PRIVATELY PLACED ’40 ACT FUNDS

A Private Equity Primer

By Nick Veronis and Michael Keogh
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As advisors seek to meet the objectives of income and diversification in client portfolios, registered funds that incorporate direct access to private equity, private credit, or hedge funds often are overlooked. Although relatively few funds provide this type of exposure to accredited investors, significant recent developments can make them an attractive alternative.

The registered fund market encompasses both closed-end and open-end funds that can be sold either publicly or through private placement. To differentiate them from listed closed-end funds, exchange-traded funds (ETFs), and open-end mutual funds, we still refer to privately placed funds that incorporate access to private capital as “the ’40 Act market,” consistent with the term used by many practitioners.

Specifically, we define a ’40 Act fund as an investment company registered under the Investment Company Act of 1940 that is a privately placed (e.g., non-listed), closed-end, tender-offer fund that has elected to be taxed as a registered investment company.

There are compelling reasons to consider this class of investments, which is designed to provide accredited investors and qualified clients with access to the private capital markets, which historically have been the domain of institutional investors, such as endowments, pension funds, and large family offices.

As these firms have become interested in tapping into the multi-trillion-dollar accredited investor market, we’re seeing positive developments in the construction of these funds (no doubt a consequence of increased competition).

*Increased availability:* The number of these funds is growing, with many new products currently in registration. Those in the market have been somewhat slow to garner attention and investors’ capital, with the entire asset class now at just under $53 billion in total assets (see figure 1). Consequently, there is virtually no independent research on the ’40 Act market; it is still small enough that traditional research firms can afford to ignore it. However, despite its relatively small size, the quality and breadth of these offerings have reached a level that we believe merits attention.

*Expanded set of managers:* As the ’40 Act market has evolved in recent years, it has attracted a growing number of firms with demonstrated success in managing private investments. Established players such as Partners Group, Carlyle, and Pantheon have launched funds under this structure. Others have explored this space and we expect to see several prominent private equity firms enter this market in 2020 with new registered funds.

*Improved product features:* As these firms have become interested in tapping into the multi-trillion-dollar accredited investor market, we’re seeing positive developments in the construction of these funds (no doubt a consequence of increased competition). More of these established managers are reducing fees and thoughtfully addressing the challenges of liquidity, transparency, and the inevitable cash drag that can occur in making private equity investments through registered vehicles.

*Liquidity expectations have changed:* Managers are keenly aware that the only way to successfully open the market broadly to individual investors is to provide real value and solve the problems that held back the often flawed first generation of ’40 Act funds, many of which disappointed investors. One area of improvement has been in the alignment between the liquidity of the ’40 Act fund and the anticipated liquidity of the underlying private investments. We will discuss this in more detail below, but most investors can expect lock-up periods of at least two years when a fund first launches, early repurchase fees, and pro-rata redemptions if a tender is over-subscribed. There is no guarantee of liquidity.
Limited opportunities in the public market: It is no coincidence that the increase in registered funds incorporating private equity is occurring as the universe of public companies ages and shrinks. The combination of fewer initial public offerings, continued consolidation driven by mergers and acquisitions, and take-privates has led to a sharp reduction in the number of U.S. publicly listed companies—from almost 8,000 in 1998 to around 4,000 today (see figure 2). Meanwhile, the average age of a U.S. public company has increased from 12 years in 1996 to 20 years today—with the vast majority of dynamic, high-growth companies existing in the private markets, out of reach of the average equity investor. In fact, Cambridge Associates reported that top-quartile private equity (PE) managers substantially outperformed the S&P 500 each year from 2008 through 2017 (most recent full-year performance reporting where the PE data is meaningful).\(^1\) Even the average PE manager has outperformed the S&P 500 in seven out of nine of the years tracked (see figure 3).

Although non-listed, closed-end funds have been around for quite some time, they differ from open-end mutual funds in ways that advisors and their clients should understand. A long-held rule of thumb has been that investors should not invest in a mutual fund unless they expect to hold the investment for at least three to five years. This is particularly true of the ‘40 Act market structure, where investors should consider hold periods of five to seven years to gain the benefits of the PE value creation process.

