Institute for Portfolio Alternatives

September 24, 2019

VIA ELECTRONIC DELIVERY

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

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

Dear Ms. Countryman:

The Institute for Portfolio Alternatives ("***IPA***") is pleased to submit this letter in response to the request by the U.S. Securities and Exchange Commission (the "***Commission***") for comments regarding the above-referenced concept release (the "***Concept Release***"). The IPA commends the Commission for undertaking a comprehensive review of the current exempt market framework and for seeking public input on whether changes should be made to improve its consistency, accessibility, and effectiveness both for issuers and investors, while maintaining investor protections.

As the Concept Release states, today there is significantly more money being raised in the private markets over the public markets. Companies are taking longer to go public, and many are choosing not to go public. Meanwhile, unlike 40 years ago, most individuals now self-direct their investments including regarding their retirement savings. While there are more investment options available to individual investors, private market fundraising excludes many small investors in favor of pension, sovereign-wealth, hedge funds, banks and insurance companies.[1] Given the drastic change in public market fundraising, a thorough review of the exempt market system is both timely and critical for retail investors that don't have access to the same investment opportunities and portfolio diversification as institutional investors.

For over 30 years the IPA has raised awareness of portfolio diversifying investment ("***PDI***") products among stakeholders and market participants, including investment professionals, policymakers and the investing public. We support increased access to investment strategies with low correlation to the equity markets: lifecycle real estate investment trusts (Lifecycle REITs), net asset value REITs (NAV REITs), business development companies (BDCs), interval funds and direct participation programs (DPPs). IPA member firms support individual investor access to a wide variety of asset classes that have

1 *See, e.g.*, Jean Eaglesham and Coulter Jones, "The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising," The Wall Street Journal, Apr. 2, 2018, *available at* https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249.

historically been available only to institutional investors. These investment products have been held in the accounts of more than 3 million individual investors. With over $135 billion in capital investments, they remain a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for national, state and local economies. Through advocacy and industry-leading education, the IPA is committed to ensuring that all investors have access to real assets and the opportunity to effectively balance and diversify their investment portfolios.

The IPA submits the following recommendations to the Commission and supports regulatory changes that promote both capital formation and investor protection, and provide efficiency, simplicity and clarity for both issuers and investors.

I. ACCREDITED INVESTOR DEFINITION

The "accredited investor" definition is intended to encompass those individuals and entities "whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."[2] The Commission defined "accredited investor" in Rule 501 of Regulation D in 1982. With the exception of limiting the pool to exclude the value of one's permanent residence in 2011,[3] the definition has remained largely unchanged at $200,000 of income for an individual, $300,000 for a couple or $1 million in net worth, excluding the value of the investor's primary residence. Market experience has shown that these thresholds exclude sophisticated and otherwise qualified investors from pursuing opportunities currently available only to accredited investors.

IPA member firms offer investments in both publicly registered, non-listed REITS and BDCs as well as other direct participation programs that offer securities in reliance on Rule 506 of Regulation D. Accordingly, sales are restricted to natural persons and entities that qualify as accredited investors. The IPA appreciates the Commission's interest in considering a new, streamlined framework that continues to meet its dual mission of protecting investors and facilitating capital formation. We therefore recommend a three-prong approach to updating the accredited investor definition. First, we believe that net worth and income limits should be retained at their current levels. While dollar limits are not the only way to determine whether an investor has financial sophistication and the ability to sustain the risk of loss, the current amounts set forth a baseline standard with a long-established history. The Commission has also considered indexing these amounts for inflation. We believe that the current dollar limits should be maintained.[4]

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2 *See*, e.g., Rel. No. 33-6683 (Jan. 16, 1987) [52 FR 3015] (Regulation D Revisions; Exemption for Certain Employee Benefit Plans).

3 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 413(b), 124 Stat. 1376, 1577-78 (2010); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–15 (2012).

4 Should the Commission consider an inflation adjustment, we urge it to consider the practical challenges for issuers of determining accredited investor status after completion of an offering. As an example of the practical challenge of

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As a second tier, we recommend that the accredited investor pool be expanded to include individuals that have passed examinations, and received attendant licenses, that test their knowledge and understanding in the area of securities and investing, including the Series 7, Series 65, Series 66, Series 82, CPA, CFA and equivalent examinations. Similarly, we suggest that the Commission include individuals that are represented by a fiduciary or by a financial professional subject to the Best Interest standard. We encourage the Commission to explore ways to allow participation by investors based on criteria such as education, job or professional experience in securities or financial matters or relating to a particular issuer or industry, or other measures of financial sophistication such as assets under management or experience investing in exempt offerings. Finally, we suggest that the Commission include in a third tier investors that may not qualify as accredited, but are able to invest no more than: (a) 10% of the greater of annual income or net worth (for natural persons); or (b) 10% of the greater of annual revenue or net assets at fiscal year-end (for non-natural persons). This is consistent with the Commission's treatment of non-accredited investors under Regulation A, and we agree with the Commission that it is an appropriate means of protecting investors while promoting efficiency, competition and capital formation.[5]

We support changes that will expand the current definition of accredited investor in a manner that is safe and responsible, while not unduly shrinking the current pool of eligible investors. We similarly oppose recommendations further restricting investor choice by, for example, adding investment limitations to the current dollar thresholds, indexing the current amounts to inflation (thus shrinking the existing accredited investor pool), or replacing the $5 million assets test with a $5 million investments test. We support commonsense changes such as permitting spousal equivalents to pool their finances to achieve accredited investor status; permitting all entities to qualify regardless of type; and grandfathering existing accredited investors for future offerings from the same issuer. Without a grandfather provision, existing accredited investors could be excluded from investments in which they have participated previously, thus diluting their current investments.

