XA INVESTMENTS

Auction Funds

In recent years, interval and tender offer funds have improved access to alternatives. Now auction funds provide enhanced liquidity for illiquid private market assets.

The auction fund represents a new innovation in the U.S. closed-end fund (CEF) marketplace and is designed to improve liquidity for continuously offered, non-listed CEFs, including interval funds and tender offer funds.

As investor demand for alternative and uncorrelated assets has grown, interval funds and tender offer funds have increasing appeal for investors. With interval funds becoming more mainstream, we anticipate the CEF marketplace soon will include numerous auction funds. While many interval funds have daily net asset values (NAVs), that is not the case for all alternative strategies. A growing subset of interval and tender offer funds have less frequent NAV strikes and redemptions because they invest in illiquid assets with higher potential for liquidity premiums, such as private equity (PE) and venture capital. Investors seeking access to alternatives may be hesitant about interval funds given their liquidity restrictions. Through an auction process that occurs more frequently than the periodic tender offer,[1] new auction funds may help satisfy liquidity demands.

"A structured secondary marketplace powered by technology is a key component to making quality private investment opportunities available to a broader set of investors."

Lauren Dillard, EVP Investment Intelligence at Nasdaq

What is an auction fund?

Auction funds are non-listed, closed-end, continuously offered investment funds. They are typically registered as 1940 Act investment companies and usually opt to be taxed as Regulated Investment Companies (RICs). Shareholders of auction funds can sell their shares through the Nasdaq Private Market ("Nasdaq") so that the fund itself need not hold cash or liquidate assets to meet shareholder liquidity needs. Nasdaq has designed the auction system to host auctions on a regular cycle (i.e., monthly) and anticipates that with robust bidding, pricing for auction shares may be near a fund's NAV.[2] Access to the Nasdaq auction system is limited to financial professionals; individual investors may not participate directly. The auction fund buyer network is expected to be comprised of institutional investors, including hedge funds, insurance companies, sovereign wealth funds, private funds and secondary funds, endowments and pension plans.

The advantages of auction funds benefit both investors and fund managers

Investors gain	Fund managers appreciate
Access to private markets	Minimal/no cash drag
Potential monthly liquidity through auctions	Liquidity for shareholders
IRA eligibility	Avoid the need to sell underlying assets
Lower investment minimums than typical limited partnerships (LPs)	Broader investor base (vs. traditional PE)
Protections offered by registered funds	Freedom to invest in most alternative investment strategies
Form 1099 tax reporting	Continuous offering for fund share subscriptions and asset raises

1 Interval funds and tender offer funds are closed-end investment companies ("CEFs") registered under the Investment Company Act of 1940 (the "1940 Act"). Interval funds periodically offer to repurchase shares at their net asset value ("NAV") from shareholders at *predetermined* intervals under Rule 23c-3 under the 1940 Act. Tender offer funds, on the other hand, conduct periodic tender offers on a *discretionary* basis pursuant to the Securities Exchange Act of 1934 (the "Exchange Act") and the rules thereunder. The term "tender offer" used herein refers to both interval fund *repurchase offers* and tender offer fund *tender offers.* **2** There is no guarantee that the auction process will function as intended or that there will be sufficient demand to support regular monthly auctions. Shareholders may be unable to sell auction fund shares at the price they desire or at any price at all. It is likely that shares sold at auction will receive a price that is less than the fund's most recently calculated NAV, and depending on buy side interest in a particular auction, the price could be substantially below such fund's NAV.

Evolution of Private Fund Structures*

	Institutional investors	HNW QPs	HNW QC/AI	HNW investors
	LP Structures	Feeder Funds	Interval Funds	Auction Funds
Minimum investment	High minimums	Lower minimums ($150K–$250K)	Lower minimums ($25K)	Lower minimums ($25K)
Accreditation	QP only	QP only	Lower accreditation (QCs and AIs)	Lower accreditation (QCs and AIs)
Tax reporting	K1 reporting	K1 reporting	Tax RICs, 1099 reporting	Tax RICs, 1099 reporting
IRA eligibility	No	No	Yes	Yes
Capital collection	Capital calls	Capital calls	Continuously offered, no capital calls	Continuously offered, no capital calls
Liquidity mechanism	Secondary sale to QPs	Secondary sale to QPs	Regular intervals (generally quarterly) self-tender by fund	Market-driven auctions; backstop tenders
Liquidity caps	Secondary: 2% Max (Max 10% with QMS)	Secondary: 2% max (max 10% with QMS)	5%–25% per interval	None
Cash drag	None	None	Yes; potentially significant	Minimal

Source: Nasdaq Private Market

*Abbreviations in table (above): HNW, high net worth; QP, qualified purchaser; QC, qualified client; AI, accredited investor; LP, limited partnerships; QMS, qualified matching service. See last page for glossary.

