COMMITTEE ON CAPITAL MARKETS REGULATION

September 19, 2019

Vanessa Countryman, Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: File Number S7-08-19: Concept Release on Harmonization of Securities Offering Exemptions

Dear Madam Countryman:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Securities and Exchange Commission's (the "**SEC**") concept release on harmonization of securities offering exemptions (the "**Concept Release**").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean Emeritus, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee previously released a report in November 2018, *Expanding Opportunities for Investors and Retirees: Private Equity*[2] (the "**Committee Private Equity Report**"), which included a proposal that the SEC rescind its informal 15% limit on public closed-end fund investment in private equity funds. The staff of the Committee has prepared a question and answer supplement to this report to provide further clarity as to the policy, legal and practical issues related to this proposal. We are submitting the Committee Private Equity Report and the question and answer supplement in response to the Concept Release. Both are attached to this letter.

[1] *See* Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460 (June 26, 2019), https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.
[2] Expanding Opportunities for Investors and Retirees: Private Equity, Committee on Capital Markets Regulation (Nov. 2018).

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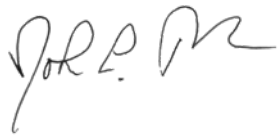
Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Prof. Hal S. Scott (hscott@law.harvard.edu), or Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,



John L. Thornton
Co-CHAIR

Hal S. Scott
PRESIDENT

R. Glenn Hubbard
Co-CHAIR

Expanding Opportunities for Investors and Retirees: Private Equity

The staff of the Committee on Capital Markets Regulation (the "**Committee**") has prepared questions and answers to provide further clarity as to the policy, legal and practical issues related to the Committee's proposal that the SEC rescind its informal 15% limit on public closed-end fund investment in private equity funds, as set forth in the Committee's November 2018 report, *Expanding Opportunities for Investors and Retirees: Private Equity*.[1]

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Questions

1. **Ensuring Incentive Alignment Between Main Street and Professional Investors.** In a September 9 speech to the Economic Club of New York, Chairman Clayton noted that the SEC is "examining whether appropriately structured funds can facilitate Main Street investor access to private investments in a manner that ensures incentive alignment with professional investors—similar to our public markets—and otherwise provides appropriate investor protections."[2] Are additional investor protections necessary? How would the CCMR proposal to expand retail investor access to public closed-end funds that primarily invest in private equity funds seek to ensure incentive alignment between Main Street and professional investors?

2. **Disclosure.** If the SEC staff removed the 15% limit on closed-end fund investments in private equity funds, should the SEC require any additional disclosures to protect retail investors?

3. **Regulatory Process.** What process must the SEC staff use to reverse its prior position?

4. **Valuation.** Should the SEC impose regulations on the valuation methodology used by public closed-end funds that primarily invest in private equity funds?

5. **Distributions.** What is the role for SEC regulation of the distributions made by closed-end funds that primarily invest in private equity funds?

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[1] *Expanding Opportunities for Investors and Retirees: Private Equity*, Committee on Capital Markets Regulation (Nov. 2018) (hereinafter referred to as the "**Private Equity Report**"), *available at:* https://www.capmktsreg.org/wp-content/uploads/2018/10/Private-Equity-Report-FINAL-1.pdf.

[2] Chairman Jay Clayton, Remarks to the Economic Club of New York (Sept. 9, 2019), *available at https://www.sec.gov/news/speech/speech-clayton-2019-09-09.*

6. **Fees on Uninvested Proceeds.** Should the SEC mandate a waiver of management fees on uninvested capital by closed-end funds that primarily invest in private equity funds?

7. **Underlying Fund Fees.** Should the SEC limit public closed-end fund investment in private equity funds to those that charge management fees below a regulatory cap?

8. **Impact of Regulation on Availability.** What is the risk that additional regulations on private equity funds that accept investments from public closed-end funds would effectively limit the universe of private equity funds in which public closed-end funds could invest?

Ensuring Incentive Alignment Between Main Street and Professional Investors.

1. **Question. In a September 9 speech to the Economic Club of New York, Chairman Clayton noted that the SEC is "examining whether appropriately structured funds can facilitate Main Street investor access to private investments in a manner that ensures incentive alignment with professional investors—similar to our public markets—and otherwise provides appropriate investor protections." Are additional investor protections necessary? How would the CCMR proposal to expand retail investor access to public closed-end funds that primarily invest in private equity funds seek to ensure incentive alignment between Main Street and professional investors?**

   Response. In our view, and as explained throughout this supplement to our Private Equity Report, we believe that the regulatory protections that currently exist under the Investment Company Act of 1940, as amended (the "1940 Act"), are sufficient to enable retail investors to invest safely in public closed-end funds that primarily invest in private equity funds.

   In general, we note that investors in a registered closed-end fund receive the protections provided by the 1940 Act, regardless of the types of investments held by the fund. These protections include oversight of the fund by an independent board, restrictions on leverage and conflicts of interest, and all of the disclosure requirements applicable to a registered closed-end fund under Form N-2, as reviewed in further detail in this supplement to our report.

   We also note that retail investment in a public closed-end fund that primarily invests in private equity funds would involve determinations by two separate fiduciaries—the registered fund's adviser and the private equity fund's adviser—each with a duty to act in the respective fund's best interest. Retail investors in a public closed-end fund would have the benefit of a registered investment adviser subject to significant regulation and oversight by the SEC. In addition, the registered investment adviser that manages an underlying private equity fund would provide a second layer of protection to retail investors.

   As to the second question, we agree with Chairman Clayton that ensuring incentive alignment between Main Street investors and professional investors is critical to ensuring that Main Street investors can obtain the benefits of private equity investing described in our report.[3] We further acknowledge that if the SEC eliminated its current informal 15% limit on investments in private equity funds, then there is a risk that inexperienced private equity sponsors could begin offering private funds specifically designed for indirect retail investors, which may pose investor protection concerns.

   Although the registered adviser to the closed-end fund must conduct due diligence on each private equity fund, we believe that the SEC staff could further enhance retail investor protection by solely permitting such public closed-end funds to invest in private equity funds where the affiliated manager meets threshold "scale and experience"[4] criteria and

[3] *See* Private Equity Report.
[4] Private Equity Report at 69.

attracts substantial institutional capital.[5] The latter could be achieved by the SEC only allowing such public closed-end funds to invest in private equity funds that accept more than a certain percentage (e.g. 50%) of their capital commitments from institutional investors. Sophisticated institutional investors, such as qualified institutional buyers,[6] are unlikely to invest in private equity funds that lack a history of strong performance or seasoned management. Main Street investors would further benefit from the fact that the terms and provisions of the private equity funds available indirectly to retail investors would be negotiated by sophisticated institutional investors, including appropriate disclosures.

[5] Id at 68
[6] Id.

Additional Disclosure Requirements

2. **Question. If the SEC staff removed the 15% limit on closed-end fund investments in private equity funds, should the SEC require any additional disclosures to protect retail investors?**

   Response. Our view is that disclosure regarding the risks of investing in private equity funds, including risks associated with the timing and uncertainty of private equity fund returns, is already required by Form N-2, the disclosure form that the SEC has prescribed for closed-end investment companies to use when registering under the 1940 Act, and when registering their securities under the Securities Act of 1933, as amended (the "Securities Act"). For example, Item 8.2 of Form N-2 requires, among other things, a description of the types of securities in which a registered closed-end fund will principally invest (e.g., private equity funds). Similarly, Item 8.3 of Form N-2 requires a registered closed-end fund to discuss the principal risk factors associated with an investment in the fund specifically, as well as those factors generally associated with an investment in a fund with similar investment objectives, capital structure or trading markets.

   We believe this means that a registered closed-end fund investing in private equity funds would be required to disclose material information regarding the specific risks of investing in private equity funds, including risks associated with the timing and uncertainty of private equity fund returns and capital calls, and the operation and investments of private equity funds. As the Director of the SEC's Division of Investment Management, Dalia Blass, noted in her October 25, 2018 address to the ICI Securities Law Developments Conference, a fund's disclosure should tell a clear story, and a fund's risk disclosure should be tailored to the fund's investment strategies.[7] Accordingly, although investments in private equity funds may present unique risks and issues, we do not believe additional disclosure requirements are necessary.