One of the greatest areas of concern related to having a change in the definition of accredited investor is how it will impact persons engaged in like-kind exchanges under Section 1031 of the Internal Revenue Code. An investor who previously met the accredited investor standard and engages in a Section 1031 exchange may not be able to reinvest sales proceeds in a new investment when the original investment is sold. This could cause the investor to recognize significant tax liability potentially in excess of their equity.

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qualifying investors after an offering, see the discussion in Section IV below on Rule 12g-1. Further, any inflation adjustment should be made only on a going forward basis.

5 Amendments for Small and Additional Issues Exemptions under the Securities Act, 17 CFR Parts 200, 230, 232, 239, 240, 249, and 260, Release Nos. 33-9741; 34-74578; 39-2501; File No. S7-11-13.

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II. RULE 506(B) AND (C)

The IPA proposes that the Commission retain Rule 506(b) in its current form for offerings that do not use general solicitation. Rule 506(b) provides certainty, simplicity and efficiency for issuers and investors and thus is the most widely used exemption. While the IPA believes that Rule 506(b) should be modified to allow general solicitation given the significant advances in technology, consumers communication preferences through email, the Internet and social media, and firms' modern-day business practices, we acknowledge that general solicitation and advertising is incompatible with the Section 4(a)(2) private placement exemption. Therefore, legislative and/or regulatory changes may be necessary to implement this change, which the IPA would support.[6] The IPA also suggests that guidance from the Commission on whether the use by third party print media and online news sources, through publicly available Form D filings, of specific names and terms of offerings pursuant to 506(b) while the offering is currently raising capital constitutes general solicitation.

The IPA believes that there are a number of factors that have led to underuse of Rule 506(c). Rule 506(c) imposes heightened obligations on issuers compared to other Regulation D exemptions. Unlike Rule 506(b), an issuer would have to go beyond the reasonable belief of accredited status that is required by Rule 501(a).[7] Requiring that an issuer take "reasonable steps to verify" accredited investor status imposes serious consequences for failing to meet this strict liability burden of proof. An issuer that does not meet the "reasonableness" standard will not qualify for the Rule 506(c) exemption, nor any other exemption—including Rule 506(b) which relies on the Section 4(a)(2) exemption that prohibits general solicitation.[8] Without an available exemption, an issuer will have violated Section 5 of the Securities Act of 1933, which requires registration in the absence of an exemption. Verification of natural persons also imposes practical difficulties including privacy concerns associated with requiring the disclosure of personal financial information. Investors are reluctant to provide this information to someone they are directed to or have otherwise just met. It can also be more difficult for issuers to obtain information about a person's assets and liabilities than their annual income. In addition, the "reasonableness" of the steps taken to verify is susceptible to challenge long after the investment and capital raise. This raises concerns of rescission or other serious consequences for the issuer or the financial professional or intermediary that verified accreditation status.

We appreciate that the Jumpstart Our Business Startups Act of 2012 ("JOBS Act") required that the Commission promulgate rules to require the issuer to take reasonable steps to verify that purchasers are accredited investors.[9] We suggest that the Commission consider alternative and more flexible methods of

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6 For example, the Commission may consider removing the safe harbor status of Rule 506(b) and creating one unified exemption that allows general solicitation and addresses the practical challenges with underuse of Rule 506(c).

7 17 CFR § 230.501(a)

8 The reasonable belief standard of Rule 501(a) is an important provision if an investor claims incorrectly, either intentionally or inadvertently, to be an accredited investor. If the issuer reasonably believed on the basis of its own diligence that the investor met one of the enumerated categories, then the offering would not lose its exempt status.

9 Pub. L. No. 112-106, 126 Stat. 306 (2012), at Sec. 201(a)(1).

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verification that don't raise privacy concerns for individuals, or in the case of net worth, require verification every three months. We suggest that Commission provide for an annual certification process and consider self-certification as a reasonable method to establish and verify accredited investor status.[10]

III. REGULATION A

Regulation A allows companies to raise money from investors subject to certain limitations and disclosure requirements. The IPA encourages the Commission to raise the offering limit under Tier 2 of Regulation A to $100 million. This is a meaningful change for companies in industries where there are high up front, fixed costs such as real estate which requires significant capital expenditures. Increasing the threshold to $100 million also allows greater economies of scale in the time and money it takes to make a Commission filing and complete the required audit (which can be as high as $250,000 whether a company is raising $10 million or $50 million). Along with raising the total offering limit, the Commission could include additional investor protections such as requiring that investors work with a registered broker-dealer or investment adviser intermediary and include more disclosures than those in the current Form 1-A. The IPA also encourages the Commission to index the Regulation A offering thresholds to inflation.

We also encourage the Commission to allow companies to continue advertising after qualification of the Regulation A offering subject to a legend requirement, as is available during the period prior to qualification. Prior to qualification companies can utilize multiple types of marketing communications provided certain disclosures are included with the communication, including, upon filing with the Commission, disclosure regarding where to obtain a preliminary offering circular. However, immediately following qualification with the Commission the ability to market the offering is restricted to those methods that can be preceded or accompanied by an offering circular, essentially foreclosing the ability to market through print/radio/television and restricting other types of communications to those that can be accompanied by an offering circular. We believe that issuers should be allowed to continue to use the same advertising methods after qualification with the Commission as it used prior to qualification (i.e. providing marketing materials that include a legend disclosing where to obtain an offering circular).

In addition, we note that issuers conducting a Regulation A offering are not permitted to use a tombstone (following the guidance of Rule 134) to market the offering post-qualification. We request that if the Commission does not relax the advertising restrictions for Regulation A offerings to permit post-qualification advertising that is not preceded or accompanied by an offering circular, it extend the tombstone exemption to Regulation A offering.