Perhaps the most critical concept for advisors and their clients to bear in mind when considering ‘40 Act funds that invest in private companies is that, regardless of the liquidity terms, these are fundamentally longer-term holdings and should be viewed as such in a broader portfolio. PE firms generate an illiquidity premium through their ability to collaborate with the management teams of their portfolio companies to execute value

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1. Cambridge Associates
creation plans that require three to five years (or longer) to realize. These strategies may include expansion into new markets, selective consolidation of a fragmented sector through add-on acquisitions, efficiency improvements and cost reduction, the sale of non-core assets, and/or professionalization of senior management teams. These plans take time. Put a different way, one of PE’s main advantages, particularly over public companies that must deal with the constant pressures of quarterly earnings and “short-termism,” lies in thinking and acting with a long-term time horizon in mind. Individual investors need to adopt the same long-term mindset for the capital they allocate to these registered funds.

Indeed, as a CFA Institute report in 2018 concluded:

Public markets are often perceived to be short-termist in their outlook, causing corporate managers to focus on meeting quarterly earnings targets rather than working on creating long-term value. Private markets are perceived to be more long term in their thinking and in their structural characteristics by comparison ... it is not credible to allow an entire generation of retail investors to be left with only diversified public market exposure to generate retirement returns, while institutional investors crowd into innovative business models [through the private markets] that offer potentially higher returns.

The CFA Institute made several policy recommendations in its report, including improving access to private market investments by retirement savers. These registered funds represent an important advancement in providing retail investors with access to the private capital markets and in leveling the playing field with institutional investors.

CURRENT STATE OF THE MARKET
Since 2000, there have been several false starts in the closed- and open-end registered fund space, as managers sought to deliver private market returns generally reserved for the institutional market. The first generation of these funds was characterized by high annual fees, substantial upfront load fees, market-like beta, and liquidity mismatch issues. Although some quality products were developed in this first generation, most of the funds fell well short of investors’ expectations.

A review of Securities and Exchange Commission (SEC) filed documents reveals that most funds have been able to meet the redemption requests of investors who have chosen to tender their shares.

At least for now, the vast majority of advisors and their investors appear to be paying heed and staying in these funds for relatively long periods. These funds generally offer limited quarterly liquidity through a share repurchase tender process. A review of Securities and Exchange Commission (SEC) filed documents reveals that most funds have been able to meet the redemption requests of investors who have chosen to tender their shares. Redemptions appear to have been relatively light, which is a sign that most investors and their advisors understand the longer-term nature of these funds and the need to remain invested to reap the upside. And, of course, buoyant market conditions likely also have helped.

Matching liquidity features with the underlying investment: Funds focused on private equity generally register as tender-offer funds (as opposed to interval funds), allowing the fund’s advisor and its independent board to limit redemptions through tenders if they deem it necessary. Although tender-offer funds try to maintain some minimal level of quarterly liquidity, 5 percent for example, these funds have fairly wide latitude in establishing the amount and timing of their share repurchases. In contrast, an interval fund must adopt a fundamental policy, changeable only by a majority vote of the outstanding voting securities of the company, and in which the timing and minimum amount of each tender is mandated (between 5 percent and 25 percent). Credit-focused funds often register as interval funds with a minimum requirement of 5 percent per quarter. In these structures, the underlying investments have a greater level of liquidity than PE investments and often generate current income, which should enable the fund sponsor to manage the share repurchases, even during challenging market cycles.

Registration: All ‘40 Act funds must register with the SEC. This registration allows access to these private investment opportunities for accredited investors (some funds are restricted to qualified clients). To qualify for accredited investor status, individuals must have $1 million in investable assets or annual income of $200,000 ($300,000 with a spouse). The SEC is currently weighing changes to the accredited investor definition that would enable some individuals to bypass the income and investable asset minimums, which would open registered funds to a broader base of investors.

Board oversight: Consistent with all registered funds, each ‘40 Act fund is overseen by an independent board designed to represent shareholders’ interests. The board reviews the fund’s operations, including adherence to its stated investment objective and investment advisory fees, and is responsible for approving any share repurchases or tender offers. It is important to note that during times of market stress or dislocation, the board may decline to make a tender offer if it believes that such action
is not in the best interest of all shareholders (as noted, interval funds are required to meet their minimum stated tender amounts). For example, the board may find that to honor the tender offer, the fund would have to sell investments at distressed prices significantly below true market value, which may not be in the best interests of the overall shareholder base (even if some shareholders wished to sell) and thus the board could decline to allow any tenders during that period. These instances tend to be rare, but they highlight the responsibilities of the board toward all shareholders and not just those looking to tender shares for repurchase in a possible fire-sale situation.

