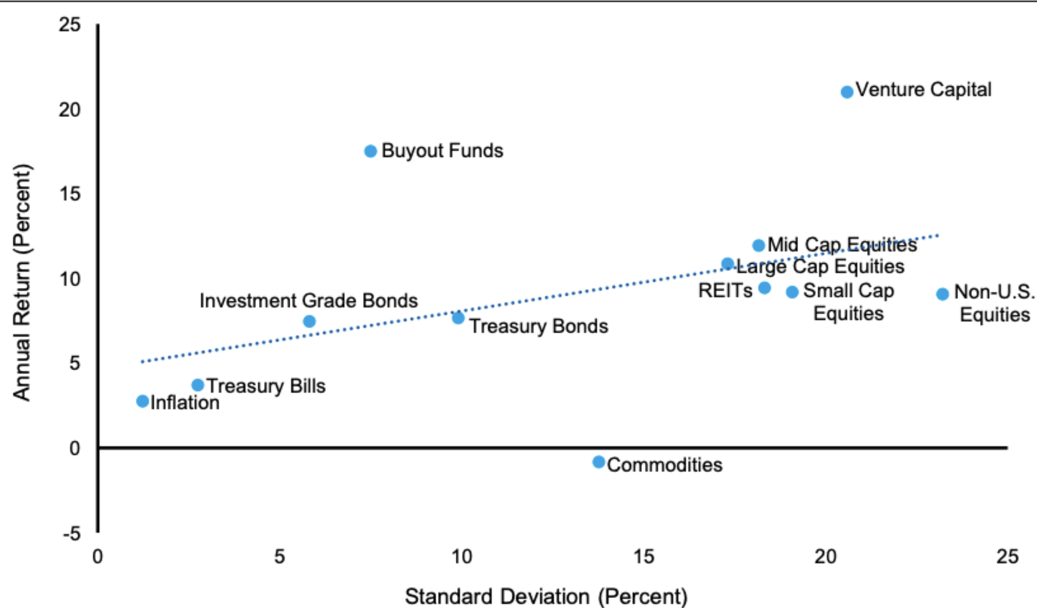
Barred from Growth

Private markets are growing faster than public markets. From 1996 to 2019, the market capitalization of public companies increased threefold from 13 trillion to 37 trillion and the assets under management (AUM) of public investment vehicles sevenfold from 1.5 trillion to 10.5 trillion, while private equity (PE) and venture capital (VC)[1] grew more than tenfold from 0.2 trillion to 2 trillion.[2] While the value of public companies grew threefold, the number of public companies declined by half.[3] This decline is almost exclusively from the loss of younger and smaller companies. Companies are going public later – from 4 years in 1999 to 11 years in 2014 – when they are

[1] We use PE and VC as examples because it is where data is most accurate and available. Our proposal extends to other private asset classes as well.
[2] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 30. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128
[3] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 3. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128

past their early growth stage.[4] Private capital markets are now spearheading economic growth: companies have raised more money in private markets than public markets every year since 2009.[5]

Alongside this shift in growth, comes a shift in yield: between 1984 and 2015, venture capital (20% Annualized) private equity (16% Annualized) significantly outperformed public equities (11% – S&P 500) on an absolute basis and even more so on a risk-adjusted basis.[6] A hypothetical retiree who put $10,000 dollars in each of these asset classes in 1984 would have received $2,370,000 from venture capital, $858,000 from private equity, but only $228,000 from public equities in 2015.



Risk and Reward for Asset Classes[7]

The privatization of growth and yield did not go unnoticed by the most sophisticated investors. Yale's endowment, for example, transitioned from 80% allocation to public assets in the 1980s[8] to less than 10% today. Yet, for the 300+ million individuals who do not qualify as accredited investors, there is no channel to be exposed to private markets.[9] Accredited investor regulations that were merely a nuisance 30 years ago when the public markets were the primary vehicle of growth, have now become the main impediment to prosperity and mobility. A single

[4] Erdogan, Begum, Rishi Kant, Allen Miller, and Kara Sprague. "Grow Fast or Die Slow: Why Unicorns Are Staying Private." McKinsey & Company. McKinsey & Company, May 11, 2019.
[5] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 3. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128
[6] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 30. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128
[7] Copied from Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 7. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128
[8] David F. Swensen, "Investment Philosophy," 1985. See http://investments.yale.edu/about-the-yio.
[9] DQYDJ. *How Many Accredited Investors are there in America?* https://dqydj.com/accredited-investors-in-america/#:~:text=We%20estimate%20in%202020%20there,trillion%20in%20wealth%20in%202020.

change in regulation – allowing retail investors to invest in public fund-of-funds – will adapt our legal framework to this new privatized economic order.