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[10] If an additional step is viewed as necessary and provides commensurate investor benefit, then we believe a short form questionnaire and follow-up contact with the investor through electronic or other means should provide the additional confirmation necessary to meet the statutory verification requirement.

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IV. RULE 12G-1

Section 501 of the JOBS Act increased the threshold triggering public company registration from 500 to 2,000 investors, with no more than 500 non-accredited investors. It its 2016 rulemaking,[11] the Commission built in a new requirement that the 500 unaccredited investor threshold must be determined annually, at year-end. The Proposal asks whether it is difficult for an issuer to calculate the number of holders of record that were not accredited investors as of the last day of its most recent fiscal year pursuant to Rule 12g-1. We believe that this is a difficult if not impossible standard to achieve and that the Commission should permit issuers to determine accredited investor status at the time of the last sale of securities to the respective purchaser, rather than the last day of its most recent fiscal year.[12]

The Commission's rulemaking upends thirty years of accepted practice of determining "accredited" status only at the point of sale—when there are legally mandated disclosures and the ability to obtain verifiable information about investor.[13] It also impacts the longstanding certainty that public company reporting is only triggered when an issuer's investors and assets exceed set number and dollar thresholds, respectively, and not investor qualification standards. Rule 12g-1 now requires that an issuer annually confirm with its investors their ongoing financial status and consider—in the price of its offering or its operating capital—the uncertainty of triggering public company registration and yearly reporting.

The risk of public company reporting can be particularly harmful for a company with non-cash flowing investments and a fixed pool of reserves. Moreover, a number of factors may impact accredited status and trigger public company reporting—stock market or economic changes, job loss, retirement of aging investors, divorce or death (where one investor becomes three). Even a change to the Commission's definition of accredited investor could trigger a change in investor status. These costs and added risk and uncertainty are borne not only by the issuer, but also by the underlying investors with seemingly no corresponding investor protection benefit seeing as they are already invested.

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[11] *See* Final Rule, Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act; 17 CFR PARTS 230 and 240; Release No. 33-10075; 34-77757; File No. S7-12-14, available at https://www.sec.gov/rules/final/2016/33-10075.pdf.

[12] Although there are several methods that are being used to determine investor status on a year-end basis, the process is difficult and uncertain because the investors have no legal obligation to respond to an issuer's request. As a result, issuers are left with uncertainty concerning whether they will trigger Section 5 registration. First, an issuer can only count the non-accredited responses it actually receives; this will usually result in no registration. Second, an issuer can only count the accredited investor responses it receives; this will usually result in registration. Third, an issuer can count all of the actual responses it receives and can extrapolate the results. This probably is the most accurate method but is it reasonable with only a 10% to 15% response. This can cost a company up to $5,000 a year (i.e., the time and expense of contacting investors through the mail and other means, including legal costs) to make this determination and there is still no certainty.

[13] The IPA is not aware of any other securities provision that requires testing for accreditation after the transaction is completed.

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We suggest that the Commission consider amendments to provide that accredited investor status, as defined by the Commission, is to be determined only at the time the applicable person becomes a holder of record, rather than as of the last day of each fiscal year.

V. RETIREMENT SAVINGS AND DEFINED CONTRIBUTION PLANS

Since 1941, traditional pension plan participants have been treated differently than defined contribution plan beneficiaries despite both defined benefit and defined contribution plans serving the exact same investment purpose – to provide retirement income to American workers.[14] In the defined benefit context, the rules restricting access to private funds were repeatedly relaxed. Most significantly, in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551(1979), the Supreme Court determined that securities laws designed to apply to or limit access for retail investors do not apply in the defined benefit context. In the defined contribution context, the Commission adopted a more restrictive position. If participants have discretion to allocate assets held in a plan, the Commission stated that its rules apply at the participant level (and that the plan itself is not a security).[15] This has effectively prohibited defined contribution plan participants from investing in any vehicle that relies upon Section 3(c)(1) to avoid investment company registration as it has meant that investment vehicles have been generally required to look through to individual participants in defined contribution plans for purposes of satisfying the 100 beneficial owner limit. As a result, admitting even a single defined contribution plan would typically cause the fund to run afoul of the exemption.

In the late 1990s, the Commission began to recognize that rules that had the effect of prohibiting private funds from accepting investments from participant directed defined contribution plans was bad public policy. In the PanAgora Group Trust (1994), Standish Ayer and Wood (1995) and H.E.B. (2001) no action letters, the Commission updated its guidance so that private funds could rely on Section 3(c)(1) while accepting participant directed contributory plans if the vehicles met three requirements:

- The participants' discretion would be limited to allocating assets to generic investment options and the decision to make any particular private fund investment or to withdraw assets from that private fund investment would be solely that of the fiduciary that managed the plan;
- The plan would limit investment in the private fund to less than 50% of its assets invested in any investment option; and

14 Opinion of the Assistant General Counsel of the Commission – first opinion (1941). CCH Fed. Sec. L. Rep., 1941-1944 Transfer Binder, 75,195.

15 Securities Act of 1933, Release No. 628 (Jan. 15, 1981).

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- No representation would be made to participants that any specific part of their contributions or any specific portion of the assets allocated to a generic investment option would be invested in the fund.[16]

While these updates have proven helpful, very few participants have access to private funds because very few plans have developed investment vehicles that meet the three criteria. The criteria have not worked largely because:

- Implementing the restrictions and requirements in the no action letters has proven to be challenging for all but that largest 401(k) plans.
- Because plans cannot provide an assurance that any portion of plan assets will be invested in a specific fund, there has been little incentive for fund managers themselves to design standardized investment vehicles.
- Because plans cannot provide assurances that a specific fund will be used, they have typically provided generic information which has led to concerns about the opacity of these products.
- Because the first three reasons have deterred the inclusion of private funds, plaintiffs have alleged that the lack of uptake by defined contribution plans is itself a sign that these products are unsuitable to retirement savers.

