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By Nasdaq Private Market Team

INVESTMENTS & WEALTH INSTITUTE®

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Private market investments have become increasingly important to investors. Outperformance to the public markets, particularly through the financial crisis, drove the increasing investment in this space over the past 10 years. Private market assets under management now stand at a record high of $5.8 trillion; private equity represents $3.4 trillion, and an additional $2 trillion in dry powder is ready to be deployed.[1] Ultra-high-net-worth and high-net-worth investors continue to participate in record fundraises as many aim to allocate more than 20 percent of their portfolios to alternatives.[2] At the same time, the broader wealth management world looks for ways to satisfy the recommended allocations that their chief investment officers are making to the private markets.

ACCESS TO PRIVATE MARKETS

One of the biggest challenges of investing in private markets always has been access. Retail and smaller high-net-worth investors have had limited access to the wealth opportunities in private markets available for institutional investors. Even Securities and Exchange Commission Chairman Jay Clayton has commented about the lack of access to private markets. In a speech delivered at the Economic Club of New York in September 2019, Clayton stated:

> *We should: (i) increase the attractiveness of our public capital markets as places for companies to raise capital, and (ii) increase the type and quality of opportunities for our Main Street investors in our private markets.*

Access is greatly challenged by three things: high minimum investments, high accreditation standards, and lack of liquidity.

One solution to these challenges has been the proliferation of registered funds such as interval-style or tender offer funds. The Investment Company Act of 1940 registration lowers barriers to access, in some cases down to accredited investors for minimums as low as $25,000 in practice. If the fund is filed as a tax-regulated investment company (RIC), it can use 1099 tax reporting, which eliminates the tax complexities of the K-1.

Although these structures do provide access in an evergreen format with simplified tax reporting, their liquidity is limited to a certain percentage of assets that investors can redeem on a quarterly basis (usually 5 percent of the overall fund value). This also introduces a cash drag issue, particularly when the underlying investments are as illiquid as private equity. The fund manager needs to hold enough cash to satisfy redemptions without being forced to sell the underlying investments, which can lead to a host of operational issues and potentially lower returns than if that capital had been invested. This also may increase the possibility that investors are unable to redeem when requested redemptions are above that limit.

How can an investor get access to private markets without cash drag?

Auction funds make a small tweak to registered funds with impactful results: Liquidity comes in the form of a secondary market where investors can buy and sell shares on a monthly basis without affecting the underlying assets.

How is this possible? Nasdaq Private Market was granted limited exemptive relief by the Securities and Exchange Commission from Rule 102 of Regulation M under the Securities Exchange Act of 1934, which allows Nasdaq Private Market to conduct periodic liquidity auctions for certain '40 Act registered funds.

AUCTION FUNDS: AN OVERVIEW

Auction funds can be thought of as privately placed versions of exchange-traded funds (ETFs) for illiquid assets. As with ETFs, the primary liquidity mechanism for investors is a market auction instead of a redemption or tender back to the fund. And, also like ETFs, various mechanisms are in place to keep the auction pricing near net asset value (unlike traditional closed-end funds, which often trade at significant spreads to net asset value).

The technical description is a bit more involved. To start, auction funds are closed-end, but continuously offered, investment funds. They typically are registered under the Investment Company Act of 1940 or are business development

Figure 1

KEY CHARACTERISTICS AND BENEFITS OF AUCTION FUNDS

KEY CHARACTERISTIC	DETAILS	POTENTIAL BENEFITS / OUTCOMES
Investors may not face capital calls as they do with traditional private equity and similar funds, since investor capital is funded at the time of investment.	When an auction fund needs additional capital for investments, it simply issues more shares, just as traditional open-end mutual funds do at net asset value.	Investment minimums can be set at low levels, i.e., thousands of dollars, instead of the hundreds of thousands required for most private partnership funds; investors also are freed from long-term commitments.
As tax RICs, auction funds will issue 1099s rather than K-1s, and they will not throw off unrelated business income.	The issue of unrelated business income can force private equity funds to be organized with an offshore blocker, but this is not needed to shield auction-fund income.	Auction funds will be eligible for purchase by individual retirement accounts and by Employee Retirement Income Security Act of 1974 (ERISA) qualified plans.
The typical auction fund will be registered either under the Investment Company Act of 1940 or have elected treatment as a business development company.	Auction funds will have investor protections in place that typical private funds lack, such as boards with independent members and prohibitions against self-dealing through affiliates.	These protections help ensure transparency with regard to fees and key holdings as well as disclosure of significant developments.
Auction funds may be purchased only by accredited investors and higher-net-worth individuals.		Most often, this means that sponsors will offer auction funds as private placements, relying on the Jumpstart Our Business Startups (JOBS) Act to market them broadly, avoiding the expense and time of a public offering.

