Expanding access to
Non-traditional investments

September 23, 2019

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: File Number S7-08-19: Concept Release on Harmonization of Securities Offering

Dear Ms. Countryman,

Aditum Alternatives and Aditum Asset Management welcome the opportunity to respond to the SEC's request for comments "on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections". As the Commission is aware, it has been widely reported that there are fewer public companies today than there were 20 years ago and that, on average, today's public companies are much larger. (See Michael Wursthorn and Gregory Zuckerman, "Fewer Listed Companies: Is That Good or Bad for Stock Markets?" The Wall Street Journal, January 4, 2018; Jeff Sommer, "The Stock Market Is Shrinking. That's a Problem for Everyone," The New York Times, August 4, 2018). As reported by the Financial Times, "companies are now waiting about twice as long to go public. And they're raising about twice as much money in private capital markets before they do." (See Colby Smith and Brendan Greeley, "The Slow Death of Public Markets," The Financial Times, August 13, 2018.) Consequently, public market investors, including those investing via mutual funds and ETFs have less choice of underlying equities today, particularly with regard to the equity of small companies.

For over 25 years, the Fama-French three factor model has been used by finance professionals to explain the risk and return of equity portfolios. Size, referring to the higher risk/reward associated with small cap stocks, is one of its three factors. Thus, size has mattered and continues to matter to many finance professionals when constructing a portfolio. Given today's smaller universe of public equities and given that universe is comprised of fewer small companies, it may be that the type of small companies on which Fama and French based their model are much less common in today's public markets, and much less available to the portfolios of investors today. One can debate the importance of size as a portfolio factor, but the reality that today's public equity investors have fewer choices, particularly among small companies, is widely acknowledged.

<u>The Role of Private Funds</u>

Investing in private companies is an opaque process, because private companies are resistant to disclosing information to the investing public at large. For this reason, private companies have largely confined their disclosures to adviser-sponsors, who have access to sizeable pools of investment capital. These adviser-sponsors represent to sources of capital, primarily institutional investors, that their knowledge and experience qualifies them to make informed decisions regarding investing in private companies. In addition, due to the extended identification and due diligence processes needed, as well as

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the illiquid nature and the complexity associated with purchasing such assets, investing in private equity is also an episodic process. As such, access to the vast majority of private equity investments is provided through adviser sponsored co-mingled private funds, which are exempt from registration as investment companies, subscribed in the form of unfunded commitments and available only to institutions and other Qualified Purchasers (as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended).

While access to private funds and the private companies in which they invest is limited, nevertheless it appears that there is a more than adequate supply of capital available to fuel the growth of private companies. Investors and their capital are competing for investment opportunities. As noted in the forward to the Preqin Quarterly Update: Private Equity & Venture Capital Q2 2019

> "The unprecedented period of fundraising has pushed dry powder to a new high of $1.54tn as of the end of June, meaning that many investors have significant commitments yet to be deployed…
>
> …Private equity is certainly more difficult to navigate than ever, and with almost 4,000 funds seeking capital, the challenges are greater than ever for both for allocators and operators. Long-term performance is strong, investor appetite is substantial and deal opportunities are certainly out there. But for investors and fund managers alike, it will require more intensive analysis, more granular insights and more sophisticated strategies to succeed in private equity than ever before."

Institutional Liquidity for an Illiquid Asset Class

At the same time, driven in part by the record levels of dry powder in the form of unfunded commitments, institutional investors seeking immediate private equity exposure are buying interests in existing private equity funds that have already drawn and applied capital. These purchases are generally made in privately negotiated, secondary market transactions between two institutional investors. Historically, these secondary interests were frequently acquired at a discount to the fund sponsor's valuation, as the selling investor experienced a reversal of the illiquidity premium associated with holding the investment over the full 7 to 12 year life of the fund. More recently, secondary investments have at times been acquired at a premium to the fund sponsor's valuation (See Paul J. Davies, "Private Equity: So Hot Even Second-Hand Funds Can Sell at a Premium" Wall Street Journal, June 25, 2018). In addition, over the past several years, the institutional secondary market has grown substantially. As the Financial Times reported,