The current rules distinguishing between the accredited investor status of defined benefit plan participants and defined contribution plan participants have proven to be arbitrary and have placed defined contribution plan participants at a significant disadvantage. The Commission can protect investors while giving them tools to meet their long-term investing needs. The easy fix to the challenges created by the requirements set forth in the Commission's PanAgora, Standish Ayer and Wood, and H.E.B. no-action letters is to eliminate the requirement to "look through" 401(k) plans to each individual plan participant as long as the decision to offer an investment option on a plan's investment menu is made by an ERISA fiduciary or other investment professional. Plan participants would be sufficiently shielded by the layers of protection offered by ERISA through their plan's fiduciary. Notably, this change would be consistent with the IPA's suggestion to expand the scope of the accredited investor pool to include individuals that are represented by a fiduciary or by a financial professional subject to the Best Interest standard.

This change would likely lead to the development of target-date funds that allocate a portion of their assets to portfolio diversifying investments like those offered by members of the IPA.

While changing the accredited investor rules would thus help plan fiduciaries to offer defined contribution plan participants an investment menu that best enables a path to retirement security, such guidance would represent a signal from the Commission reminding plan fiduciaries and retirement savers

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16 The Panagora Grp. Tr., SEC No-Action Letter, 1994 (Apr. 29, 1994); 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).

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that portfolio diversifying asset classes can be part of a well-designed portfolio under modern portfolio theory. There has been a recognition internationally that alternative investments can be a vital part of a long-term investment strategy. However, under the current regulatory framework, participants in contributory defined contribution plans have largely been left on the sidelines.

In addition to updating the rules surrounding Section 3(c)(1) discussed further below, the Commission's Section 22e-4 mutual fund liquidity rules similarly restrict access to alternative investments. Section 22e-4 requires mutual funds to classify each of the investments in its portfolio based on liquidity level.[17] These classifications must be routinely reviewed and used to establish a liquidity threshold (the "highly liquid investment minimum") from which the fund cannot deviate for any prolonged period of time. The rule also generally prevents funds from investing more than 15% of its assets in illiquid investments. Limiting illiquid assets to 15% means funds are generally forced to keep illiquid assets significantly below 15% or risk being forced to sell them in a firesale in a market downturn where losses in other asset classes cause the illiquid hedge to make up more than 15% of the vehicle. Allowing for greater concentration would be most helpful in designing modern target date funds for retirement savers. We encourage the Commission to allow both target date funds and other managed account products that are designed to provide a glide path similar to target date funds to have greater concentration of illiquid holdings.

VI. CLOSED END FUNDS AND BUSINESS DEVELOPMENT COMPANIES

A. Elimination of 15% Assets Limitation for Closed-End Funds

The Commission has taken an informal staff position (the "***15% Prohibition***") requiring closed-end funds to adopt a policy limiting the amounts that such closed-end funds can invest in entities excluded from the definition of "investment company." Generally, the 15% Prohibition provides that a registered closed-end investment company cannot invest more than 15% of its assets in investment funds that would be investment companies but for the exclusions under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. In some cases, the Commission has permitted this policy prohibition to be narrowly tailored to apply to "private funds employing hedging strategies (commonly known as 'hedge funds,' *i.e.*, investment funds that would be investment companies but for the exemptions under Rule 3(c)(1) or 3(c)(7) under the 1940 Act)."[18] In other cases, the Commission has required registrants to limit their investments in investment funds "that are excluded from the definition of "investment company" under the Investment Company Act of 1940, as amended (the "***1940 Act***") solely by Section 3(c)(1) or Section 3(c)(7) of the 1940 Act,"[19] with

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17 17 C.F.R. § 270.22e-4

18 *See* Griffin Institutional Access Real Estate Fund Registration Statement on Form N-2, 1933 Act File No. 333-232511, 1940 Act File No. 811-22933; *see also* Bluerock Total Income+Real Estate Fund, Registration Statement on Form N-2, 1933 Act File No. 333- 222772, 1940 Act File No. 811-22710.

19 *See* Wildermuth Endowment Strategy Fund, Registration Statement on Form N-2, 1933 Act File No. 333-191152, 1940 File No. 811-22888.

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no corresponding additional use of strategy limitation used to exclude the subject funds from the 15% Prohibition.

The 15% Prohibition does not have a statutory basis in the 1940 Act. Such a limitation was not discussed in Congressional hearings nor subject to the typical comment and review process required for the promulgation of regulations by federal administrative agencies. Rather, the adoption of some variant of the 15% Prohibition, depending on what is requested during the registrant's comment and review process, is required as a condition for a declaration of effectiveness of a registrant's registration statement by the Commission. Presumably, the policy rationale for the 15% Prohibition is to prevent non-qualified investors, such as non-qualified purchasers, from investing indirectly in entities that they would be unable to invest in directly, in violation of Section 48(a) of the 1940 Act.[20]

However, the justification for the 15% Prohibition has never undergone the public scrutiny of the formal rulemaking process of the Commission, nor has the motivation been clearly articulated to registrants. The resulting lack of transparency and inconsistent application of the 15% Prohibition is therefore an example of the "patchwork of non-public guidance" that has resulted in a "body of secret law" that is "immune from judicial – and even Commission – review" that has been the subject of recent criticism from at least one Commissioner.[21] Moreover, eliminating the 15% prohibition would accomplish a number of the objectives outlined in the Concept Release. Specifically, allowing closed-end funds to invest more freely in private funds would allow retail investors to gain exposure to a large segment of the market from which they have long been excluded, but through a registered, regulated vehicle in which they would benefit from professional management and all of the investor protections embodied by the 1940 Act, transparency, governance and a fiduciary duty, to name a few.

