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September 24, 2019

Ms. Vanessa Countryman, Secretary  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

Re: File Number S7-08-19, RIN 3235-AM27, Concept Release on Harmonization of Securities Offering Exemptions

Ladies and Gentlemen:

Thank you for the opportunity to share our views on the “Concept Release on Harmonization of Securities Offering Exemptions.” Morningstar brings two different perspectives to the questions in the request for comment. First, through our PitchBook subsidiary, we track data on nearly 14,000 private equity (PE) funds, along with other private funds and investment opportunities, spanning venture capital, real estate, private debt, and mergers and acquisitions. Through PitchBook, we are also users of the data available on Form D. Second, we act as fiduciaries for retirement plans, particularly in selecting investments, giving us additional insight into the question in the concept release about retirement plans and private investments.

In this letter, we address two lines of questions the SEC raised: 1) Whether the Commission should take any action to make it easier for workers investing for retirement to access exempt offerings in target-date funds or through accounts managed by robo-advisers; and 2) Whether the Commission should adjust filing or other regulatory requirements, such as the requirements that trigger amendments to Form D, in light of increasing access to private investment opportunities.

**Because of Their Characteristics, We Think It Will Be Challenging to Facilitate Access to Private Pooled Investments for Ordinary Retirement Investors**

The Commission requested comment on whether it should make it easier for people saving for retirement to access exempt offerings through target-date funds and investment advisory services, including robo-advisers. Since most money *saved* for retirement is saved through employer-sponsored plans, we focus on the challenges that will be presented to employer sponsors. Although individual retirement accounts (IRAs) have more assets than defined-contribution plans, most of that money is from rollovers, and much of it is being used for the drawdown phase, when less-liquid private investments may be the least useful.

Based on our experiences analyzing private pooled investments, facilitating regular retirement investors' access to these investments will be very challenging through target-date funds or robo-advisers in employer-sponsored plans. While it may be easier to facilitate access to these investments outside of employer-sponsored plans, accredited investors already have access to exempt investments in their IRAs. If the SEC were to make it easier for target-date funds to invest in private equity funds, we think those funds would largely end up in IRAs rather than in employer-sponsored accounts. As there are fewer protections for investors outside of employer-sponsored accounts, the SEC should proceed with caution, particularly since rapid investor redemptions could lead to a target-date fund holding too much in illiquid assets, undermining confidence in those funds and perhaps registered funds more broadly.

The first challenge is that returns from private fund companies are difficult to compare and verify. Returns are easy to calculate once a fund has sold its investments and returned capital to investors. They are harder to verify and calculate while the fund is actively holding and invested in portfolio assets. Managers do not report returns consistently, and valuations are not computed in a rigorous way. This inconsistency makes it very difficult for a target-date fund considering investment into a private equity fund or a retirement plan sponsor choosing a target-date fund to engage in a prudent process to evaluate whether a private pooled investment is in the best interests of their plan participants, including the private funds that might be offered as part of a target-date fund. Plan sponsors would face a similar challenge if they wanted to include a private fund as part of an investment advisory service. For example, mark-to-market practices vary among fund managers, as do ways to account for other kinds of cash flows and the differences between the general partner's commitment and the limited partners' commitments. Although our PitchBook researchers could not find consistent evidence that internal rates of return are being systematically or consistently manipulated, the data has more subjectivity than open-end mutual funds returns data.

The second challenge is infrequent pricing and illiquidity. Target-date funds seeking to invest in private funds will certainly face challenges in complying with their liquidity risk-management programs. Further, plan sponsors will face challenges in managing daily valuations, recordkeeping, and any other operations of defined-contribution plans. As the Commission notes, target-date retirement funds generally invest in other open-end funds to obtain exposures to different types of asset classes while retaining appropriate liquidity. We believe this is because of market demand from employers and participants. Although retirement investors are theoretically long-term savers, almost all investments inside employer-sponsored plans feature daily liquidity for good reason. The labor force in the U.S. is very dynamic; people leave their jobs and find new ones all the time. Further, participants may need their money for hardship withdrawals or loans. Simply because a worker has a long-term investment time horizon vis-à-vis their retirement does not mean they can give up liquidity.<sup>1</sup>

The third challenge is that private pooled investments tend to have a high performance variance compared with other pooled investments. For example, based on PitchBook's most recent

<sup>1</sup> In contrast, of course, defined-benefit plans can manage these liquidity issues and are better positioned to invest in private markets.

private markets benchmark data, as of the third quarter of 2018, private equity had a one-year return of 13.3% and a 10-year annualized return of 11.6%, based on a capital-weight calculation. However, because of its idiosyncratic risk, private equity has a much wider spread of returns. Over the 10-year period from 2008 to 2018, the standard deviation of returns was 10.61%. In practical terms, investors who chose a fund in the top quartile enjoyed returns of 16.23%, while the bottom quartile was 5.19%. The bottom decile of funds actually produced negative returns.

In sharp contrast, mutual funds performed much more similarly over the same period. For example, the standard deviation of returns for open-end mid-cap funds and small-cap funds (two possible proxies for private equity investments in the public markets) were around 2.10% and 2.43%, respectively, over the past 10 years, according to Morningstar data. Idiosyncratic risks will make it very difficult for plan sponsors to bet on private equity funds, compared with other kinds of pooled investments, which have a much tighter spread in returns. Plan sponsors will likely shy away from an investment in which performance may deviate considerably compared with open-end funds. Again, these characteristics of private funds—a wide variance in outcomes and incomplete information—are intrinsic to private pooled investments.