> "The game of pass the parcel in the private equity industry is booming with secondary market activity — the buying and selling of assets before the end of a PE fund's agreed term — running at record levels…
>
> …Deals worth $42.1bn were completed in the first half of 2019 in the private equity secondary market, up by a third on the same period last year" (See Chris Flood, "Private equity secondary deals soar", The Financial Times, September 15, 2019)

Increased demand led to increased secondary market participation, increased liquidity and more favorable pricing for sellers. However, to date, these benefits have accrued only to institutional investors.

Limited Adoption by Accredited Investors

Given the institutional interest and activity in private equity, it would stand to reason that the broader investing public would quickly embrace an opportunity to invest in private equity. Over the past

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few years, such opportunities have been available to Accredited Investors (as defined in Rule 501(a) of Regulation D promulgated under the 1933 Act) in the form of registered closed-end funds of private equity funds. However, despite the launch of several such registered closed-end funds, they have raised relatively modest assets, particularly over the past two years. We believe that those Accredited Investors who are not also Qualified Purchasers have hesitated to invest in private equity, an asset favored by institutional investors and other Qualified Purchasers, primarily due to two structural issues:

- **Liquidity** – The registered closed-end fund of private equity funds referenced above provide liquidity at a time and in an amount determined at the fund's discretion. By definition, Accredited Investors who are not Qualified Purchasers have less investable assets than Qualified Purchasers, and therefore put a greater emphasis on the potential to liquidate their investments during periods of personal and market duress. It is exactly at a time of market duress, when investors may most want liquidity – and may be willing to accept a substantial discount to net asset value, that a registered closed-end fund of private equity funds is least likely to offer liquidity, in part due to the impact on remaining fund investors.

- **Cash Drag and/or Over-Commitment** – A number of the registered closed-end funds referenced are subscribed in cash and in turn subscribe to underlying private equity funds via unfunded commitments. As a result, these registered closed-end funds are likely to have significant balances of cash and equivalents on hand, which are un- and/or under-invested while awaiting capital calls from underlying private equity funds. For some registered closed-end funds, these balances cash and equivalents have represented 35%-40% of fund net assets for extended periods. At times, these registered closed-end funds have applied cash balances to acquire secondary interests in private equity funds and over-commit (i.e. make or acquire unfunded commitments in excess of the liquid assets available to fulfill them). Of course, this over-commitment comes with an attendant risk of default, which may occur if the registered closed-end fund is unable to respond to an underlying private equity fund capital call. For some registered closed-end funds, the level of over-commitment has represented 230%-450% of fund liquid assets for extended periods.

Structural Solutions

For the past year, Aditum Alternatives has been focused on addressing these issues through modifications to the structure employed by registered closed-end funds of private equity funds. Last week at the Delivering Alpha conference, Commission Chairman Jay Clayton asked, "Can we have a fund structure to ensure that ordinary investors are getting the same deal?" (see Julie Segal, "The SEC Wants to Democratize Private Investments", Institutional Investor, September 19, 2019) We believe that Aditum Alternatives has defined such a structure. Among other features, our proposed fund structure provides individual investors with:

- **Liquidity** – Our proposed structure, as a fundamental policy, provides annual, ungated investor liquidity via collective, adviser managed access to the institutional secondary market;

- **Investor Control of Liquid Assets** – Our proposed structure provides individual investors with direct and/or indirect control of their assets when in liquid form (i.e. when not deployed in private equity investments), thereby eliminating cash drag without requiring over commitment.

As the Commission might expect, our proposed structure would require exemptive relief, largely comprised of expansions of past relief granted to other applicants. Additionally, the structure presupposes

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that the Commission will implement a form of Rule 12d1-4 (applicable to funds that invest in other funds) as proposed by the Commission in December 2018. Aditum Asset Management hopes to engage the Commission on this proposed structure later this year.

