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By Nelson Griggs

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A fundamental change is occurring in the investment world: Quality opportunities are found increasingly outside the public markets.

One indicator of the trend is the continued rise of unicorns (private companies valued at $1 billion or more) along with a decline in the total number of U.S.-listed public companies of roughly 50 percent in the past two decades. A recent McKinsey report outlines the "shift in investment paradigms … opening clients' minds to new innovation that cuts across asset classes … in turn leading to a radical shift in how clients invest—for example, private equity now increasingly competes directly with public equity."[1] Indeed, investment has skyrocketed in strategies such as private equity, where assets under management have grown rapidly to $2.5 trillion.

But as any financial advisor knows, few other than large institutions have been able to take advantage of this trend. Numerous practical hurdles including illiquidity, very large minimum investment sizes, and cumbersome tax reporting have prevented even high-net-worth investors from participating.

Fortunately, in 2017 the U.S. Securities and Exchange Commission (SEC) opened the door to auction funds, a new investment vehicle designed to address these issues. Auction funds are meant to provide affluent individuals much broader access to many non-public investment categories, including private equity, venture, real assets, infrastructure, and private credit.

We think these private-but-liquid investments will become critical tools for the advisor of the future for two big reasons. First, and most importantly, sophisticated financial advisors who learn to use them will be able to craft and actively manage more-diverse, institutional-caliber portfolios for higher-net-worth clients. Secondly, because these investments will require a higher level of portfolio management expertise, they will help financial advisors distinguish themselves from competitors of both the human and robo variety.

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 NAV).

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 companies (BDCs), but they must elect treatment as a tax-regulated investment company (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?

First, investors may not face capital calls as they do with traditional private equity and similar funds given that 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 NAV. Aside from freeing investors from long-term commitments, this means that 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.

Second, 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. As a result, auction funds will be eligible for purchase by individual retirement accounts and by Employee Retirement Income Security Act of 1974 (ERISA) qualified plans.

Third, because the typical auction fund will be registered either under the Investment Company Act of 1940 or have elected treatment as a BDC, it 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.

Finally, auction funds may be purchased only by accredited investors and higher-net-worth individuals. Most often this means that sponsors will offer them 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.

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.

Some products have attempted to address this issue by adopting interval-style or tender-offer fund formats in which investors typically have the option to redeem up to a given percentage of the fund's outstanding interests each quarter. In practice, this can introduce cash drag that significantly lowers returns because the fund must hold enough liquid assets to meet redemptions plus a large cushion to assure distributors that redemptions won't set off a self-perpetuating liquidity crisis. Moreover, any liquidity option that depends on generating cash from inside the fund itself tends to penalize investors remaining in the fund who must finance the exiting investors.

Holders of auction funds, by contrast, 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 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: offer their shares for tender at NAV. This process is described below and 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.

For each issue and in each month, institutional buyers known as secondary liquidity providers (SLPs) initiate the bidding. SLPs are financial institutions, such as 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.

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. 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.

Who would the other buyers be, aside from the SLPs? One group will be other financial buyers. These 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 such as insurance companies, pension plans, sovereign wealth funds, etc.

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.

A third class of buyers includes financial advisors who, having seen the indicative pricing by 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. Indeed, 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.

Perhaps the most distinctive buyers are arbitrageurs. This is another way that auction funds mimic ETFs, 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) may actually 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 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. Indeed, 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. And, 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 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'll also 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 workflow, 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.

OTHER PRIVATE INVESTMENT LIQUIDITY

Auction funds aren't the only kinds of private securities that can be accessed on the NPM.

As most advisors to high-net-worth clients know, feeder funds often have longer lives than investors have patience. Indeed, much of the earliest demand for our platform is for liquidity and price discovery for feeder fund interests. We are working with several wealth management platforms and bank sponsors, as well as dozens of prospective institutional buyers, to make

AUCTION FUNDS AND DEFINED CONTRIBUTION PLANS

Defined benefit plans have long relied on private investments, especially private equity, to fund beneficiaries' retirements. Today, these plans are being replaced by defined contribution plans (and greater use of individual retirement accounts) where, for many reasons, investment in private assets is difficult or effectively impossible.

As a result, retirees are ever more responsible for funding their own retirements yet lack access to the same tools professional investors have used. Most fiduciaries recognize this disparity, but defined contribution plan design requirements have not meshed well with product configurations previously possible for private investments.

For example, some have attempted to marry true private equity exposure with cash equivalents inside a collective investment trust but, among other issues, this just reprises the cash drag problem.

We believe that, when deployed inside a target-date option, auction funds are the right way to deliver private equity exposure to defined contribution plan participants. The key reason is the relative certainty of liquidity, which protects participants in the event of extraordinary developments that would require a rapid exit from private equity positions, such as a major spin-off or plan design change. But there are many other reasons, too:

- The market-based pricing protects fiduciaries from concerns that they are transacting from a price established by a counterparty or negotiated in a vacuum.
- The structure of an auction fund avoids plan assets and, hence, prohibited transaction issues.
- The tax RIC status shields the plan from unrelated business income.
- The required diversification fits ERISA plans well.
- Solid methods have been developed to establish published valuations at the intervals required.
- The overall structure is designed to maximize economic returns and minimize fees and drag.

this possible. We expect continued interest in the adoption of quarterly liquidity in feeder funds through 2018 and beyond.

Significantly, we have obtained a private letter ruling from the Internal Revenue Service that confirms our process as a qualified matching service. This allows us to provide liquidity for traditional limited partner interests and feeder funds in an amount up to 10 percent of the fund's total commitments each year, without the risk that the partnership will be characterized as a publicly traded partnership and hence taxed as a corporation—this risk is a key reason such trading rarely occurs today.

In addition, we run liquidity events for dozens of private companies, many of them unicorns with valuations exceeding $1 billion. Some of the companies will go public eventually, but others expect never to do so. Initially, these companies used our services to provide liquidity for employees and executives, and buyers were primarily those who already had invested in the company. But, increasingly, we are facilitating purchase of these private shares by outsiders, including larger institutional investors seeking exposure to late-stage venture. Products centered on portfolios of these nonpublic operating companies may become available down the road.

CRITICAL ROLE OF FINANCIAL ADVISORS

We strongly believe that private assets will become significant elements of affluent individuals' investment portfolios. Allocating to them, however, will require specialized knowledge of the underlying strategies, fluency in related performance metrics, and a keen understanding of how these new elements complement existing holdings. But they will not be appropriate for or available to every investor.

Thus, allocating to these products will require much more than generic investment advice and will be beyond the capabilities of automatic investing solutions such as robo-advisors. Sophisticated financial advisors will be essential to our success, and we hope to be integral to their success as well.

ENDNOTE

1. Pooneh Baghai, Onur Erzan, and Ju-Hon Kwek, "The Best of Times, The Worst of Times: North American Asset Management," McKinsey & Company (December 2017), https://www.mckinsey.com/industries/financial-services/our-insights/bright-spots-in-the-north-american-asset-management-landscape.

Nelson Griggs is president of Nasdaq Stock Exchange, where he oversees new listings, capital market business, global business development, and relationship management. He earned a BA from Denison University. Contact him at nelson.griggs@nasdaq.com.

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5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org