IPA therefore urges the Commission staff to abandon the policy of requiring future registered closed-end investment companies to adopt the 15% Prohibition as a condition to declaration of effectiveness. IPA further urges existing closed-end investment companies to be permitted to rescind this policy in future filings with the Commission.

B. <u>Permitting Closed-End Funds and BDCs to Issue Multiple Classes of Shares</u>

On February 23, 1995, the Commission adopted Rule 18f-3 under the 1940 Act to permit open-end funds to issue multiple classes of voting stock representing interests in the same portfolio without obtaining an exemptive order.[22] In the Rule 18f-3 Adopting Release, the Commission acknowledged the significant amount of resources devoted to issuing exemptive orders to permit open-end funds to offer multiple classes

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20 *See* 15 U.S.C. §80a-48(a).

21 *See* Commissioner Hester M. Peirce, Secret Garden: Remarks at SEC Speaks 2019, Washington, D.C., April 8, 2019, *available at* https://www.sec.gov/news/speech/peirce-secret-garden-sec-speaks-040819.

22 Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Rel. No. IC-20915 (February 23, 1995), codified as amended at 17 C.F.R. § 270.18f-3 ("***Rule 18f-3 Adopting Release***").

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of shares by stating that "[s]ince 1995, the Commission has issued approximately 200 exemptive orders allowing funds to issue multiple classes of shares."[23] The Commission stated that offering multiple classes of shares "may increase investor choice, resulting in efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to different investor markets."[24] In the Rule 18f-3 Adopting Release, the Commission cited to the potential benefits permitted by offering multiple classes of shares, noting that fund sponsors could "attract larger asset bases, permitting them to spread fixed costs over more shares, qualify for discounts in advisory fees ('breakpoints'), and otherwise experience economies of scale, resulting in lower fees and expenses."[25]

Examining the results in open-end fund fees and expenses since adoption of Rule 18f-3 is instructive. On an asset-weighted basis, average expense ratios[26] incurred by mutual fund investors have substantially decreased.[27] In 2000, equity mutual funds incurred expense ratios of 0.99%.[28] By 2018, that ratio had fallen to 0.55%, or a decline of 44%.[29] A factor in contributing to the decline in average expense ratios is the rise in no-load share classes, or share classes that have neither a front-end load nor a contingent deferred sales load, and often on a 12b-1 fee of 0.25% or less.[30] Over the past few decades, the way that fund shareholders compensate financial professionals has changed significantly, moving away from upfront sales loads paid at the point of sale, or "front-end loads," to an asset-based fee. Indeed, funds with front-end loads have experienced net cash outflows every year since 2009, often considerable decreases.[31] By contrast, no-load funds experience cash inflows every year since 2009 except for 2018.[32] There is a pronounced trend towards lower expense ratios and demand for lower or nonexistent sales loads since adoption of Rule 18f-3 in 1995.

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23 *Id.*

24 *Id.*

25 *Id.*

26 An expense ratio is the percentage of assets claimed annually for operating the fund. Distribution fees (or 12b-1 fees) are included the expense ratio calculation. Upfront sales loads are not included in the expense ratio calculation.

27 2019 Investment Company Fact Book, Investment Company Institute (2019), *available at* https://www.icifactbook.org/.

28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.* Front-end load funds experienced net cash outflows of $56 billion in 2010, $100 billion in 2011m $67 billion in 2012, $57 billion in 2013, $160 billion in 2014, $101 billion in 2015, $183 billion in 2016, $218 billion in 2017, and $156 billion in 2018.

32 *Id.* No-load fund experienced net cash inflows of $266 billion in 2010, $169 billion in 2011, $299 billion in 2012, $271 billion in 2013, $339 billion in 2014, $79 billion in 2015, $122 billion in 2016, $450 billion in 2017, and a net cash outflow of $7 billion in 2018.

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Closed-end investment companies were not included in the relief granted to open-end investment companies under Rule 18f-3. IPA submits that closed-end investment companies in 2019 are similarly situated to open-end investment companies in 1995. Since 2000, there have been over 100 exemptive relief applications filed requesting relief from Section 18 allowing closed-end investment companies to issue multiple classes of shares. These applications contain identical terms and conditions across applicants. Indeed, applicants often provide the Commission with a redline comparison showing the differences between a precedent application filed by a non-affiliate and the applicant's application to aid the Commission in its review. While this process is routine and exemptive orders are routinely granted, IPA submits that it is an inefficient use of Commission resources to review each application to grant an exemptive order with customary and uniform conditions across applicants, as well as a poor use of fund resources to pay for such an application. In addition, IPA notes that unlike registered closed-end investment companies, business development companies have never been granted an exemptive order permitting it to issue multiple classes of shares, despite having filed the initial exemptive relief application almost five years ago.[33] IPA therefore asks the Commission to amend Rule 18f-3 to include closed-end investment companies, including business development companies, in the relief granted to offer multiple classes of shares.