Beyond Accredited Investors

As other commenters have noted, the current position of the Commission's staff is that sales of registered closed-end funds that invest more than 15% of their assets in private funds (including private equity funds) must be limited to Accredited Investors. While this position is not currently in SEC rules or guidance, it has been consistently communicated during the registration review process. It is our view that the use of underlying private equity funds and adviser-sponsors with experience, access to private company information and deal flow, can substantially reduce risk and improve outcomes for investors in private equity. Of course, this view assumes that the adviser to a registered closed-end fund conducts the appropriate on-going due diligence and monitoring of the underlying adviser-sponsors, in order to be confident of their approach, execution and value added. However, we acknowledge that investing in underlying private equity funds may expose the registered closed-end fund investor to the risks of substantial leverage and as such may require more prominent disclosure.

We recommend that the Commission reverse the staff's current position limiting sales of registered closed-end funds that invest more than 15% of their assets in private equity funds to Accredited Investors, and instead require such registrants to establish financial suitability standards for subscribers akin to those employed by BDCs.

Defined Contribution Plans

As the Commission is aware, assets in Defined Contribution (DC) retirement plans are substantial and growing at a faster rate than Defined Benefit (DB) retirement plans. "For employer-sponsored DC plans, assets totaled $8.1 trillion as of Q3 [2018] — of which $5.6 trillion were held in 401(k) plans." (See Marlene Satter, Retirement Assets Hit $29.2T: ICI Report, ThinkAdviser, December 27, 2018) In fact, DC plan assets have recently overtaken DB plan assets. However, while DB plans have long invested in private equity, DC plans have generally not. Given the reduction in public market equities and the change in market composition, the lack of a private equity allocation may be impactful to DC plan investors. Some DC plans have acknowledged this. "Defined contribution pension plans are waking up to the reality that they will need to start allocating to private markets some way, some how." (See Isabel Markham, "Fund of funds: Opening Up the Defined Contribution World", Private Equity International, March 4, 2019).

While there is longstanding guidance from the Commission that that a DC plan could invest in a private fund even if each participant were not an accredited investor, several practical obstacles remain. We believe these obstacles are (i) investment structure, (ii) a lack of what plan trustees perceive to be adequate safe harbors per ERISA Section 404(c) and (iii) the relatively high fees associated with private equity funds. In our view, once a workable investment structure is established, the Department of Labor will be better positioned to specify and adopt the desired safe harbor. Once that safe harbor is in place, substantial DC assets will be available for investment. We believe that competition for DC plan asset allocations among private equity advisers, who will be faced with declining DB assets, will engender reduced fees for DC plans.

So again, we believe that an investment structure suitable for DC plan use, is the first pre-requisite. Fortunately, there are trends underway that, in conjunction with Aditum's proposed registered closed end

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fund structure, we expect will address this issue. Both target date funds and collective investment trusts (CITs) are growing in popularity among DC plans. As reported in Pensions & Investments:

> "The target-date managers are capitalizing on growing interest among plan sponsors for CITs, which boast lower costs, greater flexibility and fewer regulatory/administrative requirements.
>
> "We typically see 70% of inflows flowing into DC plans going to the target-date funds," said James Veneruso, a Summit, N.J.-based senior vice president and defined contribution consultant for Callan LLC, referring to the overall target- date market."

(See Robert Steyer, "CIT target-date assets surging as mutual funds hit by outflows", Pensions & Investments, June 24, 2019)

Given their well-defined, typically long-term investment horizon and relatively predictable pattern of inflows and outflows, target date funds are an ideal vehicle for incorporating private equity into an individual's retirement portfolio. Additionally, CITs have more flexibility regarding illiquid investments than do mutual funds, which may only invest up to 15% in illiquid securities. Aditum's proposed registered closed-end fund of funds structure (referenced above), includes a registered closed-end illiquid master fund in which a target date fund organized as a CIT could invest in order to get exposure to private equity.

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Thank you again for the opportunity to comment on these matters of critical importance to the investing public. Should you have any questions, please feel free to e-mail me at [redacted].

Respectfully,

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President
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