Towards Liberalization

Fortunately, regulators have realized the import of this transformation and introduced vehicles to enable retail investors to allocate to private assets, the most promising of which are interval funds. Interval funds register under the Investment Company Act of 1940 (40-act) and can be sold to retail investors. They do not offer daily liquidity, instead purchasing back shares at set intervals. This allows managers to invest in more illiquid assets. In fact, when they were made possible in 1992 by the introduction of Rule 23c-3, the SEC explicitly stated that the creation of interval funds was intended "to provide investors with greater investment flexibility and the option to invest in less liquid securities, including venture capital and small business securities."[10]

Access to the Best

This is a step in the right direction. But there is a single regulatory limitation that is preventing the SEC from realizing its own stated aim. When interval funds invest more than 15% of their assets in private funds – such as VC and PE funds – they are classified as fund-of-funds. The SEC has repeatedly taken the position[11] that such funds can only be offered to accredited investors. Effectively, this means that to offer an interval fund to retail investors, the interval fund must invest directly in private companies and cannot invest in private funds. There is no formal rule or regulation imposing this limitation and the SEC has not explicitly stated the legal basis for this decision.

This single restriction is preventing retail investors from gaining access to private assets. To this day, 61% of interval funds are available only to accredited investors.[12] The ones that are available to retail investors are almost exclusively private credit funds or simply trading illiquid strategies with public assets. Almost all private equity interval funds run fund-of-funds strategies and are limited to accredited investors. Accredited-only interval funds are favored by broker-dealers because the 40-act structure enables general solicitation: even if they can only accept money from accredited-investors, they can be marketed to anyone. What was created for retail investors, is instead used exclusively as a vehicle to sell more effectively to accredited investors!

By only allowing retail interval funds to directly invest in private companies, the SEC is encouraging the formation of *de facto* public venture capital and private equity funds. This is the wrong model of enabling retail access to private assets because good private managers will not manage public funds. As flexible as interval funds are, they are still 40-act funds: they cannot charge performance fees without limiting their client base, are subject to increased regulatory scrutiny and prohibitions, and have stringent reporting, valuation, and liquidity requirements. Because of these burdensome restrictions, top private managers would never run these funds directly and we would end up with incompetent managers who couldn't raise money in private markets. Manager selection is extremely important in

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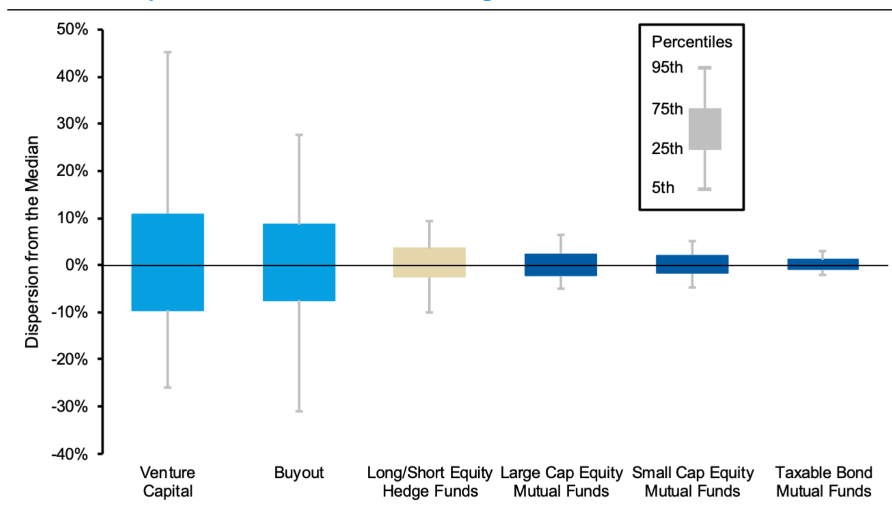
[10] 57 Fed. Reg. 34701, 34706 (Aug. 6, 1992).

[11] See, e.g., Wildermuth Endowment Strategy Fund, SEC Comment Letter (Oct. 11, 2013); Cross Shore Discovery Fund, SEC Comment Response Letter, (Sept. 17, 2015); Resource Real Estate Diversified Income Fund, SEC Comment Letter (Oct. 19, 2012); Oxford Lane Capital Corp., SEC Comment Response Letter, (Aug. 17, 2015).

[12] For the intents of our proposal, we are grouping interval and tender funds together when quoting this statistic. UMB Financial Corporation. *Unlisted Closed-End Funds: Continued Growth during Uncertain Markets*. New York, NY: UMB Financial Corporation, 2020, 4. https://irei.com/wp-content/uploads/2020/10/UMBFUSEUnlistedCEFsOct2020.pdf

private markets because of the greater variance in returns. From 1980 to 2018, choosing the 5th percentile manager meant losing only 6% annualized in small cap equity mutual funds but a whopping 27% and 32% respectively in venture capital and private equity.[13] Because top private managers will never run these public vehicles directly, the SEC's position bars those who aren't wealthy from the most effective wealth-generating asset.