C. Permitting Tender Offer Funds to Use Notification Process of Rule 23c-3

Tender offer closed-end investment companies are investment companies registered under the 1940 Act but conduct share redemptions pursuant to a discretionary share repurchase program, rather than the mandatory provisions of Rule 23c-3 that apply to interval funds.[34] Rule 23c-3 requires an interval fund to adopt a fundamental policy to repurchase its securities, changeable only by a majority vote of the outstanding voting securities of the interval fund, and under which the interval fund may only suspend or postpone a repurchase offer pursuant to a vote of a majority of the directors, and then only under very limited conditions.[35]

By contrast, a tender offer closed-end investment company's share redemption program is discretionary and may be amended, suspended, or terminated by the board of directors at any time and for any reason, though usually the board is required to provide advance notice of such amendment, suspension, or termination prior it taking effect. Because a tender offer closed-end investment company is not subject to Rule 23c-3, it must conduct its share redemptions in accordance with Rule 13e-4 of the Securities Exchange Act of 1934, as amended.[36]

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33 FS Energy & Power Fund II, Application Pursuant to Section 6(c) of the Investment Company Act of 1940, as Amended, For An Order Granting Exemptions from Sections 18(c), 18(i), and 61(c) of the 1940 Act and Pursuant to Sections 17(d) and 57(i) of the 1940 Act and Rule 17d-1 Under the 1940 Act, filed on October 24, 2014.

34 17 C.F.R. §270.23c-3.

35 *Id.* at (b)(3).

36 17 C.F.R. §240.13e-4.

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A company conducting a tender offer must comply with significant disclosure and substantive requirements. In addition, the filing requirements associated with an issuer tender offer are extensive. First, the issuer files a Schedule TO, which includes as exhibits the formal offer to purchase to shareholders, a letter of transmittal to shareholders, and letters to shareholders. The total documentation associated with the Schedule TO filings regularly exceeds 40 pages. In addition, after completion of the tender offer, the issuer must file an amended Schedule TO providing the results of the tender offer.

By contrast, interval funds are only required to file a Form N-23c-3, the notification of a repurchase offer, which consists of approximately five pages describing the terms of the repurchase offer, and an additional five pages containing the repurchase request form to be completed by the shareholder.

IPA submits that shareholders incur significant additional expenses, and receive no corresponding benefit, from the increased filing requirements associated with operating its share redemption program pursuant to the tender offer rules. IPA urges the Commission to consider permitting tender offer closed-end investment companies to take advantage of the reduced filing requirements of Rule 23c-3 by permitting them to use the streamlined notification procedures of Rule 23c-3.

D. Permitting Interval Funds to Conduct More Frequent Repurchases under Rule 23c-3

Rule 23c-3 defines "interval period" as meaning an interval of three, six, or twelve months.[37] In addition, interval funds are permitted to make one discretionary repurchase offer every two years.[38] As a result, an interval fund can, in practice, make repurchase offers to investors not more frequently than once a quarter. Rule 23c-3 sets forth certain definitions that contain timing requirements:

- Repurchase Request Deadline: This is the date by which shareholders must notify the interval fund of their participation in the repurchase offer. The repurchase request deadline can be no more than 42 days nor less than 21 days from the date that an interval fund sends notice of a repurchase offer to shareholders.
- Repurchase Pricing Date: The date on which the shares being repurchased are valued. The repurchase pricing date can occur no later than 14 days after the repurchase request deadline.
- Repurchase Payment Deadline: The date by which the fund must pay participation shareholders their consideration for the shares being repurchased. A repurchase payment deadline must occur seven days after the repurchase pricing date.

The significant length of time for the repurchase request deadline (21-42 days) is to ensure that shareholders have enough time to determine whether to participate in a repurchase offer. The length of time for the repurchase pricing date is to allow the interval fund investment adviser flexibility to meet repurchase

37 17 C.F.R. §270.23c-3(a)(1).

38 *Id.* at §270.23c-3(c).

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requests. The repurchase payment deadline's seven-day requirement is intended to match the seven-day requirement applying to open-end investment companies.

IPA urges the Commission to permit repurchase offers to occur monthly, rather than quarterly. IPA notes that the Commission has already permitted, via exemptive order, certain interval funds to make repurchase offers on a monthly basis; this would merely codify what the Commission has already granted via exemptive order.[39]

To permit monthly interval periods, the Commission should consider whether it is necessary to shorten some of the regulatory deadlines set forth in Rule 23c-3. For example, the 21-42 day period for the repurchase request deadline could be shortened, since any shareholder that has not determined whether to participate in the shortened repurchase request deadline would be able to participate the following month, rather than waiting until the following quarter. In addition, in practice an interval fund investment adviser does not need 14 days to price the repurchase offer. Most interval funds calculate a net asset value daily; as a result, interval funds do not need 14 days to price a repurchase offer. Finally, while seven days is permitted to elapse between the repurchase pricing date and the repurchase payment deadline, in practice most interval funds, like open-end funds, pay redemption proceeds in cash to redeeming shareholders within a day or two of the repurchase request deadline.

As a result, IPA urges the Commission to permit interval funds the flexibility to conduct more frequent repurchases should those interval funds determine that more frequent repurchases are in their shareholders' best interests. Permitting monthly intervals coupled with a corresponding reduction between the repurchase request, pricing and payment dates likely necessitates facilitating such correspondence electronically. The IPA further suggests that the Commission explicitly permit repurchase communications to be transmitted electronically.