   We also note that Securities Act registration of securities offered by a registered closed-end fund would likely be required to attract retail investors, and that the fund would be exposed to liability under Section 11 and Section 12(a)(2) of the Securities Act for material misstatements or omissions with respect to its registration statement and prospectus. Registered closed-end funds also must distribute annual and semi-annual shareholder reports. If securities offered by these funds are listed on a national exchange, then the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and exchange rules require additional ongoing disclosures. Rule 10b-5 under the Exchange Act imposes liability for material false statements or omissions of fact in these disclosures or public filings. Such liability under the Securities Act and Exchange Act would offer retail investors a further measure of assurance that registered closed-end funds that invest in private equity funds accurately disclose any specific risks of doing so.

[7] Dalia Blass, Keynote Address – ICI Securities Law Developments Conference (Oct. 25, 2018), *available at* https://www.sec.gov/news/speech/speech-blass-102518.

Process for Relaxing 15% Limit

3. **Question. What regulatory process must the SEC staff use to reverse its prior position?**

   Response. The 15% limit on public closed-end fund investments in private equity funds has always been an informal position of the SEC staff, and has been developed and communicated through the registration statement review and comment process and enforced through decisions to withhold or grant effectiveness orders. Accordingly, our view is that the SEC would not need to rely on the administrative rulemaking process to reverse its position with respect to the 15% limit. Instead, the SEC staff could accomplish a complete or partial roll back of the 15% limit through the registration statement review and comment process.

   Separately, we understand that the SEC staff has informally taken the position that a national securities exchange cannot list shares of a registered closed-end fund that exceeds the 15% limit on investments in private equity funds. We therefore suggest that the SEC staff consider changing that position as well and communicating the reversal of that position to the exchanges. Although we do not believe that any special listing requirements would need to apply to a public closed-end fund that invests in private equity funds, to the extent the exchanges view such listing standards as necessary, the SEC should approve any changes to generic listing standards required by exchanges to list these products for trading.

Valuation Issues

4. **Question. Should the SEC impose regulations on the valuation methodology used by public closed-end funds that primarily invest in private equity funds?**

   Response. Our view is that the framework that the 1940 Act provides for valuation of a registered fund's investments is sufficiently broad to address investments in private equity funds. The 1940 Act requires the fund's board of directors to determine a fair value for investments for which market quotations are not readily available. For many years, registered funds have made investments in difficult-to-value assets, and the 1940 Act has imposed on the board a duty to determine the fair value of those assets, rather than prohibiting registered funds from holding them altogether. The adviser to a registered fund investing in such hard-to-value assets typically provides substantial information to the board, often in consultation with third-party pricing vendors, to enable the board to determine (or to direct that a third party determine, with an approved methodology) the fair value of these assets.

   Several registered funds that invest in private equity funds already exist, including Altegris KKR Commitments Master Fund, Pomona Investment Fund, CPG Carlyle Commitments Fund, LLC and AMG Pantheon Fund, LLC. Each of these closed-end funds discloses its methodology for valuing private equity funds[8] and our understanding is that in connection with its investment in a private equity fund, such a registered fund negotiates with the private equity fund to establish certain rights and benefits in favor of the registered fund. Such rights and benefits may include a requirement that the private equity fund provide the registered fund with certain information at specified intervals to facilitate the closed-end fund's valuation process.

   We do not believe the SEC should impose a blanket requirement for private equity funds to provide their registered fund investors with valuation-related information. Instead, the SEC should continue to allow registered funds the flexibility to negotiate with underlying private equity funds for valuation information reporting that meets the registered fund's needs and is consistent with the underlying private fund's capabilities and investment strategy. If the SEC takes a "one size fits all" approach on specific valuation information that must be provided by a private fund to a registered fund, it risks the requirement becoming outdated over time and may provide private funds with an argument against providing additional information over and above the SEC's stated requirements.

[8] *See* Form N-2, Altegris KKR Commitments Master Fund, 46 (July 31, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1606789/000110465918048426/a18-17639_4pos8c.htm; Form N-2, Pomona Investment Fund, 44-45 (July 16, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1616203/000114420418038534/tv497008-n2a.htm; Form N-2, CPG Carlyle Commitments Fund, LLC, 64 (Mar. 30, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1560916/000114420418019920/tv490744_posami.htm; Prospectus, AMG Pantheon Fund, LLC, 19 (July 31, 2019), *available at* https://www.sec.gov/Archives/edgar/data/1609211/000119312519210056/d770339d497.htm#pro770339_8.

Distributions

5. **Question. What is the role for SEC regulation of the distributions made by closed-end funds that primarily invest in private equity funds?**

   Response. Distributions by public closed-end funds are highly regulated if the fund elects to be treated as a regulated investment company ("RIC") for federal income tax purposes. Subchapter M of the Internal Revenue Code allows RICs to pass through their income and gains to shareholders and to avoid taxation at the fund level, so long as RICs distribute to shareholders an amount equal to at least 90% of taxable income for the year. RICs generally distribute all of their income and gains, since amounts not distributed may be subject to tax at the entity level.

   Beyond the requirements of Subchapter M, the timing of distributions made by a registered closed-end fund that primarily invests in private equity funds would be a commercial decision, as it is with other types of registered funds. For example, a bond fund might make monthly distributions, while a micro-cap fund might make annual distributions. Our view is that a public closed-end fund could be structured to make a lump sum distribution at the end of its term or to make distributions periodically. As required by Item 10.1 of Form N-2, the fund's disclosures would clearly indicate whether investors could expect income and capital gains to be distributed periodically throughout the life of the fund or reinvested and returned at the end of the fund's term. Section 19 of the 1940 Act requires funds to disclose the sources of distributions (including returns of capital) that come from any source other than the fund's net income. Due to the existing disclosure requirements, we do not see a need for additional SEC regulation.

Fees on Uninvested Proceeds

6. **Question. Should the SEC mandate a waiver of management fees on uninvested capital by closed-end funds that primarily invest in private equity funds?**

   Response. Our view is that the amount of any management fees charged by a public closed-end fund on offering proceeds that have not yet been invested in private equity funds would be a decision for the fund's board of directors and, ultimately, investors. To make the product appealing, advisers would need to take a reasonable approach with respect to how the proceeds of a public offering would be invested while the adviser identified appropriate private equity investment opportunities, including the extent to which the adviser would charge management fees on uninvested capital. Fee arrangements would be disclosed in the registered fund's prospectus, as required by Form N-2, and board oversight and the background risk of Section 36(b) litigation would serve as practical limitations on management fees that realistically could be charged on uninvested offering proceeds. In addition, management and selection of cash management investments is a bona fide service and waiver of fees on the liquid portion of a portfolio would mean there is not compensation for this service.

   We note that Guide 1 and Item 7 of Form N-2 provide detailed disclosure requirements regarding the use of offering proceeds, including how long it is expected to take to fully invest net proceeds in accordance with a registered closed-end fund's investment objectives and policies, the reasons for any anticipated lengthy delay in investing the net proceeds, and the consequences of any delay. Any public closed-end fund with an initial ramp up period (e.g., an investment strategy that calls for investment in opportunities that may take time to identify) would face the same issue. Accordingly, we do not view this as a novel issue for registered funds of private equity funds and due to the existing disclosure requirements we do not think additional SEC regulation is necessary.

Underlying Fund Fees

7. **Question. Should the SEC limit public closed-end fund investment in private equity funds to those that charge management fees below a regulatory cap?**

   Response. We do not see a need for additional regulation limiting the universe of private equity funds available for investment by public closed-end funds to those that charge management fees below a certain cap. Management fees and other expenses paid by an underlying fund are one consideration in the overall investment analysis and would inform the decision about whether an underlying fund is likely to generate attractive returns net of fees and expenses. In addition, relatively expensive funds may outperform relatively inexpensive funds on a net basis. For example, managers of relatively expensive underlying funds may be able to devote greater resources to investment management research or sourcing opportunities. The manager of a registered closed-end fund evaluating a potential private equity fund investment, and not the SEC, is best positioned to decide whether an underlying fund presents an attractive performance-to-cost opportunity, which historically has been acknowledged legislatively, in court decisions and by the SEC.