companies, but they must elect treatment as a tax RIC. They may be purchased only by accredited investors or those with higher qualifications through a private placement process.

What does this combination of characteristics mean in practice (see figure 1)?

It's the "auction" in auction funds that makes this so interesting. Typically, private investment funds do not offer investors meaningful liquidity beyond the cash flows they generate from normal operations. Investment periods often can exceed a decade, which can be an enormous hurdle for most individual investors, especially when combined with the large minimum investments normally required. Indeed, liquidity can be perceived as the greatest single barrier to overcome in broadening access to private strategies.

Holders of auction funds can sell their shares through the Nasdaq Private Market (NPM) so that the fund itself need not hold cash or liquidate assets to meet its liquidity needs. Auctions will occur on a regular cycle (typically monthly), and we anticipate robust bidding and pricing near net asset value (NAV), for several reasons discussed below.

It's important to highlight that if for some reason auctions do not produce satisfactory pricing, sellers have a second option: They may choose to offer their shares for tender at NAV. This process, described below, serves two functions: First, it provides an important backstop for investors and, second, it helps ensure that the prices available via the auction process remain close to NAV.

AUCTION PROCESS

Auctions typically will operate once a month. Critically, all buy and sell interest for the month is consolidated into one event, and all trades for the month are executed at a single clearing price. Aside from facilitating price discovery, this helps attract bids in size and affords protection for smaller participants whose orders will be executed at the same price as all the others.

Bid indication period. For each issue and in each month, institutional buyers known as secondary liquidity providers (SLPs) initiate the bidding. SLPs are financial institutions (e.g., private equity secondary funds) that are motivated to purchase the assets on offer and will have an obligation to provide bids at each auction. These bids are aggregated to create an indicative price that's published to drive the price discovery process.

Auction period. In the following several days, interested sellers and other buyers can place limit orders into the system, knowing the indicative price range as well as the fund's NAV. Of course, they also can modify and withdraw offers to buy or sell until the auction actually closes.

Finalization and closing periods. At the appointed hour on the appointed day of the month, the auction will close. Then our proprietary algorithms will determine the price at which the greatest number of shares will trade as well as the clearing price, and it will execute the trades at that level by combining orders as needed.

Importantly, because of the way the auctions are synchronized and run by NPM, SLPs can place aggregated block bids of a total dollar amount for a range of products offered at each monthly auction, specifying the different prices they are willing to pay for each fund. NPM can allocate the block bid across those funds, depending on the single clearing price for each fund. This creates an incentive for large bidders to participate each month even though the amounts available for purchase in any given position may be small.

Who would the other buyers be, aside from the SLPs (see figure 2)?

1. Other financial buyers may include private funds specifically created to hold the kinds of assets that are up for sale (e.g., private equity, venture, credit) and traditional institutional investors (e.g., insurance companies, pension plans, sovereign wealth funds, etc.).
2. Financial advisors who, having seen the indicative pricing of the SLPs and institutional investors, can then decide whether their clients (including existing holders) may be interested in buying, with the hope of entering the fund at a price just below NAV. These may be buyers of the auction fund who otherwise would be subscribing to purchase new shares being issued by the fund. By crossing these prospective subscribers with any remaining sellers, the fund can minimize its cash drag and administrative burdens.
3. Perhaps the most distinctive buyers are arbitrageurs. This is another way that auction funds mimic exchange-traded funds, which have a consistent track record of trading very close to NAV. The arbitrage here arises because any buyer at an auction (or any other holder) actually may tender its stake back to the fund at NAV should prices at auction prove unsatisfactory. As a result, arbitrageurs have a big incentive to come into an auction and top any bid that is substantially below NAV; in this way, the option to tender should itself keep the prices at any auction quite close to NAV.

