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SEC May Lift Limits on Private Alts Funds for Retail Market

By Tom Stabile   August 5, 2020

The Securities and Exchange Commission is considering the removal of staff guidance that limits closed-end funds with large quantities of illiquid assets to an accredited investor audience – a change that could pave the way for more private equity and hedge fund strategies to reach retail investors. It's also a move the agency can take immediately, without a formal rules change.

The potential move was one of several ideas that Dalia Blass, director of the SEC's Division of Investment Management, outlined last week during a Practising Law Institute forum in which she posed questions to the industry on the broad theme of expanding access to alts for retail investors. Most of her comments focused on target date, tender offer, and interval fund structures that could deliver alts to the retail market.

"I believe there are two potential 1940 Act-registered fund structures we could explore to provide enhanced access to private investments," she said. "They are target date funds and closed-end funds of private funds. Both could provide convenient, professionally managed means for Main Street investors to invest in these markets."

Under Chairman Jay Clayton, the SEC has made expanding alts access to more investors a priority, including a sweeping concept release issued last year that collected industry comment on possible initiatives and rule changes. But with the prospects of a new president and administration in 2021 or of Clayton leaving for another post, the timeframe for potential moves from the concept release is shortening, says Rajib Chanda, attorney and partner at Simpson Thacher & Bartlett.

“They’re kind of running out of time,” he says. “Regardless of what happens in the election, it’s unclear if any successor would have the same focus. For better or for worse, we’re nearing the end of this particular chapter, and it’s really anybody’s bet where it goes next.”

That’s why some of the changes Blass discussed last week are intriguing, because they may be possible in short order, says **George Silfen**, partner and attorney at **Kramer Levin Naftalis & Frankel**. Unlike new rules or amendments that require 90-day comment periods and several levels of review, a change to a staff position can take place immediately, he says.

“As a matter of policy, if the SEC supports greater access to private equity and hedge funds, then I think they can do it through closed-end funds relatively easily and relatively quickly,” he says. “She seems to be paving the way for the SEC staff to relax that position.”

During a portion of the speech where Blass laid out about a dozen related questions, she left breadcrumbs for industry players, Chanda says.

“From her questions, you can get a sense of what the staff’s final guidance might look like,” he says.

In the speech, Blass recounted some of the main goals of Clayton’s alts expansion initiative, before putting direct focus on closed-end funds of funds and target date funds, which many in the industry hope will be another vehicle through which private alts managers can deliver their strategies to retail investors in defined contribution retirement plans. But while the target date funds route would require approval from other agencies, the SEC is the primary agency overseeing closed-end funds.

“While a few closed-end funds of private funds exist in today’s marketplace, the staff of the division has historically raised investor protection concerns if these products were to be offered to retail investors,” she said. “For this reason, closed-end funds with more than 15% of their assets in private funds have, in the past and at the division’s urging, limited their offerings to accredited investors. The division is currently re-examining whether this staff position should be reviewed consistent with our firm commitment to investor protection.”

Blass framed the questions around closed-end fund of funds vehicles that don't offer daily redemptions and therefore can hold illiquid assets. She asked whether any fund of funds under relaxed rules should be limited to underlying managers that meet experience and scale criteria; whether interval funds or tender offer funds are preferable; and whether managers in new structures should receive performance-based compensation or payment in the form of fund shares. She also asked how to prevent "an extra layer of fees and expenses" in such products.

Blass opened up the call for comment to managers, investors, and other market participants, asking them to contact the SEC staff directly. But unlike with a rule change, there is no deadline, and there will be no formal collection and publication of comment letters, according to a source familiar with the matter.

The Blass speech appears to envision a narrow version of fund of funds products that might be available to retail investors, according to a Simpson Thacher alert. "[I]t appears that the staff is not considering a full retraction of the 15% limitation, but rather a more nuanced approach that would permit registered funds of private funds that meet certain criteria to be available to retail investors," the memo states.

Several existing funds of funds already in the market may qualify to reach retail investors if the SEC changes its staff position, allowing those managers to simply expand their distribution efforts, Silfen says. But changing the staff guidance would also spark development of new products, he says.

"Once you expand distribution, that could bring more capital to the underlying private hedge funds and private equity funds," he adds.

If the SEC were to change its staff position on the 15% fund of funds limit, managers would most likely choose to offer closed-end tender offer vehicles to reach retail investors, because those structures don't require valuation as frequently as interval funds, Silfen says. And while, for now, the rule would most likely apply to non-listed funds, a staff position change could open the door for the SEC to expand the concept to closed-end funds traded on exchanges as well, he says. "That's potentially the most exciting piece of this," he adds.