   We further note that Form N-2 would require disclosure of the aggregate fees paid by a registered closed-end fund to any underlying private equity funds. Item 3 of Form N-2 requires a registered closed-end fund to disclose the fees that investors will indirectly bear as a result of investments in any underlying private equity funds. The fee table for a registered closed-end fund would disclose, in addition to a management fee that is charged at the investing fund level, the total expenses (expressed as a percentage of the investing fund's assets) that the fund's investors indirectly bear as a result of the fund's investments in underlying private equity funds. These acquired fund fees and expenses ("AFFE"), which are effectively borne by investors because they reduce the return on the fund's interests in underlying private equity funds, include any carried interest component of the underlying private funds. Form N-2 also requires a registered closed-end fund to describe the methodology used to calculate the AFFE ratio shown in the fund's fee table.

Impact of Regulation on Availability

8. **Question. What is the risk that additional regulations on private equity funds that accept investments from public closed-end funds would effectively limit the universe of private equity funds in which public closed-end funds could invest?**

   Response. We believe this is a real concern. As discussed above, our view is that existing regulations and market practice are sufficient to address the investor protection concerns associated with public closed-end fund investments in private equity funds. We believe that private equity funds will make rational business decisions about whether to accept capital from public closed-end funds, and that additional regulatory burdens on private equity funds that accept such capital could create incentives for private equity funds to avoid subscriptions from public closed-end funds. This could have the unintended consequence of causing well-known, outperforming private equity funds in high demand to decline to accept capital from public closed-end funds, limiting the universe of private equity funds available to public closed-end funds to those that are less well known, underperforming and/or in less demand. We also note that many of the most attractive private equity funds are already over-subscribed and are turning away capital. Over-subscribed private equity funds in high demand would likely avoid making room for any retail capital if doing so would increase their regulatory burdens.

COMMITTEE ON CAPITAL MARKETS REGULATION

EXPANDING OPPORTUNITIES FOR INVESTORS AND RETIREES: **PRIVATE EQUITY**

NOVEMBER 2018

The Committee is an independent 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations. The Committee's membership includes thirty-seven leaders drawn from the finance, business, law, accounting, and academic communities (www.capmktsreg.org/members). The Committee Co-Chairs are R. Glenn Hubbard, Dean of Columbia Business School, and John L. Thornton, Chairman of the Brookings Institution. The Committee's President is Hal S. Scott, Emeritus Nomura Professor of International Financial Systems at Harvard Law School and the Committee's Executive Director is John Gulliver.

Founded in 2006, the Committee undertook its first major report at the request of the incoming U.S. Secretary of the Treasury, Henry M. Paulson. Over ten years later, the Committee's research continues to provide policymakers with an empirical and non-partisan foundation for public policy.

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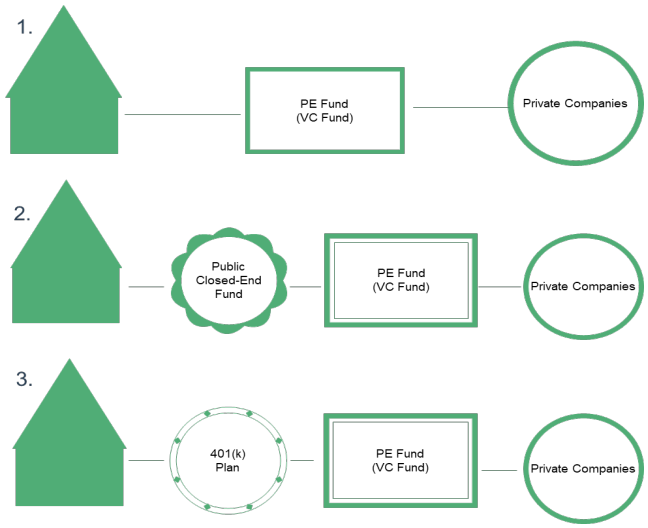
Executive Summary

In recent years, U.S. companies have raised more equity through private offerings available only to institutional and high-net-worth investors than through initial public offerings ("**IPOs**") that are available to the general public.[1] The number of U.S. public companies has also been steadily declining, and private start-up companies are frequently reaching billion-dollar valuations without opening up to the public for investment.[2]

In this report, *Expanding Opportunities for U.S. Investors and Retirees: Private Equity*, we examine whether U.S. policymakers should expand access to investments in private companies through private equity funds. A private equity fund refers to an investment vehicle that invests in the securities of private companies and that is not registered with the Securities and Exchange Commission ("**SEC**") as an investment company.[3] Private equity funds include buyout funds that acquire controlling stakes in businesses and venture capital funds that invest in young private companies with high growth opportunities.[4]

We find that private equity funds have a well-established performance history that justifies expanding investor access to them. We recommend three ways to do so. First, legislative reforms to expand access to direct investments in private equity funds. Second, SEC reforms to expand access to public closed-end funds that invest in private equity funds. And finally, Department of Labor ("**DOL**") reforms to facilitate the ability of 401(k) plans to invest in private equity funds. For clarity, **Figure 1** illustrates these three ways to expand access to private equity funds.

Figure 1



[1] *See* COMM. ON CAPITAL MKTS REGULATION, U.S. PUBLIC EQUITY MARKETS ARE STAGNATING (2017), http://www.capmktsreg.org/wp-content/uploads/2017/06/US-Public-Equity-Markets-are-Stagnating.pdf.
[2] *See* Jean Eaglesham & Coulter Jones, *The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising*, WALL ST. J. (Apr. 3, 2018), https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249.
[3] *See* JOHN DOWNES & JORDAN ELIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 577 (2014).
[4] While expanding access to alternative investments other than private equity, such as private real estate, is beyond the scope of this report, such access may well also be advisable and deserve serious consideration.

Part I: Evaluating the Performance of Private Equity Funds

We explain the many factors that allow the managers of private equity funds to generate attractive returns for long-term investors. We then describe the measures used to evaluate the returns of private equity funds and review the existing academic literature on the returns of private equity funds, which finds that private equity funds have historically outperformed public equity markets while also offering portfolio diversification benefits. Finally, we review institutional investors' asset allocations to private equity funds.

Part II: Expanding Investor Access to Private Equity Funds

We describe the legal and regulatory restrictions on access to private funds and the policy basis for these restrictions.[5] We focus on the restrictions on access to private funds generally because these restrictions also apply to private equity funds.

Chapter 1: The Restrictions on Access to Private Funds

Congress and the SEC have restricted access to private funds through the accredited investor standard, which prohibits investors with less than $1 million in assets or $200,000 in annual income from directly investing in private funds. Congress has also restricted access to private funds through the qualified purchaser standard, which prohibits investors with less than $5 million in investments from directly investing in private funds that have more than 100 investors. Approximately 87% of U.S. households do not meet the accredited investor standard, and approximately 98% of U.S. households do not meet the qualified purchaser standard.[6] For simplicity, we refer to investors that do not meet the accredited investor and qualified purchaser standards as "**retail investors**."

Chapter 2: The Policy Basis for Restricting Access to Private Funds

Congress and the SEC have restricted access to private funds on the presumption that retail investors are not financially sophisticated, so they need the protections afforded by mandatory disclosure requirements in the public market. Congress and the SEC have also noted concerns regarding the risk posed by private funds and the inability of retail investors to bear economic loss. However, we find that private equity funds provide frequent and extensive disclosures to investors and that private equity funds are not excessively complex investments. Retail investors also have access to investment advisers that can provide the requisite sophistication to invest in private equity funds. And, as described in Part I, private equity funds have a long history of outperforming public equity markets, with lower volatility than public markets. We therefore recommend that Congress allow retail investors to invest in private equity funds, so long as access is provided by a financial professional with a duty to act in the best interest of the retail investor. We describe additional regulatory protections that Congress and the SEC could apply to private equity funds that are available to retail investors in this manner, such as threshold scale and experience criteria.

[5] For purposes of this report, we define "private funds" as investment funds that are exempt from the definition of an investment company under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.
[6] *See infra* nn.99 & 107 and accompanying text.

Chapter 3: Can Public Funds Invest in Private Equity Funds?

Public funds are investment vehicles that are registered as investment companies with the SEC and are generally open to all investors. Public funds represent a potential vehicle for providing retail investors with access to private equity funds and, indirectly, private companies that are not otherwise available to the public. However, there are certain statutory and SEC restrictions on public funds that restrict their ability to invest in private equity funds.

Most importantly, public open-end funds (i.e. mutual funds) are statutorily required to provide investors with the right to redeem their investments on demand and must deliver payment within seven days. Mutual funds sell their assets to meet investor redemptions and the SEC only permits them to invest 15% of their net assets in illiquid assets (including private equity funds). We find that, in practice, investor inflows and outflows from mutual funds can be volatile. We therefore do not recommend expanding the extent to which public open-end mutual funds can invest in private equity funds.