**Simplified tax reporting:** Almost all current PE-focused registered funds elect to be taxed as a Registered Investment Company (RIC) by the Internal Revenue Service (IRS), delivering a 1099 form (instead of a K-1, which PE funds issue), simplifying the reporting and accelerating delivery to the investor to be consistent with other major investment products. Ideally, this reduces the number of investor inquiries regarding tax reporting and avoids the onerous process of waiting for K-1s and incorporating them into investors’ IRS tax filings.

**THE CASH DRAG CHALLENGE**

New ’40 Act funds that focus on less-liquid investments such as PE also face a “ramping-up risk” that traditional mutual funds do not. When most mutual funds receive a new subscription from an investor, they can invest those proceeds almost immediately into public equities or fixed income securities. In contrast, many of the underlying PE investments made by ’40 Act funds can take months from identification to due diligence to actual investment, and then three to five years to an exit and the realization of proceeds.

Capital that is committed to PE funds is deployed over several years and thus, in the traditional private fund structure, the fund manager calls that capital down from investors when needed as deals are completed. In the ’40 Act fund model, there is generally no “call down” process because 100 percent of an investor’s money is placed into the ’40 Act fund at the time of investment; even with a robust investment pipeline, it takes time to deploy this capital. As a result, the nature and structure of a ’40 Act fund’s deployment of capital into underlying investments can lead to significant cash drag on the overall performance if not properly managed. There are strategies that ’40 Act funds can employ to try to mitigate this drag, such as investing the cash into equity index ETFs until it is ready to be deployed into private deals or pursuing an overcommitment strategy. Each of these strategies has benefits and drawbacks.

**THE J CURVE**

The J Curve refers to an investment performance arc where a significant gain follows an initial loss. In PE, the fund manager charges fees and expenses from day one on the total committed capital. In the early years of the investment period when the manager calls down that capital to invest in private companies, those fees and expenses can result in a near-term loss because, as noted above, it takes time to both deploy the capital and then to create value in the portfolio companies (see figure 4).

One of the most common ways to minimize the J-curve effect, particularly in new registered funds that are in a ramp-up phase, is to have a high exposure to secondary and income-generating investments in the early years. These strategies tend to return capital faster than an investment in a traditional PE fund, which can take several years to execute its value creation plan and does not generate meaningful distributions until around year four. By contrast, a secondary investment involves the purchase of a mature stake in an existing underlying PE fund that is already four to seven years old with portfolio companies that are close to an exit. Thus, a secondary investment should start seeing the sale of portfolio companies within six months from the original investment. Further, by including secondary investments in their strategy, registered funds can deploy more capital right away, which can further help alleviate the cash drag.

Similarly, including credit-oriented strategies early on can generate income immediately, which also can help a ’40 Act fund manager partially offset the J Curve and meet investors’ liquidity needs.

Direct investments (or co-investments) also can help accelerate the deployment of cash and mitigate the J Curve, but not as quickly as secondary or credit-oriented investments. An advantage of direct investments is their reduced fee cost, because most transactions are offered on a fee basis significantly below the traditional 2-percent management fee and 20-percent performance fee that underlying private fund managers typically charge.
One risk in a relatively new registered fund loading up too quickly on secondary investments or co-investments early on is that it can end up with a significant concentration of assets acquired in the same period of time when asset prices (both secondaries and co-investments) may be trading at historically high levels; however, we would note that this is not different from making investments in the public markets. If, for example, a registered fund invests in a large pool of secondaries or co-investments that end up accounting for 40 percent of the fund's assets early in its life, and those private assets were purchased at a high point in the market cycle, that fund could be vulnerable if prices normalize over a short period of time and cause the valuation of those assets to decline. The secondary investments typically will comprise multiple “vintages” (the years when the underlying funds were launched and deployed capital), which can help achieve a level of diversification early on. We would encourage prospective investors to examine the vintage year diversification of a registered fund’s private equity holdings, among other factors.

