The hard work of democratization in PE/VC land

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Originally published on Alternatives Watch on Aug. 20, 2021

Greg Bassuk, the chief executive of AXS Investments, is riding a wave that perhaps began over one-year ago with the U.S. Department of Labor's letter regarding access to private investments in defined contribution plans.

In his view, the drive for greater access is key for all types of investors to institutional-quality portfolios and strategies. This access not only smooths returns, it also offers opportunities for stronger long-term performance.

Bassuk observed that AXS offers the only '40 Act fund vehicles that provide access to, in particular, private equity and venture capital returns.

One of the long-standing trends in the system of financial regulation in the United States has been the gradual erosion of the walls between alternative and traditional investment or, more importantly, over who counts as a "qualified" investor for participation in the former.

In the New Deal era, in reaction to the wretched excess of the 1920s, Congress and the SEC decided that certain high-risk, high-reward investment opportunities were too risky for ordinary people, and would be left to institutions and the sophisticated.

For lack of any more sophisticated understanding of who is sophisticated, the word came to be used as a synonym for "wealthy." Within the circles of those allowed participation, the "accredited investors" have a golden ticket, but the "qualified purchasers" have something even better: a platinum ticket, if you will. This framework of ideas received the imprimatur of the US Supreme Court in 1953, in the Ralston Purina decision.

Through administrations of both parties, since at the latest 1996, though, there has been a trend toward lightening up on these distinctions. In '96, amidst the Clinton era, the SEC issued the "knowledgeable employee" rule. It said, for example, that employees of a hedge fund manager, who make decisions about the hedge fund's investments as part of their jobs, are "sophisticated" on precisely that subject. It waived, with regard to such individuals, distinctions of net worth.

This was a narrow move but an important one: it signalled a broader transition to a functional rather than a mechanical understanding of sophistication. A No-Action letter indicated that employees do not have to have an executive title in order to benefit from the Knowledgeable Employee rule. Research analysts, members of an analytical or risk team, traders, tax professionals, and attorneys can all qualify.

In 2012 Congress passed and President Obama signed the JOBS Act, designed to "jumpstart" business by, among other matters, allowing internet crowdfunding as a way of raising money for private placements, subject to yearly aggregate limits on the amount various individuals could contribute as members of the "crowd."

Jumping forward

Skipping other specific moments of importance in this general trend, let us jump forward to July 2021, when Hester Peirce, an appointee of former President Donald Trump on the Securities and Exchange Commission, offered her opinion that the SEC must "unlock the existing gates to the private markets."

In a speech she delivered at Georgetown University she said that “disparate treatment of individuals on an arbitrary basis, how rich you are, should strike us as unjust in any area of the law, but in this context it has particularly pernicious effects….”

Is this a partisan issue? Does it reliably split the SEC appointees of Republican Presidents from those of Democratic Presidents?

For some time now (perhaps since the global financial crises of 2007-09) the center of gravity for investment activity in the United States has been moving away from the public listings, and in the direction of private placements. This broad shift makes the need to democratize such activity more urgent. It simply would not be right to leave the bulk of actual or potential investors looking to the exchanges while letting those exchanges become, effectively, backwaters.

This raises the question: why is that happening? Why the shift away from the public markets? Some have hypothesized that the entrepreneurs behind small and medium sized enterprises have been frightened off by developments within the public markets: stories of abuses by high-speed traders or the sellers of “naked” shorts have convinced some management teams they are better off without those headaches.

The source of the push for change

Bassuk doesn’t believe that is an important driver for this trend, though. “There is very little reluctance [to go public] from the management side,” he said. “The change is from the investors’ direction.”

There has also been much discussion about how large a corporation ought to be before it makes sense for that corporation to go public. Going public is a grueling process and it leaves corporate affairs thereafter open to inquiries that smaller firms — family businesses, for example — naturally find intrusive. So: how large before one should make that plunge?

Bassuk doesn’t offer a capitalization threshold. He does say, though, that “if we were going to assign a number, we’d have to see it as on the rise.” Though the judgment for any firm is unique to that firm, the case for an IPO is compelling only for firms larger than those for which it might have been compelling a decade ago.

AXS’ Funds as democratizing forces

AXS’ offers ‘40 Act funds that track indexes that in turn allow non-qualified investors the opportunity to gain exposure to venture capital and private equity performance.

It offers the AXS Thomson Reuters Venture Capital Return Tracker Fund (LDVIX) as well as a private equity analogy (LDPIX).

Thomson Reuters launched its VC index in 2012 precisely as a way of tracking the gross performance of the U.S. venture capital industry through a comprehensive aggregation of VC funded private company values. It launched the PE analog in 2014.

Bassuk praised the Thomson Reuters indexes. He says that there is “virtually no tracking error” and that there is no comparable database available.

The two funds that AXS has built upon these indexes have strong long-term performance records, and their performance is, as an aggregation, free of the idiosyncratic manager risk run by those who do get to invest in actual PE or VC funds.

So, while regulators in Washington take different views of the subject and the scholar democratization trend within the beltway can take its sweet time: out in the marketplace, there are work-arounds for investors who have neither the platinum nor the golden ticket.