On the other hand, public *closed-end* funds are not subject to redemption requirements. Investors in public closed-end funds generally obtain liquidity by selling their fund shares in secondary markets, which does not require a public closed-end fund to sell its assets. However, the SEC presently only allows *accredited investors* to invest in public closed-end funds that invest more than 15% of their assets in private equity funds. We recommend that the SEC allow retail investors to invest in public closed-end funds that invest more than 15% of their assets in private equity funds. We explain that public closed-end funds are subject to extensive disclosure requirements as to their asset allocations to specific private equity funds and management and performance fees charged by these funds. Additionally, the SEC could further protect retail investors by requiring that public closed-end funds only invest in private equity funds that are subject to additional regulatory protections, such as requiring that the affiliated manager of the private equity fund have an investor base with a material institutional component.

Part III: Enhancing Retirement by Expanding Access to Private Equity Funds

Chapter 1: The State of Employer-Sponsored Retirement Plans

We describe the two primary forms of employer-sponsored retirement plans: defined benefit plans and defined contribution plans with a focus on 401(k) plans. We explain that over the past twenty years, private-sector employers have shifted retirement assets away from defined benefit plans, where they directly bear the risk of a shortfall in plan assets, and towards defined contribution plans, where they do not. We find that the shift away from defined benefit plans and towards defined contribution plans could be hurting U.S. retirees, because defined contribution plans earn lower returns than defined benefit plans. We then describe a key difference between the two types of employer-sponsored retirement plans—defined benefit plans invest in private equity funds, whereas defined contribution plans generally do not. Finally, we show that private equity funds have positively contributed to the performance of defined benefit plans.

Chapter 2: Can 401(k) Plans Invest in Private Equity Funds?

We explain that, as a technical matter, 401(k) plans can legally invest in private equity funds. In practice, however, 401(k) plans generally do not invest in private equity funds because the employers that sponsor 401(k) plans (and other 401(k) plan fiduciaries) are concerned that offering investment options with exposure to illiquid assets, such as private equity funds, would unduly expose them to liability for breach of their fiduciary duties. We explain the basis for these meritless, yet burdensome, claims.

Chapter 3: How to Minimize Legal Risks and Safely Enhance Returns for Retirees

We further address the ERISA provisions and DOL regulations that expose 401(k) plan fiduciaries to litigation risk for offering investment options with exposure to private equity funds. First, we address the requirements that apply under ERISA's Section 404(c) safe harbor, which protects plan fiduciaries from legal risk from decisions made by plan participants. Most importantly, these provisions require that plan participants have the control necessary to shift among a broad alternative of investment options. As a result, plan fiduciaries offer plan participants the ability to shift assets among investment options on a *daily* basis. We then explain how a 401(k) plan could invest in private equity funds while still providing participants with the ability to shift among investment options on a daily basis. Ultimately we recommend that the DOL provide guidance as to how a plan fiduciary can offer investment options with exposure to private equity funds while qualifying for the Section 404(c) safe harbor. Second, we address the legal risk that a plan fiduciary can face from investment decisions made by plan fiduciaries, such as investing in an asset class with excessive fees or one that underperforms. We recommend that the DOL establish a new safe harbor for such legal risk that should apply if plan fiduciaries have complied with a diligent and independent process for selecting investments. We note that our recommended safe harbor approach is generally consistent with recent efforts by the DOL to create a safe harbor for annuities. We believe that private equity funds warrant similar treatment.

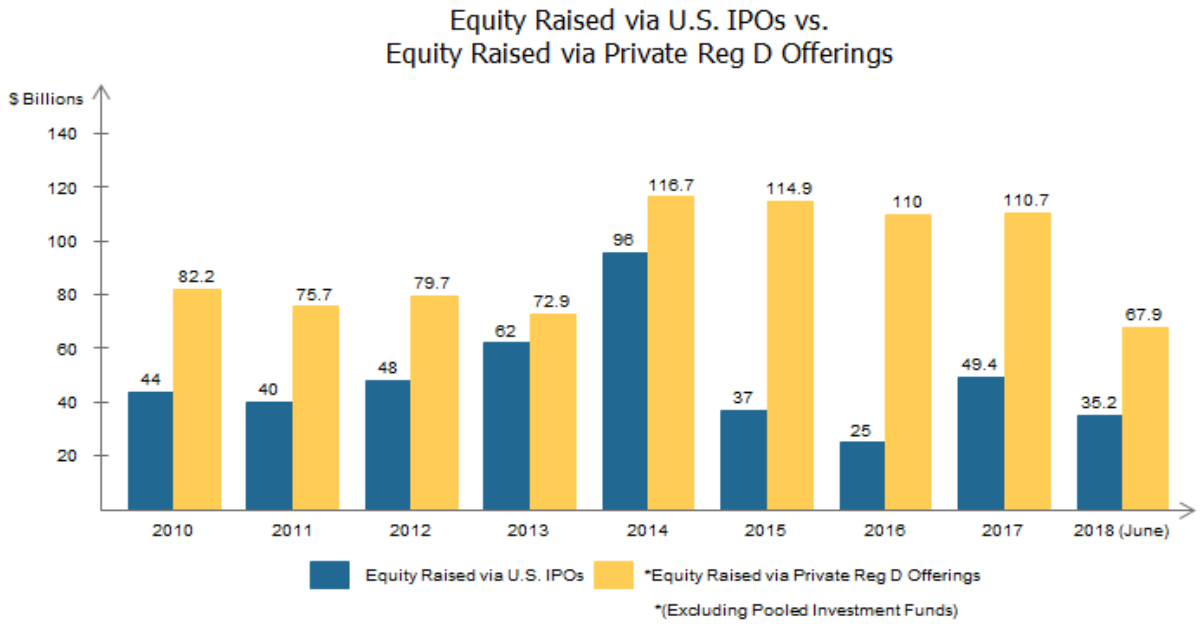
Introduction

Investment opportunities in private companies and private equity funds are growing. However, the vast majority of U.S. investors are missing out as they are excluded from private markets. We therefore believe that now is the right time to examine how to safely expand access to private markets. Indeed, we note that SEC Chairman Walter J. Clayton recently indicated that the SEC intends to do the same.[7]

In the Introduction, we profile the growth of private markets, the decline in the number of public companies, and the rise of private equity funds. We then explain that public funds and retirement accounts represent the majority of savings by U.S. households and are promising vehicles through which to expand access to private equity funds.

Figure 2 shows that in recent years companies have raised more than twice as much equity through U.S. private offerings than through U.S. IPOs.[8] **Figure 2** also shows that the market for raising equity capital privately has generally trended upwards from 2010 to June 2018.

Figure 2[9]



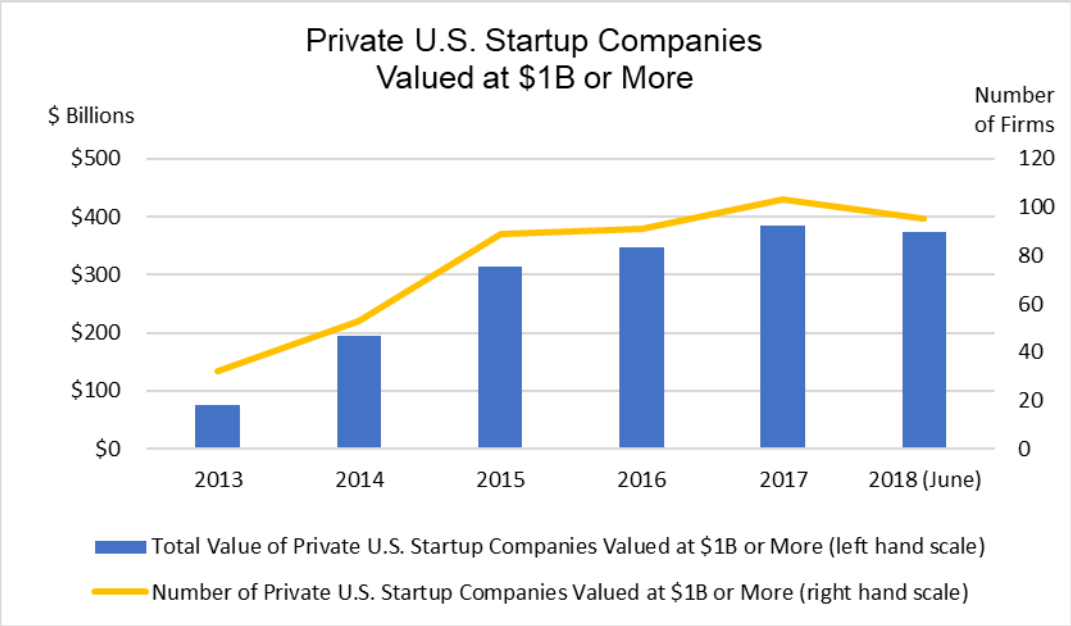
[7] Walter J. Clayton, Chairman, Securities and Exchange Commission, Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival (Aug. 29, 2018), *available at* https://www.sec.gov/news/speech/speech-clayton-082918.