What happens during periods of serious market disruptions? Will buyers really show up?

We believe that they will, for natural economic reasons. It's important to understand that the institutional buyers described above (insurance companies, sovereign wealth funds, etc.) are always on the hunt to buy long-term assets that match their long-term liabilities at good prices, and the best prices usually are available during periods of market stress. Many institutional buyers have expressed enthusiasm about our platform precisely because they've never before had a centralized venue to shop for these kinds of private investments when large groups of holders are suddenly anxious to raise cash. We believe these buyers will have a strong incentive to bid and compete for quality assets if and when there's a rush to sell.

Separately, the arbitrageurs (e.g., hedge funds) should be out in force if they see spreads between bid prices and NAV get too wide.

Just like any marketplace, an auction fund holder cannot be guaranteed to be matched at NAV of the fund, but we anticipate that a robust market will exist for auction fund interests even in difficult times and that fair prices will be achievable. Also, with the ability to place limit orders, sellers can test the market without risk of having a trade clear at a price lower than they are willing to accept. If all else fails, an auction fund holder can exchange an auction share for a tender share and redeem it back to the fund at NAV during the next scheduled tender period.

ACCESSING AUCTION FUNDS

Only financial professionals can access and use the NPM auction system; individual investors are not permitted to participate directly. The organizations where those professionals work (or where they clear and trade) also will set their own rules concerning use of the system, determining suitability of specific funds, and so on. They will customize the NPM platform and

Figure 2 THE NASDAQ PRIVATE MARKET AUCTION FUNDS BUYER NETWORK

workflow to integrate with their existing systems.

Whatever the circumstances at a given firm, the auction market will be accessed through a simple and intuitive portal. Advisors will be able to see funds that are available for bidding (and offer existing holdings for sale) and the indicative price range, and they can place different kinds of orders for different numbers of shares. They also will be able to access all relevant fund information, disclosures, and other materials in the same location.

The interface comes complete with a system for tracking progress, ensuring documents have been delivered, with electronic execution and the other necessary "plumbing." Orders are matched and money settlements are facilitated by NPM's broker–dealer subsidiaries with reports to relevant parties, streamlining the process normally entailed in a private securities transaction.

SUMMARY

The growth of private equity NAV since 2002 is sevenfold[3] that of the public markets and investors' desire for access to alternative investments does not appear to be curtailing anytime soon. The number of U.S. private equity-backed companies doubled from 4,000 in 2006 to 8,000 in 2017, while the number of U.S. publicly traded firms fell from 5,100 to 4,300 (and fell by 46 percent since 1996).[4] The current low-yield environment and market uncertainty have forced investors to more aggressively pursue alternatives in an attempt to maximize returns. Auction funds can offer access to the high-quality alternative investment strategies, allow for robust liquidity, and minimize cash drag. The availability of auctions as the main source of investor liquidity in a registered fund is a reflection of the changes being made in this market and the commitment that Nasdaq has to providing more open and transparent marketplaces. This type of liquidity is the latest tweak to an evolving marketplace for private investments, and it will open the door for high-net-worth retail investors to partake in the premiums the private markets have enjoyed for decades.

The NASDAQ Private Market, LLC, a business of Nasdaq, Inc., provides liquidity solutions for today's private securities. The NASDAQ Private Market, LLC, was formed in 2013 with a dedicated focus on deploying comprehensive private market technology and workflows, a robust regulatory framework, and an ecosystem of institutions to address the challenges of liquidity across private assets. To learn more, visit https://www.nasdaqprivatemarket.com.

ENDNOTES

1. McKinsey Global Private Markets Review 2019: "Private Markets Come of Age," McKinsey & Company, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/private%20markets%20come%20of%20age/private-markets-come-of-age-mckinsey-global-private-markets-review-2019-vf.ashx.
2. Henry H. McVey, "The Ultra High Net Worth Investor: Coming of Age," KKR (May 10, 2017), https://www.kkr.com/global-perspectives/publications/ultra-high-net-worth-investor-coming-age.
3. See endnote 1.
4. See endnote 1.

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