The monthly auction process in brief

Timeline:

1. *Subscription period:* Subscriptions for the auction fund are collected from eligible investors during the month prior to the auction. The transfer agent collects the subscription documents, and sends the information to Nasdaq.
2. *Auction period:* The auction period begins when the fund strikes and publishes its NAV. During this period, secondary liquidity providers (SLPs), often institutional investors, will place limit buy orders in the Nasdaq order system. Shareholders who wish to sell shares will submit their limit sell orders via a redemption document collected in the same manner as subscription documents. Orders may be modified or withdrawn until the auction period closes.
3. *Closing period:* Once the auction period closes, Nasdaq will determine the clearing price at which the greatest number of shares will trade. All trades will be executed at a single price. The order system executes orders priced within the limits at the single execution price. Orders that did not include the execution price within the limits will not be executed. Unmatched limit orders can choose to participate in the next month's auction, or tender at year end. Subscriptions may be crossed with unmatched limit orders when there is no clearing price established, or when there is unmatched selling demand at or below the clearing price.

Nasdaq facilitates the auction fund market and brings institutional buyers into the mix. An auction fund has four layers of buyer support:

- New subscribers and current holders
- Secondary liquidity providers
- Long-term investors
- Financial buyers and arbitragers

Investor objections and concerns

- The primary concern is whether there will be a consistently available market when investors need liquidity. Auction funds are designed to have at least one obligated liquidity provider. If auction bids are not available, investors may seek liquidity through the fund's tender offer process.
- Newness, general lack of investor familiarity
- Nasdaq auction price discovery mechanism may result in differences between market price and execution price.

Promising new structure and market

XA Investments believes that auction funds can offer access to more attractive alternative investment options for advisors and their clients. Auction funds may open the door to some of the least liquid but most desirable alternative investments, such as private equity and venture capital, which have historical returns that have exceeded U.S. equity returns over time.[1] Following the financial crisis of 2008, investor demand for liquidity increased, and, with the proliferation of exchange-traded funds (ETFs), it remains high today. By providing a secondary trading platform, auction funds solve the most basic investor need: liquidity. These funds are structured to provide investors with the opportunity to sell their interval and tender offer fund investments on a more frequent basis. Because auction funds relieve some liquidity constraints, a wider range of investors may be comfortable making an allocation to these institutional-quality alternative investments.

With the shift from defined benefit plans (e.g., pensions) to defined contribution plans (e.g., 401Ks), the burden for long-term financial planning has landed squarely on the shoulders of the individual investor. While this issue may be most urgent for those making a retirement plan, all investors should have access to institutional alternatives to meet their income and return goals. As an indication of the evolving market, Securities and Exchange Commission (SEC) Chairman Jay Clayton has also expressed a desire for additional regulatory changes that would make investing in institutional alternatives possible for the average American investor with a long-range financial goal, like retirement or a college fund.[2] Furthermore, alternative investment managers seeking to launch permanent or semi-permanent capital funds stand to benefit from the auction fund structure. The launch of an auction fund into the retail channel allows alternative managers to diversify their revenue streams and asset base. Please contact us to learn more about the potential advantages of auction funds for you and your clients.

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XA Investments LLC (XAI) is a Chicago-based alternative investment management firm founded in April 2016 by XMS Capital Partners to provide investors with improved access to institutional-caliber alternative investments. The firm provides access to alternatives through proprietary registered funds, development of private label registered funds for asset managers, and through partnerships with experienced alternatives managers via private funds. XAI has expertise in CEF product structuring, product management and sales and distribution. To learn more, visit xainvestments.com

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Nasdaq Private Market

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1 Simon Constable, *The Wall Street Journal*, November 3, 2019. wsj.com/articles/private-equity-might-be-going-downscale-should-you-invest-11572836700
2 Speech by SEC Chairman Jay Clayton to the Economic Club of New York on September 9, 2019. sec.gov/news/speech/speech-clayton-2019-09-09

Glossary

For purposes of this publication, terms are defined below.