[8] Equity raised via U.S. IPOs is derived from Dealogic. Equity raised via private offerings is derived from Regulation D filings available on the SEC's EDGAR database and excludes pooled investment vehicles and real estate investment trusts.

[9] *Id.*

Figure 3 shows the rapid increase in the number of private U.S. start-up companies with valuations of over $1 billion. In 2009, there were only fifteen such start-ups in the United States, and they had a total value of $36 billion.[10] **Figure 3** shows that as of June 2018 there were 95 privately-held U.S. start-ups with valuations of over $1 billion and a total value of $373 billion.[11]

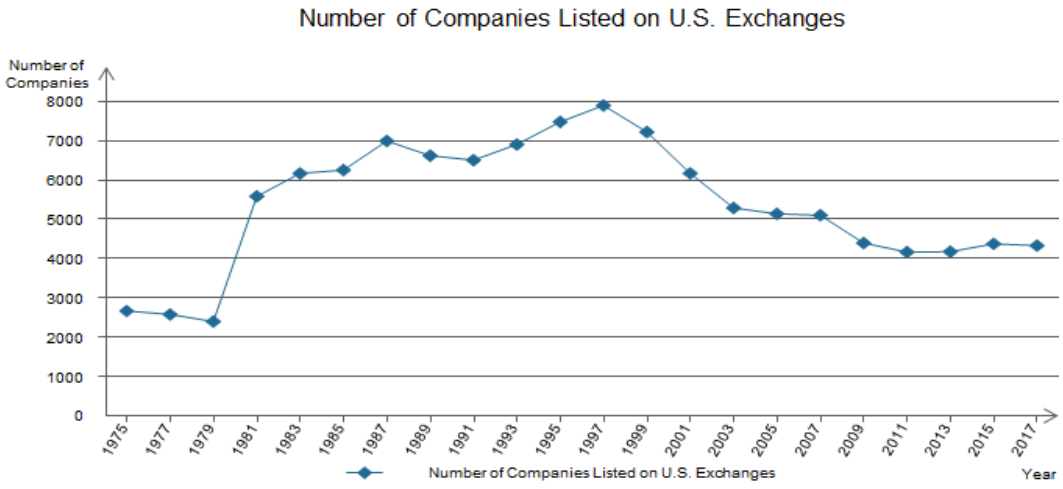
Figure 3[12]



Not only are private U.S. start-up companies reaching billion-dollar valuations without going public, but many public companies are leaving U.S. public markets, which reduces U.S. investors' ability to diversify their investment portfolios. **Figure 4** on the next page shows that the number of public companies in the United States is now at levels last seen in the early 1980s.[13]

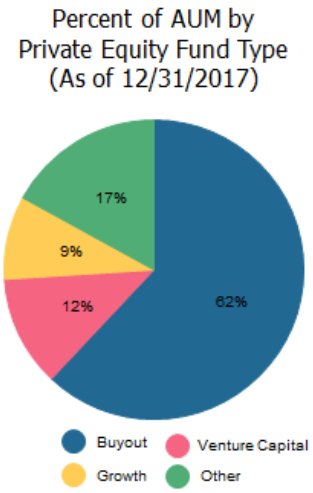
[10] *See* PITCHBOOK, UNICORN REPORT 4-5 (2017).
[11] Scott Austin et al., *The Billion Dollar Startup Club*, Wall St. J. (last accessed July 30, 2018), *available at* https://www.wsj.com/graphics/billion-dollar-club/.
[12] *See* sources cited *supra* n.10-11.
[13] The World Bank, *Listed Domestic Companies* (last accessed July 30, 2018), *available at* https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US&view=chart.

Figure 4[14]



In this report, we do not focus on expanding access to *direct* investments in private companies. We note that it is difficult to assess the performance of direct investments in private companies, as indices tracking their performance do not exist as they do for public companies. Instead, we focus on expanding access to private companies through private equity funds because these funds are a large and well-established asset class for institutional investors and have a history of outperforming public markets. According to Preqin, U.S. private equity funds had $1.7 trillion in assets under management ("**AUM**") in Q4 2017, up from only $448 billion in 2000.[15] **Figure 5** shows that 62% of U.S. private equity AUM are in buyout funds, 12% are in venture capital funds and 9% are in growth funds (late-stage venture capital).[16]

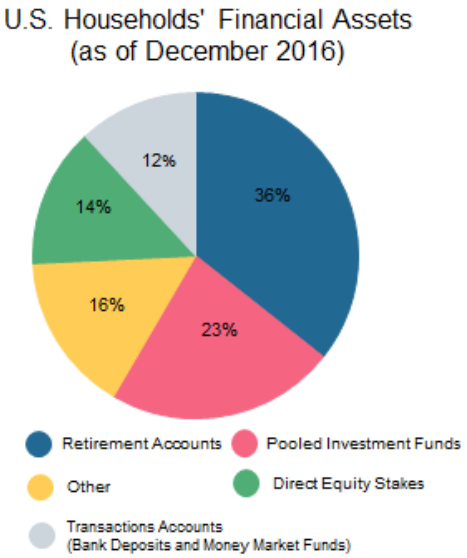
Figure 5[17]



[14] *Id.*
[15] Data derived from Preqin Ltd. as of Dec. 31, 2017.
[16] *Id.*
[17] *Id.*

Our report focuses on expanding access to private equity funds through public funds and retirement accounts, because they are the primary savings vehicles for U.S. households. **Figure 6** illustrates that the financial assets of U.S. households are primarily held in pooled investment funds, such as mutual funds, and in retirement accounts, such as individual retirement accounts and defined contribution plans.[18] Moreover, our proposals provide access to private equity funds with the benefit of a registered investment adviser and, in appropriate cases, a financial professional advising the individual retail customer.

Figure 6[19]



[18] Data derived from the FED. RES. SURVEY OF CONSUMER FINANCES (SCF) (2016), *available at* https://www.federalreserve.gov/econres/scfindex.htm.
[19] *Id.*

Part I: Evaluating the Performance of Private Equity Funds

In Part I, we focus on the performance of private equity buyout funds, as the majority of U.S. private equity AUM are held in private equity buyout funds and academic studies on private equity are generally focused on buyout funds. We begin Part I by describing the investment strategies of private equity buyout funds. We then explain the methods used to analyze the returns of private equity funds and review the empirical literature assessing the performance of private equity buyout funds. Finally, we review institutional investors' asset allocations to private equity funds.

Private Equity Buyout Funds

Investments in private equity buyout funds are illiquid, as these funds typically have a lifecycle of 8-12 years[20] and, during this time, investors cannot withdraw their capital.[21] In the interim, distributions are generally only made to investors when the fund liquidates one of its investments. Private equity buyout fund managers need access to long-term capital because their investment strategies are necessarily long-term. Buyout funds generate returns by identifying undervalued companies, purchasing them, improving their operations, and ultimately realizing gains through an exit, either through a sale or public offering.[22] Improving operations and preparing the portfolio company for a profitable exit can take a number of years; indeed, the average holding period of a company in a buyout fund's portfolio (i.e. purchase to exit) is approximately 6 years, and this does not include the time needed to identify an opportune investment.[23] Similarly, venture capital funds invest in companies with high growth prospects early in a company's life cycle and provide operational and financial support to portfolio companies as they grow. The average time from initial investment to an exit for venture capital funds is also approximately 6 years.[24]

The only way to exit an investment in a private equity fund before the lifecycle of the fund is complete is through a sale or transfer of one's investment in the fund in the secondary market, which often requires approval by the fund manager.[25] Secondary market trading in private equity

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[20] The typical lifespan across private equity funds is 10 years. However, the average lifespan is growing. *See* PEPPER HAMILTON, GOING THE DISTANCE: THE EXPANDING LIFECYCLES OF PRIVATE EQUITY FUNDS 12 (2016).