Dispersion of Returns for Active Managers[14]

Freedom and Accountability

We propose a simple regulatory change: retail investors should be allowed to invest in an interval fund manager who selects private managers. On one hand, the 40-act structure is accountable to retail investors: it guarantees accurate valuations, liquidity, diversification, and disclosure. On the other, the 40-act structure preserves the freedom of private managers: it alone is burdened with these regulatory restrictions and does not transfer it upon underlying managers. Such a large pool of money would be an attractive source of capital for top private managers.

We are not alone in advocating for this amendment.[15] Beyond this primary proposal, we suggest more regulatory suggestions to assuage potential concerns.

One concern is obscurity: private funds use sophisticated and potentially confusing strategies. While this may be true for hedge funds, it is not for private equity, private credit, and venture capital funds whose strategies rarely go beyond holding long positions with leverage. The Commission could prohibit interval funds from investing in private managers who use derivatives and short-selling as a primary profit strategy.[16] Furthermore, we suggest setting a limit on the percentage of managed capital (e.g. 50%) a private fund can attribute to retail 40-act funds.

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[13] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 52. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128

[14] Morgan Stanley. *Public to Private Equity in the United States: A Long-Term Look*. New York, NY, 2020, 52. https://www.morganstanley.com/im/publication/insights/articles/articles_publictoprivateequityintheusalongtermlook_us.pdf?1596549853128

[15] For industry leaders calling for the removal of fund-of-funds prohibitions see American Investment Council, *RE: Concept Release on Harmonization of Securities Offering Exemptions*, 2019. https://www.sec.gov/comments/s7-08-19/s70819-6193322-192491.pdf; Dechert, *RE: Investment Company Act Release No. IC-33512, 2020. https://www.dechert.com/knowledge/publication/2019/9/dechert-files-a-comment-letter-in-response-to-the-sec-s-concept-.html.*

[16] This will not diminish the effectiveness of interval funds since it is not hedge-funds but private equity, private credit, and venture capital that is primarily funding the private markets anyways.

Private funds should not be allowed to only accept retail investor capital. By ensuring that retail interval funds always invest and negotiate alongside more sophisticated investors, we protect retail investors from predatorial terms.[17]

Another concern could be liquidity: private funds have long illiquid holding periods. Interval funds already address this by holding cash or having a credit line[18] – the market standard is to offer 5% redemptions every quarter. Even in the tumultuous market conditions of 2020 this liquidity schedule has not shown strain.[19]

Fees could be another concern: an interval fund that invested in private managers has two layers of fees. The existing fee disclosure requirements of 40-act funds and the proposed legislation which ensures that there will be sophisticated clients investing alongside interval funds should greatly reduce foul play. Recent regulatory rulings have also prompted better fee disclosure from private funds.[20] More importantly, private equity funds still consistently outperform the public market net-of-fees.[21]

What we are proposing is much less risky than what is currently allowed. Retail interval funds are permitted to invest in private companies – despite their being more opaque than private funds which have quantifiable track records, just as illiquid, and with none of the diversification benefits. If the former is permitted, so should be the latter. Furthermore, the existing regulations from the 40-act protect the investor by guaranteeing proper diversification, leverage-use, disclosures and the interval fund structure already mandates liquidity.

We encourage the Commission to 1. allow retail interval funds to invest in private managers 2. prohibit interval fund investments in private funds that use short selling and derivatives as a primary profit strategy 3. set a limit on the percentage of managed capital a private manager can take from retail 40-act funds. With the 40-act structure as a bridge between retail investors and our vibrant private markets, we can preserve economic freedom while fairly distributing the fruits of growth.

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[17] For an industry leader calling for a similar proposal see American Investment Council, *RE: Concept Release on Harmonization of Securities Offering Exemptions*, 2019. https://www.sec.gov/comments/s7-08-19/s70819-6193322-192491.pdf, 5.
[18] Artivest's Altegris is an example of an interval fund that has a credit line.
[19] See UMB Financial Corporation. *Unlisted Closed-End Funds: Continued Growth during Uncertain Markets*. New York, NY: UMB Financial Corporation, 2020, 3. https://irei.com/wp-content/uploads/2020/10/UMBFUSEUnlistedCEFsOct2020.pdf, 8.
[20] Dechert, *RE: Investment Company Act Release No. IC-33512, 2020. https://www.dechert.com/knowledge/publication/2019/9/dechert-files-a-comment-letter-in-response-to-the-sec-s-concept-.html, footnote 23.*
[21] See Robert Harris et al., Private Equity Performance: What Do We Know?, 69 J of Fin. 1851 (2014).