E. Eliminating Qualified Client Look-Through Provision of Rule 205-3

Section 205(a)(1) of the Advisers Act prohibits a registered investment adviser, including a state-registered investment adviser, from entering into any advisory contract that provides for its compensation to be based upon a share of the capital gains or capital appreciation in a client's account or any portion thereof (the "***Performance Fee Prohibition***").[40] Rule 205-3 provides an exemption from the Performance Fee Prohibition, and permits a registered investment adviser to enter into a performance fee arrangement

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39 *See, e.g.,* Weiss Strategic Interval Fund and Weiss Multi-Strategy Advisers LLC, Rel. No. IC-33101 (May 21, 2018) (notice), Rel. No. IC-33124 (June 18, 2018) (order); Blackstone / GSO Floating Rate Enhanced Income Fund, et al., Rel. No. IC-32865 (October 23, 2017) (notice), Rel. No. IC-32902 (November 20, 2017) (order); Van Kampen Asset Management, et al., Rel. No. IC-27317 (May 12, 2006) (notice), Rel. No. IC-27390 (June 7, 2006) (order); ING Pilgrim Investments, LLC, et al., Rel. No. IC-25167 (Sep. 21, 2001) (notice), Rel. No. IC-25212 (Oct. 17, 2001) (order); CypressTree Asset Management Corporation, Inc., et al., Rel. No. IC-23020 (Feb. 4, 1998) (notice), Rel. No. IC-23055 (Mar. 3, 1998) (order).

40 15 U.S.C. § 80b-5.

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with certain sophisticated clients that have the capacity to bear the additional risks of the arrangement. Rule 205-3 therefore acknowledges that there are circumstances in which a performance fee is appropriate. Specifically, Rule 205-3 provides that Section 205(a)'s Performance Fee Prohibition is not deemed to prohibit an investment adviser from entering into, performing, renewing, or extending an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains upon, or the capital appreciation of, the funds or a portion of the funds of a client, provided that the client is a "qualified client."[41]

Under ordinary circumstances, an investment adviser to a pooled investment vehicle, rather than a natural person, may consider the pooled investment vehicle to be the "client." It, and not the investors in the pooled investment vehicle, is in privity of contract with the investment adviser, and it determines whether to renew, amend, or terminate the investment advisory relationship. However, Rule 205-3(b) provides for special requirements to determine whether a company is a "qualified client" under Rule 205-3. Specifically, all companies may be considered "qualified clients" if each of them meets the dollar requirements set forth above *except for*:

- a private investment company exempted from registration by Section 3(c)(1) of the 1940 Act;
- an investment company registered under the 1940 Act; and
- a business development company (as defined in Section 202(a)(22) of the Advisers Act).[42]

None of those three entities are considered "qualified clients" unless each of its underlying equity owners satisfies the "qualified client" dollar threshold as well. Thus, every investor in those entities must satisfy the "qualified client" definition.

Alternative investment funds such as hedge funds and private equity funds relying on the Section 3(c)(7) exemption from the 1940 Act regularly charge incentive allocations of 20% of realized and unrealized gains, a fact that the Commission has noted.[43] And while the Commission has stated that these performance fees typically charged by hedge fund advisers are often perceived as creating incentives for investment advisers to take greater risks with client assets, in practice the investment advisers to hedge

41 17 C.F.R. § 275.205-3(a).

42 Note that investment advisers to business development companies are permitted to charge compensation of up to 20% of the realized capital gains of the business development company over a specified period or as of definite dates under Section 205(b)(3) of the Advisers Act, and therefore while Rule 205-3 seeming prohibits them from receiving a fee on the basis of a share of capital gains upon, or the capital appreciation of, the business development company, in practice investment advisers to business developments regularly charge and receive such fees.

43 *See* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003).

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funds and private equity funds adopt certain investor protections, such as high water marks,[44] hurdle rates,[45] and clawbacks,[46] to ensure that the compensation paid to the adviser is fair, and are examples of innovations developed by the private investment fund industry to guard against an investment adviser taking undue risk to reap bigger fees.

Requiring all investors in registered investment companies to be "qualified clients" therefore limits retail investor access to the potential benefits provided by these investment companies and the access to exempt offerings that they provide. Unlike open-end mutual funds, which are prohibited from acquiring illiquid investments if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments, closed-end funds do not have this limitation, and as a result have been utilized by certain private equity fund sponsors to offer investment strategies or access to exempt offerings similar to their private equity funds available only to investors meeting the "qualified purchaser" definition under Section 2(a)(51)(A) of the 1940 Act. The Commission has noted the potential benefits to retail investors that could arise through access to these types of investing strategies or exempt offerings in its Concept Release. A challenge to investment companies in attracting investment management talent is the inability to offer a performance fee to those portfolio managers, subjecting investment companies to a significant disadvantage relative to their hedge fund and private equity fund peers. Eliminating the requirement that all investors be "qualified clients" would generate significant interest in utilizing investment companies as a means to raise capital by private equity fund sponsors, and would provide a much-needed boost to active investment fund managers seeking to compete with passive investment funds. Indeed, at least one Commissioner has acknowledged that allowing funds to experiment with performance fees may be one way to facilitate the continued availability of actively managed funds.[47] Permitting active fund managers to charge a performance fee is therefore critical to the health of the active fund management industry, which is under severe pressure from passive fund management.

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44 Generally, a high water mark varies for each limited partner based on the maximum value of the limited partner's interest in the partnership since its initial investment in the fund. The investment adviser must generate investment returns beyond the "high water mark" before the investment adviser can assess an incentive allocation. In essence, the hedge fund's performance must surpass its previous high point before additional incentive allocations can be assessed. This prohibits an adviser from collecting an incentive allocation twice for the same performance. *Id.*

45 Hurdle rates are also used to guarantee that the hedge fund achieves a minimum investment performance before the fund's adviser may receive any incentive allocation. A hurdle rate establishes a performance floor that the investment adviser must exceed in order to obtain the incentive allocation. *Id.*

46 A clawback is a contractual provision which adjusts for distortions of the intended economic arrangement attributable to the timing of gains and losses of a fund. It requires the fund manager to restore to the fund all or a portion of performance fees previously payable to the fund manager so that the cumulative distributions are consistent with the profit-sharing formula agreed to by the parties. A clawback will result in the fund manager returning all or any portion of the performance fee previously received to the fund's investors.