[21] EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 46 (Russell Sage Foundation, 2014).

[22] *See* Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, HARV. BUS. REV. (Sept. 2007); Rashida K. La Lande, *Private Equity Strategies for Exiting a Leveraged Buyout*, PRACTICAL LAW (July 26, 2016), *available at* https://www.gibsondunn.com/wp-content/uploads/documents/publications/LaLande-PrivateEquityStrategiesforExitingaLeveragedBuyout.pdf.

[23] Adam Lewis, *PE hold times keep going up*, PITCHBOOK (Nov.15, 2017), https://pitchbook.com/news/articles/pe-hold-times-keep-going-up.

[24] PITCHBOOK, VENTURE MONITOR 19 (Q3 2017), *available at* https://files.pitchbook.com/website/files/pdf/3Q_2017_PitchBook_NVCA_Venture_Monitor.pdf. Venture capital funds typically have a lifespan of 8 to 12 years. *See* Allen Wagner, *The Venture Capital Lifecycle*, PITCHBOOK (May 14, 2014), https://pitchbook.com/news/articles/the-venture-capital-lifecycle.

[25] *See* PHYLLIS A SCHWARTZ & STEPHANIE R. BRESLOW, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION 2-113 (2009), *available at* https://www.pli.edu/product_files/Titles%2F2802%2F19610_sample02_20150605160045.pdf. Private equity fund

investments has roughly sextupled over the past twelve years, growing from an annual aggregate transaction volume of $8.5 billion in 2005 to $52 billion in 2017.[26]

Given the overall illiquidity of a private equity investment, it should be expected that fund investors are compensated with an *illiquidity premium*.[27] The illiquidity premium can generally be thought of as the additional compensation that an investor must receive in exchange for a lack of liquidity in an asset. The greater the liquidity risk, the higher the illiquidity premium (i.e. higher return). Empirical studies have supported the theory behind illiquidity premiums, documenting extensive evidence of illiquidity premiums in various assets classes, including private equity.[28] Therefore, an investment portfolio that only holds liquid assets necessarily sacrifices returns, because the portfolio forgoes the higher returns from illiquid assets. The extent to which an investor should hold illiquid assets depends on the likelihood that the investor will need to quickly exit their investment.

Of course, private equity returns are not solely a function of the illiquidity of the investment. Rather, the lock-up period allows private equity fund managers to generate returns through operational improvements, multiple expansion, and leverage.[29] Operational improvements refer to changes in the operations of a firm that increase profitability or free cash flow.[30] Multiple expansion refers to an increase in the valuation multiple that allows the fund to sell an investment at a profit (e.g. purchasing a company at a 10x earnings multiple and selling at 12x earnings). Gains from multiple expansion can occur due to favorable market timing, effective negotiation skills, or overall improvements in a firm's future prospects.[31] Lastly, private equity funds also generate returns from leverage, because they can use less equity to finance the investment, thereby allowing for higher returns on equity.[32] Leverage is widely used by buyout funds: 60-90% of the initial financing for a fund's acquisition of target companies comes from borrowed money.[33] Recent academic studies of private equity performance have found that operational improvements

managers impose these transfer restrictions primarily to satisfy certain exemptions from the Securities Act and Investment Company Act.

[26] COLLER CAPITAL, THE PRIVATE EQUITY SECONDARY MARKET 4 (2018), *available at* https://www.collercapital.com/sites/default/files/Coller%20Capital%20%E2%80%93%20the%20private%20equity%20secondary%20market_0.pdf.

[27] *See, e.g.*, Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECONS. 223 (1986); *see also* Michael J. Brennan & Avanidhar Subramnyam, *Market Microstructure and Asset Pricing: On the Compensation for Illiquidity in Stock Returns*, 41 J. FIN. ECONS. 441 (1996); Lubos Pastor & Robert F. Stambaugh, *Liquidity Risk and Expected Stock Returns*, 111 J. POL. ECON. 642 (2003).

[28] *See supra* n.27; Morten Sorensen et al., *Valuing Private Equity*, 27 REV. FIN. STUD. 1977 (2014).

[29] *See* Ann-Kristin Achleitner et al., *Value Creation Drivers in Private Equity Buyouts: Empirical Evidence from Europe*, 13 J. PRIVATE EQUITY 17, 18 (2010). *See also* Michael Brigl et al., *How Private Equity Firms Fuel Next-Level Value Creation*, BOS. CONSULTING GRP, (Feb. 19, 2016), https://www.bcg.com/en-us/publications/2016/private-equity-power-of-buy-build.aspx.

[30] *See id. See also* Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPECTIVES, 121, 131- 32 (2009). These operational improvements can arise from buy and build platform deals that create substantial revenue and margin benefits from consolidation.

[31] Achleitner, *supra* n.29 at 21.

[32] *Id.* at 18 & 27, n.3.

[33] Kaplan & Stromberg, *supra* n.30 at 124.

account for roughly half of the value created by private equity buyout fund managers, while leverage accounts for roughly one-third and multiple expansion constitutes the remainder.[34]

Measuring Private Equity Returns

Calculating private equity returns is not as straight forward as calculating the returns on publicly-traded equity (e.g. the S&P 500). In the case of public equity, the liquidity in the public market provides accurate daily pricing information that can be used to calculate returns relatively easily. For example, if stock XYZ is purchased for $100 per share and the stock trades for $115 per share two years later, then the annualized rate of return is easily computed to be 7.2% (assuming no dividends are paid).[35] However, since there is no active market for the shares of private equity portfolio companies, establishing an accurate price—i.e. the net asset value (NAV)—for a private equity investment is more difficult. Therefore, the private equity industry and the academic community utilize various measures to estimate private equity returns, primarily focused on a private equity fund's supply of cash flows to its investors.

The main methodologies for estimating private equity performance are (i) the internal rate of return, or "**IRR**", and (ii) the public market equivalent, or "**PME**". The primary benefit of each of these methodologies is that actual cash flows are used to calculate the performance measure, eliminating the need for publicly displayed prices. However, to fully evaluate a fund's performance, it needs to reach its endpoint. Therefore, the complete performance of a 7-year fund launched in 2012, for example, could only be evaluated in 2019, subject to any extension.

The private equity industry frequently cites the IRR, while academic economists typically prefer the PME as the measure of private equity performance. However, both measures provide important insight into private equity returns, and recent empirical work referencing both IRR and PME show strong performance by private equity investments. The methodology for calculating each is described briefly below, followed by the empirical findings of recent studies.

Internal Rate of Return

The IRR is the discount rate that sets the net present value of an investment equal to zero.[36] For example, suppose an investor invests $100,000 in a private equity fund that is locked up for ten years. Further suppose that the private equity fund distributes $50,000 back to the investor in year 5 and makes a final distribution of $200,000 in year 10. The IRR is the discount rate that sets the present value of the two distributions (i.e. $50,000 in year 5 plus $200,000 in year 10) equal to the initial investment of $100,000. Mathematically, the IRR is illustrated as follows:

$$\$100{,}000 = \$50{,}000/(1+IRR)^5 + \$200{,}000/(1+IRR)^{10}$$

[34] *See, e.g.*, Achleiner et al., *supra* n.29; Fabian Soffge & Reiner Braun, *Corporate Raiders at the Gates of Germany? Value Drivers in Buyout Transactions*, 20 J. PRIV. EQUITY 28, 35 (2017). However, others have found that leverage plays a less significant role in value creation. *See, e.g.*, Brigl et al., *supra* n.29.

[35] Annualized rate of return = $(115/100)^{1/2}-1 = 0.07238$.

[36] See JOHN DOWNES & JORDAN ELIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 367 (9th ed. 2014).

In this case, the IRR works out to 11%. Since the IRR methodology relies on cash flows to calculate a performance measure, valuations of the underlying portfolio companies are not necessary. Importantly, the IRR is an *absolute measure* of performance, meaning the returns are not controlled for broader market returns (e.g. S&P 500) or other sources of risk.[37] The lack of relative comparison to a benchmark is a shortcoming of the IRR.[38] For example, whether an 11% IRR represents an attractive opportunity to an investor depends on the returns of other investment options – 11% looks strong against an S&P 500 IRR of 5%, but weak against an S&P 500 IRR of 15%.