1940 Act company is an open-end or closed-end fund registered under the Investment Company Act of 1940, as amended (the "1940 Act").

Accredited investors (AI) are individuals with (i) income greater than $200K, or $300K with spouse, in the prior two years and expects same for current year, or (ii) net worth with spouse of greater than $1 million (excludes residence value). Knowledgeable employees of the fund. Individuals that hold certain financial services certifications or licenses designated by the SEC from time to time.

A **business development company (BDC)** is a type of closed-end investment company that invests in the middle-market debt of small and mid-sized U.S. companies.

Cash drag occurs when a portion of portfolio assets are held in cash rather than invested in the market, causing a drag on performance returns.

Closed-end funds (CEFs) are actively managed investment vehicles that are registered with the SEC under the 1940 Act. Listed CEFs are exchange-traded and typically do not continuously offer or redeem shares directly to and from investors. Different types of CEFs include listed CEFs, interval funds, tender offer funds and auction funds.

Defined benefit plans, also known as traditional pension plans, are retirement plans that provide eligible employees guaranteed income for life when they retire and are employer-sponsored.

Defined contribution plans are retirement plans that are typically tax-deferred, like a 401(k) or a 403(b), in which employees contribute a fixed amount or a percentage of their paychecks to an account that is intended to fund their retirements.

An **exchange-traded fund (ETF)** is a passively-managed type of open-end fund that tracks a specified index or a basket of assets and trades on a stock exchange.

An **interval fund** is a non-listed CEF that continuously offers its shares at NAV and periodically offers to buy back ("repurchase") a percentage of outstanding shares from shareholders through a "repurchase offer" at predetermined time periods, or intervals, under Rule 23c-3 under the 1940 Act.

Illiquid assets are assets that cannot easily be sold or exchanged for cash in seven calendar days or less without a significant loss in value. The lack of ready buyers may lead to larger price discrepancies between asking price and the bid price.

Hedge funds are funds, often structured as limited partnerships exempt from registration under the 1940 Act, that offer shares to high-net-worth individuals. Unlike private equity funds, hedge fund investments are primarily in highly liquid assets.

Limited partnership (LP) is a form of partnership in which some of the partners contribute only financially and are liable only to the extent of the amount of money that they have invested.

Liquidity is the degree to which an asset or security can be bought or sold easily without the transaction affecting the asset's price.

A **listed CEF** is a traditional listed closed-end fund, which is an actively managed portfolio of pooled assets that raises a fixed amount of capital through an initial public offering (IPO) and then is listed on a stock exchange. Listed CEFs do not continuously offer or redeem shares directly to and from investors (with certain exceptions). Listed CEF shares trade like an equity, with prices that fluctuate throughout the business day.

Open-end funds (OEFs) are investment vehicles that are registered with the SEC under the 1940 Act and typically continuously offer and redeem shares directly to and from shareholders at the OEF's daily net asset value.

Qualified clients (QC) are individuals who have at least $1 million in assets with adviser or net worth greater than $2 million (excludes residence value).

Qualified purchasers (QP) are individuals or family-owned companies with at least $5 million in investments or investment managers or companies with a minimum of $25 million in discretionary investment assets.

A **qualified matching service (QMS)**, as set forth in U.S. Treasury Regulations Section 1.7704-1, is a computerized listing system that matches potential sellers of limited partnership interests with buyers of limited partnership interests within a specified timeframe.

Secondary liquidity providers (SLPs) are market participants that create high volume on stock exchanges with the goal of bringing liquidity to the markets.

A **tender offer fund** is a non-listed CEF that continuously offers its shares at NAV and conducts periodic tender offers on a discretionary basis to purchase a percentage of outstanding shares from shareholders through a "tender offer" at pursuant to the Securities Exchange Act of 1934 (the "Exchange Act") and the rules thereunder.

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