47 Commissioner Hester M. Peirce, Pickups and Putdowns: Remarks at the Financial Planning Association 2018 Major Firms Symposium, Chicago, Illinois, October 2, 2018, *available at* https://www.sec.gov/news/speech/speech-peirce-100218.

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IPA notes that while certain commentators have asserted that neither Congress nor the Commission have clearly articulated any reasonable basis for the Performance Fee Prohibition,[48] providing that the "client" of the investment adviser is the investment company itself would be consistent with one rationale cited by the Commission, namely that certain clients, because of their wealth and financial knowledge and experience, or ability to negotiate the terms of the advisory contract, may not need the protections which the prohibitions on performance fees is intended to provide.[49] The release published in 1983 initially proposing Rule 205-3[50] contained a "knowledge and experience" test in which the investment adviser was required to reasonably believe that the client, alone or acting with a representative, had the knowledge and experience in business and financial matters to evaluate the merits and risks of a performance fee arrangement.[51] Later, the Rule 205-3 adopting release published in 1985 replaced that test with other conditions designed to ensure that the rule is limited to clients to fend for themselves in negotiating their advisory contracts.[52]

As the Commission is aware, the 1940 Act contains procedural safeguards to be followed for the negotiation, approval, or continuation of an advisory contract with an investment company. Section 15(c) requires the disinterested directors to separately approve the advisory contract (or its continuance) in person, and requires all directors to request and evaluate, and the investment adviser to furnish, such information as may be reasonably necessary to evaluate the terms of the advisory contract.[53] The "Section 15(c) process," as it is commonly known, has been called the "cornerstone of the fund governance mandate set forth in [the 1940 Act]"[54] and "[o]ne of the board's most important duties" by scholars.[55]

In practice, the board of directors of an investment company sends to the investment adviser a "Section 15(c) questionnaire" with a list of information required for the directors' review of the advisory contract, and the investment adviser must respond in writing with the requested information. This obligation is not perfunctory; the Commission has held investment advisers, as well directors, liable for failing to satisfy specific duties imposed upon them by Section 15(c) of the 1940 Act, including providing

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48 *See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION 304 (1982).

49 Rule 205-3 Proposing Release, *supra* note **Error! Bookmark not defined.**.

50 Conditional Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Rel. No. IA-865 (June 10, 1983).

51 Rule 205-3 1983 Release, *supra* note **Error! Bookmark not defined.**.

52 Conditional Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Rel. No. IA-961 (March 15, 1985).

53 15 U.S.C. §80a-15(c).

54 H. NORMAN KNICKLE, THE MUTUAL FUND'S SECTION 15(C) PROCESS: JONES V. HARRIS, THE SEC, AND FIDUCIARY DUTIES OF DIRECTORS, 31 REV. OF BANKING & FIN. L.265 (2011).

55 ROBERT ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS 6-3 (2011).

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incomplete responses and the failure to request additional information or clarifications.[56] In addition, Section 36(b) of the 1940 Act, as interpreted by the Supreme Court, establishes a fiduciary duty on the part of fund advisers with respect to their receipt of fees, and grants fund shareholders the express right to bring lawsuits in federal court for breaches of this duty.[57] IPA submits that the safeguards and established process of Section 15(c) (and attendant failure to follow that process), as well the presence of the board of directors, including the disinterested directors, provides shareholders of investment companies with sufficient representatives to negotiate the terms and continuance of any advisory contract providing for a performance fee, and that therefore the investment company should be considered the "client" for purposes of Rule 205-3.

In addition, providing parity with other companies and acknowledging that the "client" of the investment adviser is the investment company itself, and only it need be the "qualified client," would be consistent with interpretations of the Advisers Act. For example, in the context of an assignment of an advisory contract, the wording of Section 205(a)(2) provides that consent is only required from the "other party" to the contract, which as noted above would be the investment company itself. Section 205(a) of the Advisers Act may therefore be distinguished from Section 15 of the 1940 Act, which explicitly requires approval by "the vote of a majority of the outstanding voting securities of such registered investment company" in the context of an assignment.[58] Both the 1940 Act and the Advisers Act therefore acknowledge a distinction between the client (the investment company) and the outstanding voting securities held by investors of the client. Acknowledging that the "client" of an investment adviser to an investment company is the investment company itself, and not its equity holders, would be consistent with this distinction and would also be consistent with relevant case law. In *Goldstein v. SEC*,[59] the court held that for purposes of the Advisers Act the word "client" is not synonymous with the word "investor" but itself refers to the relevant fund.[60] The court noted that the Advisers Act repeatedly made reference to "clients" and stated that "the kind of fiduciary relationship the [Advisers] Act was designed to regulate" was between the "client" (*i.e.*, a fund and not each individual investor) and an investment adviser. Thus, amending Rule 205-3 to remove the requirement that each equity owner to an investment company be a "qualified client" would be consistent with the distinction in the Advisers Act and related case law between the "client" and the "investor" and would also serve to provide access to retail investors of the type of institutional quality asset management available currently to high net worth investors. It would allow investors who seek a broadly diversified investment portfolio consisting in part of exempt offerings to benefit from these types of sophisticated asset managers, a key goal of the Concept Release.

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56 *See* Commonwealth Capital Management, Rel. No. IC-31678 (June 17, 2015);

57 Jones v. Harris Assocs. L.P., 559 U.S. 335, 348 (2010).

58 15 U.S.C. §80a-15(a).

59 451 F.3d 873 (D.C. Cir. 2006).

60 *Id.*

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If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at (202) 548-7190.

Sincerely,

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