The above-described strategies of secondary investments, direct investments, and income-generating securities help with J-curve and cash management, but they do not eliminate these issues. There are several ways ‘40 Act managers can manage the cash they are holding before it is put to work in private investments. Below is a list of cash management strategies we have seen:

**Cash or money market accounts:** This is the least-risky strategy because the likelihood of earning a negative return on cash is very small, but ‘40 Act fund expenses may outstrip any positive income generated. Typically, one can invest capital in vehicles such as money market funds, Treasury bills, or certificates of deposit, which can provide modest short-term income. However, this approach can be highly dilutive because cash tends to generate the lowest return of all asset classes.

**Invest in equity index strategies:** This approach focuses on investing the idle cash in the registered fund directly in investments tied to broad market-based indexes such as ETFs. This style allows a ‘40 Act manager to capture the returns of a target index but also poses the risk of loss of capital during periods of significant market decline.

**Overcommitment strategy:** One strategy that seems to be gaining more traction is to commit more capital to underlying investments than the total subscription received by the ‘40 Act fund. Generally, PE managers draw only 70 percent to 80 percent of the original commitment and fund the rest of the commitment with expected distributions. This approach is feasible because PE investments don’t require 100 percent of the capital at the time of the original investment. Thus, the ‘40 Act fund theoretically can deploy more capital by overcommitting in order to partially reduce cash drag. The challenge with this approach is that if the pace of distributions from previous investments is slower than expected and the amount of overcommitment is too high, the ‘40 Act fund could be overexposed. Also, regulators may view this strategy as leverage, limiting its use and increasing compliance and reporting risks.

A combination of the above strategies can help solve the cash-on-hand problem faced by ‘40 Act managers aiming to deliver traditional PE exposure. We would suggest a lower use of equity strategies, such as ETFs, because the risk of a severe decline in equity markets can exacerbate the problem.

**DECODING THE PRIVATE EQUITY FEE TABLE**

One critical factor directly impacting performance is fund fees. However, deciphering the prospectuses of registered funds can be challenging. Table 1 offers a sample fund prospectus fee table. Although this sample is similar to the fee tables found in mutual fund and ETF prospectuses, it shows some important nuances to understand before allocating capital to these funds.

Some of the most important components of a fund’s fee structure are:
- Management fee
- Performance fee or “carry” paid to the fund advisor
- Acquired fund fees, if any
- Performance fees or carried interest assessed on any underlying fund
- Fund fee waivers or fee caps

Unfortunately, only two of the above five components are clearly laid out in the fee table. Advisors should look carefully at the footnotes to the fee table, and in the body of the prospectus, to understand how the other fees impact

### SAMPLE REGISTERED PE FUND FEE TABLE

<table>
<thead>
<tr>
<th>Annual Fund Expenses</th>
<th>Share Classes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Advisory</td>
</tr>
<tr>
<td>Management Fee</td>
<td>1.00%</td>
</tr>
<tr>
<td>Distribution/Service Fee</td>
<td>0.50%</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>0.85%</td>
</tr>
<tr>
<td>Effect of Fee Cap/Waiver</td>
<td>(0.35%)</td>
</tr>
<tr>
<td>Operating Net Subtotal</td>
<td>2.00%</td>
</tr>
<tr>
<td>Acquired Fund Fees</td>
<td>0.85%</td>
</tr>
<tr>
<td>Total Expense Ratio (TER)</td>
<td>2.85%</td>
</tr>
</tbody>
</table>

Source: iCapital. For discussion purposes only. Actual fees may vary.

Continued on page 25
the total fee level (and consequently, net performance). Everything else being equal, funds with more assets under management tend to have lower operating expenses, which is an important component of the overall fee.

The fee table footnotes also contain important information about how the fees are calculated and, in the case of a fee waiver or fee cap, the period for which they will be in place. Fee waivers and caps are generally in place for 12 months and are renewed on an annual basis.

Given the historic outperformance of the private capital markets and the concurrent shrinking universe of public companies, the expansion of PE into the registered fund market is a logical and positive development for accredited investors and their advisors. Although the number of ‘40 Act funds focused on PE is limited today, the market is growing and 2020 likely will see several established PE firms launch registered funds. As with all private equity, selecting the right manager and embracing a long-term investment horizon are key to successfully investing in this space.

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ENDNOTES

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