Public Market Equivalent

The PME is a *relative measure* of performance that compares private equity returns to the broader market, typically using the S&P 500 as the public benchmark.[39] The PME is a number anchored on 1.00: a PME above 1.00 means the private equity fund outperformed the public market and a PME below 1.00 means the fund underperformed.[40] For example, if the PME of a private equity investment is 1.25, then the private equity investor has earned 25% more from the private equity fund than if the investor had alternatively invested in the S&P 500 index over the same time period. Similarly, a PME of 0.75 suggests the private equity investor earned 25% less than the S&P 500. However, the PME is a *cumulative* return measure over the life of the fund, rather than an annual return measure like the IRR.

Recognizing the importance of translating the PME into an annual performance measure for evaluation purposes, researchers often convert the PME into an annualized return based on the average duration of the private equity funds being analyzed. For example, a PME of 1.15 for a fund with a duration of 7 years represents an excess annual return of 2.0% above the return of the public benchmark. If that same fund alternatively had a duration of 5 years and a PME of 1.15, then the excess annual return would be 2.8%.

However, converting the PME in this manner requires an accurate assessment of the average duration of the private equity fund. Doing so is not always straightforward as the duration of a private equity fund investment is not necessarily equivalent to the legal life of a fund. The reason for this distinction is based on the timing of cash flows: not all capital investments by the fund investors occur at the fund's inception and not all distributions from the fund to investors occur at the end of the fund's legal life. So, while the legal life of a fund may be 10 years, the duration of the fund investment may be shorter for purposes of translating the PME into an annual return measure. Researchers must therefore review the cash flows of each private equity fund to determine the duration of a fund.

[37] *See* Steven N. Kaplan & Berk A. Sensoy, *Private Equity Performance: A Survey*, 7 ANNU. REV. FIN. ECON. 597, 599 (2015).
[38] *See id.*
[39] *Id.* at 599-600.
[40] *Id.*

Empirical Analyses of Private Equity Buyout Fund Returns

Whether measuring performance using IRR or PME, studies of private equity buyout fund performance consistently find that private equity buyout funds outperform public market alternatives. Importantly, we note that each of the studies that we review evaluates the performance of private equity buyout funds *net* of fees. Therefore, even though private equity buyout funds generally charge higher fees than public funds, such as mutual funds that track the S&P 500, these empirical analyses take that into consideration when evaluating their relative performance.

Robinson & Sensoy (2013), Harris et al. (2014), and Higson & Stucke (2014) all determine that the average private equity buyout fund has outperformed the S&P 500 index over time after netting out fees.[41] While some argue that the S&P 500 index is not the appropriate benchmark to evaluate private equity returns, each of the three studies conducts robustness tests using other indices, ultimately concluding that the choice of the S&P 500 index is not crucial to the results.[42] We focus on comparisons to the S&P 500 index, because it serves as the most widely used measure for benchmarking the performance of private equity funds.

Harris et al. (2014) finds that private equity buyout funds have achieved strong performance whether measured by IRR or PME. In particular, the study finds that the average IRR for private equity buyout funds that launched between 1984 and 2008 was 15.7%.[43] Additionally, the study concludes that private equity buyout funds "consistently outperform the S&P 500," finding that the average private equity buyout fund has a PME of 1.20, i.e. a 20% greater return versus the S&P 500 over the life of the fund.[44] Furthermore, the study estimates that the average duration of the funds in their sample is approximately 5 years, meaning a PME of 1.20 translates to excess returns of approximately 3.7% annually.[45] Similar results are found when comparing the IRR of the average private equity fund to the IRR of the S&P 500 index. When comparing IRR's, the average excess return of private equity buyout funds over the S&P 500 is also 3.7%.[46]

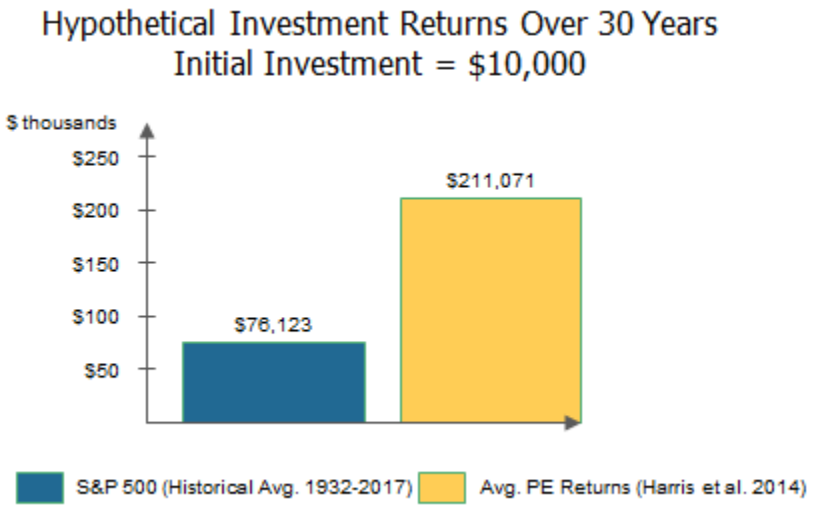
The authors of Harris et al. (2014) published a follow-up study in 2016, which examined the performance of private equity buyout funds through 2014, based on a sample of funds formed between 1984 and 2010.[47] While the study found that returns from private equity buyout funds from the late 2000s were roughly equivalent to the returns from public markets, it also found that over the entire period private equity buyout funds generally outperformed public markets.[48] The average private equity buyout fund in the sample had a PME of 1.18 (translating to approximately

[41] David Robinson & Berk Sensoy, *Cyclicality, Performance Measurement, and Cash Flow Liquidity in Private Equity*, 122 J. FIN. ECON. 251 (2016); Robert Harris et al., *Private Equity Performance: What Do We Know?*, 69 J. OF FIN. 1851 (2014); Chris Higson & Rüdiger Stucke, *The Performance of Private Equity* (2012), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2009067.
[42] Kaplan & Sensoy, *supra* n.37, at 603.
[43] Harris et al., *supra* n.41 at 1860. Note that all reported averages are weighted by capital committments of the fund.
[44] *Id.* at 1863.
[45] *Id.*
[46] *Id.*
[47] Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity*, 14 J. OF INV. MGEMT. 14, 17 (2016).
[48] *Id.* at 21.

3.4% outperformance over the S&P 500 annually versus 3.7% in the 2014 study) and the average private equity buyout PME exceeded 1.0 for 25 of the 27 vintage years.[49]

The findings of Harris et al. are significant and have major implications for the potential returns to retail investors and retirees from private equity funds. For example, as demonstrated by **Figure 7**, investing $10,000 in a retirement fund that earns 7% annually from the S&P 500 (the historical average from 1932-2017) over 30 years would result in an ending balance of $76,123. Alternatively, if the $10,000 is invested in the average private equity buyout fund, which earns 3.7% above the S&P 500 annually (Harris et al. 2014), then the ending balance would be $211,071. Thus, the private equity investment leads to a retirement balance of nearly 3 times the balance that would result from an investment in the S&P 500 index.

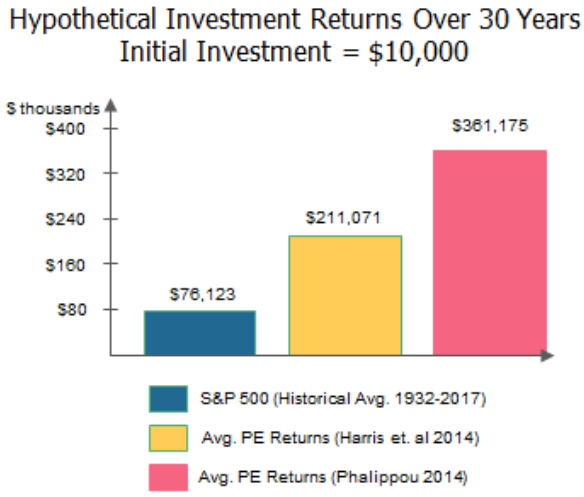
Figure 7[50]



Phalippou (2014) finds that the annualized outperformance of private equity buyout funds over the S&P 500 is even greater than the 3.7% found in Harris et al. (2014).[51] While Phalippou also finds an average PME of 1.20, similar to Harris et al., Phalippou's study examines the same funds and finds that the relevant average holding period in the sample should be 3.3 years, rather than 5 years.[52] Using 3.3 years as the average duration of the private equity funds, the annualized excess rate of return becomes 5.7% instead of 3.7%.[53] As demonstrated by **Figure 8** on the next page, extending Phalippou (2014)'s revised rate of return to the hypothetical $10,000 investment, would grow the ending balance after 30 years to $361,175 as a result of private equity investments.