Further, the solutions to address these challenges would tend to make exempt investments look much more like registered funds, blurring the differences between them and undermining the principles of keeping exempt and public offerings separately regulated. To solve these problems, the Commission would need to greatly enhance the standards of disclosure for private pooled investments, but that would make them look more like registered offerings, and perhaps defeat the point of separate markets. Attempting to find mechanisms to allow investments that are inherently illiquid into a space where customers have historically enjoyed liquidity is likely to require significant change in the infrastructure around defined-contribution plans.

### **Disclosure Requirements Should Be Enhanced if Access to Private Investments Increases**

Form D provides the Commission and investors with valuable information about private offerings. Currently, firms face limited consequences if they fail to file this form. While investors could bring an action against a firm or fund for failing to file Form D, they would unlikely do so unless other concerns, such as fraud or market manipulation, were present. The Commission does not outline specific consequences for failing to file Form D—for example, requiring an explanation or charging fines—as it does in the case of filings made by public companies. Morningstar appreciates the need to balance the burden of disclosure for private companies and funds with the need for more information if a greater range of investors are to access these investment opportunities. We recommend that the Commission consider amendments to its requirements around the completeness of Form D and consequences for a lack of filing in conjunction with any proposed rulemaking to expand access to private markets.

Further, information on this form is of a limited nature, commensurate with the fact that these offerings are not registered. Private investments are inherently more unregulated and have fewer disclosure requirements than registered funds and public companies. In Morningstar's experience with PitchBook, information obtained through Form D is usually incomplete and inconsistently provided. If such offerings were to be made more broadly available, however, the Commission would have to balance the need for better information against the cost of providing the information for private market participants.

Morningstar believes that the current Form D requirements could be expanded to better serve investors should private offerings become more widely accessible. Specifically, the Commission asks, "Are the current information requirements in Rule 506(b) appropriate or should they be modified?"<sup>2</sup> We believe that the SEC should consider changing its requirements relating to when Form D is amended.

Currently, Form D does not have to be amended if an offering is terminated.<sup>3</sup> Moreover, as the Commission has indicated, a number of other events do not trigger an amendment, including changes solely to:

1. the address or relationship to the issuer of a related person identified;
2. an issuer's revenue or aggregate net asset value;
3. the minimum investment amount, if the change is an increase, or if the change, together with all other changes in that amount since the previously filed notice, does not result in a decrease of more than 10%;
4. any address or state(s) of solicitation for a person receiving sales compensation;
5. the total offering amount, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice, does not result in an increase of more than 10%;
6. the amount of securities sold in the offering or the amount remaining to be sold;
7. the number of non-accredited investors who have invested in the offering, as long as the change does not increase the number to more than 35;
8. the total number of investors who have invested in the offering; and
9. the amount of sales commissions, finders' fees, or use of proceeds for payments to executive officers, directors, or promoters, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice, does not result in an increase of more than 10%.<sup>4</sup>

In our review, some of these events do warrant an amendment if more investors are to be permitted to participate in private offerings. Specifically, Number 5 from the above list should trigger an amendment for both private companies and funds. Additionally, Numbers 3 and 6 should trigger an amendment for private funds.

<sup>2</sup> Concept Release on Harmonization of Securities Offering Exemptions, Securities and Exchange Commission, 84 Fed. Reg. 123 (June 26, 2019) at 30486, <https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf>.

<sup>3</sup> Filing and Amending a Form D Notice: A Compliance Guide for Small Entities and Others, Securities and Exchange Commission (August 4, 2017), <https://www.sec.gov/info/smallbus/secg/formdguide.htm> (Amending a Form D Notice).

<sup>4</sup> Amending a Form D Notice.

In Morningstar’s experience with its PitchBook business, the lack of data on Numbers 5 and 6 makes it impossible to know the ultimate size of a fund offering. Funds and companies are not required to notify the Commission or the public when a fund closes or when the value of a company’s equity offering is different than anticipated. It is important for investors to know what investing opportunities are available. It is also important for companies to be aware of the availability of private capital. Thus, more information on this front would further the SEC’s mission of facilitating capital formation.

Changes in the minimum investment amount (Number 3) are also important for investors. This provides investors more information about the demand for a particular investment opportunity. For private funds in particular, the minimum investment amount should be reasonable to anticipate and update in the event of changes. For companies, it would also be helpful to have more detailed information reported in Item 9 of Form D, “Type(s) of Securities Offered.”<sup>5</sup> Information about the types of securities would help investors understand at what stage a company is in its life cycle and whether some investors have been granted preferential rights. Making these particular events trigger an amendment, and not all of the items listed above, strikes an appropriate balance between providing more information to the market and imposing regulatory costs.

We thank the Commission for the opportunity to comment on its Concept Release on Harmonization of Securities Offering Exemptions. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact either of us as indicated below:

Aron Szapiro at [REDACTED] or [REDACTED].  
Jasmin Sethi at [REDACTED] or ([REDACTED]).

Sincerely,

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Director of Policy Research  
Morningstar, Inc.

Jasmin Sethi  
Associate Director of Policy Research  
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<sup>5</sup> Form D, Securities and Exchange Commission, <https://www.sec.gov/about/forms/formd.pdf>.