[49] *Id.*
[50] Average returns of the S&P 500 from 1932-2017 and the average returns of private equity funds from Harris et al., 2014, *supra* n.41.
[51] Ludovic Phalippou, *Performance of Buyout Funds Revisited?*, 18 REV. OF FIN. 189, 190 (2014).
[52] *Id.*
[53] *Id.*

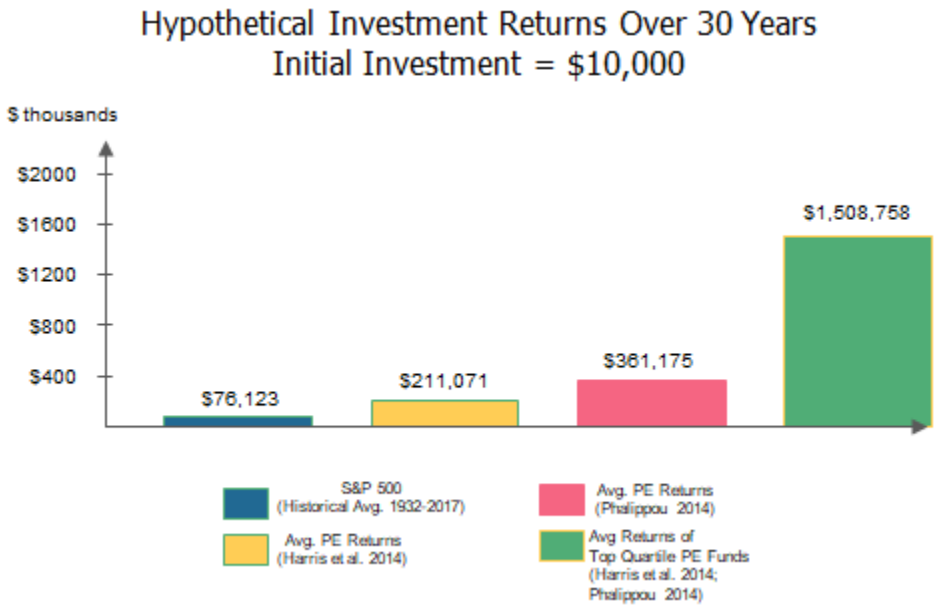
Figure 8[54]



While the empirical studies that we have reviewed consistently show outperformance of the *average* private equity buyout fund over public markets, the top performing private equity buyout funds have even more impressive results. Harris et al. (2014) find that the top 25% of private equity buyout funds have an average PME of roughly 1.42.[55] Based on an average fund duration of 5 years, the outperformance of the top quartile of private equity buyout funds is 7.3% over the S&P 500. In this case, the hypothetical $10,000 investment would grow the ending balance to $551,299 after 30 years - a 624% increase over the $76,123 balance achieved through an investment in the S&P 500 index. Moreover, using Phalippou (2014)'s average duration of 3.3 years, the excess return of the top quartile of private equity buyout funds becomes 11.2% annually over the S&P 500 return. As demonstrated by **Figure 9** on the next page, investing in the top 25% of private equity buyout funds would therefore lead to an ending balance of $1.5 million in our hypothetical $10,000 retirement account – an 1,882% increase over the $76,123 that results from an S&P 500 investment.

[54] Average returns of the S&P 500 from 1932-2017 and the average returns of private equity funds from Harris et al., 2014, *supra* n.41 and Phalippou 2014, *supra* n.51.
[55] Harris et al., *supra* n.41, at 1873.

Figure 9[56]



Furthermore, studies find that past performance of a manager of a private equity buyout fund may be predictive of future performance. Therefore, investors may be able to identify and access top performing private equity buyout funds. For example, Korteweg & Sorensen (2013) find that the top quartile of private equity buyout firms consistently outperform the bottom quartile by 7–8% annually.[57] Recent data further confirms this finding. According to PitchBook, 39% of private equity buyout funds that follow a top-quartile fund by the same fund manager also deliver performance in the top quartile.[58] This is in contrast to actively managed mutual funds that primarily invest in public securities for which past performance is generally *not* predictive of future performance.[59]

Thus far, this section has focused on the performance of private equity buyout funds. However, we note venture capital fund performance has also exceeded public markets. Harris et al. (2014) found that the average IRR for venture funds that launched from 1984 to 2008 was 19.3%, and the average PME from those years was 1.45.[60] Harris et al.'s 2016 update study showed

[56] Average returns of the S&P 500 from 1932-2017 and average returns of private equity funds from Harris et al., 2014, *supra* n.41 and Phalippou 2014, *supra* n.51 .
[57] Arthur Korteweg and Morten Sorensen, *Skill and Luck in Private Equity Performance*, 124 J. FIN. ECON. 535 (2017).
[58] *See* Paul Davies, *When Past Performance Actually Is a Guide to Future Results*, WALL ST. J. (June 18, 2018), https://www.wsj.com/articles/when-past-performance-actually-is-a-guide-to-future-results-1529316646
[59] Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. OF FIN. 57, 71- 72 (1997) ("[W]hile the ranks of a few of the top and many of the bottom [mutual] funds persist, the year-to-year rankings on most funds appear largely random.").
[60] *See* Harris et al., *supra* n.41 at 1860, 1864.

recent improvement in venture capital fund performance. The average IRR for venture capital funds that launched from 1984 to 2010 was 20.8%, and the average PME was 1.46.[61]

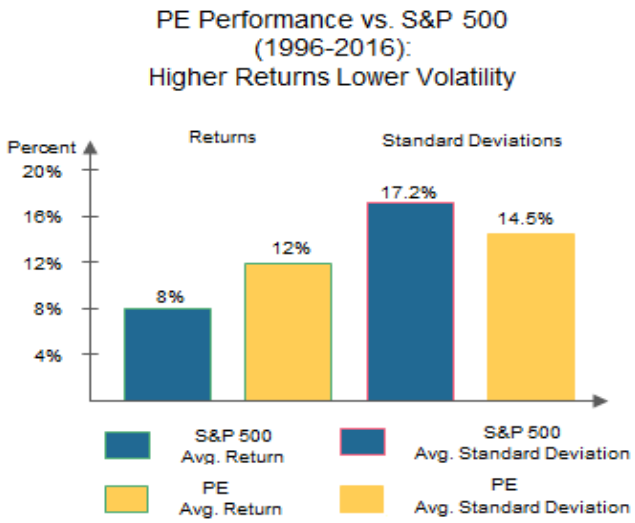
Risk, Return and Diversification of Private Equity Returns

Modern portfolio theory suggests that an optimal portfolio should maximize returns for a given level of risk. Therefore, if private equity funds were to increase returns merely by increasing the riskiness of a portfolio, then the argument for a private equity investment becomes less compelling. Sorensen & Jagganthan (2015) argue, however, that the PME is an appropriate measure of private equity fund performance regardless of the riskiness of the private equity investments, meaning PME does not need to be adjusted for risk.[62] But regardless of the theoretical arguments on risk adjustments, recent empirical studies illustrate that in addition to superior returns, private equity investments are also less risky than public market alternatives and provide diversification benefits to an investment portfolio.

As demonstrated by **Figure 10** on the next page, a 2017 white paper from Voya, an independent retirement planning company, finds that not only did private equity returns outperform the S&P 500 index over the 20-year period 1996-2016 (12% annually for private equity versus 8% annually for the S&P 500), but the riskiness of private equity returns was also *lower* than those of the public markets.[63] The study notes that the standard deviation of private equity returns was 14.5% versus 17.2% for the S&P 500, based on data from the Cambridge Associates U.S. Private Equity Index.[64] While there are multiple proxies for risk, standard deviation is a common measure of risk for investors, as it illustrates the volatility of returns (higher standard deviation means higher volatility).

[61] *See* Harris et al., *supra* n.47 at 20, 22.
[62] *See* Sorensen, M. and R. Jagannathan, 2015, The Public Market Equivalent and Private Equity Performance. Financial Analysts Journal 71, 43-50.
[63] Voya Investment Management, AN OVERVIEW OF PRIVATE EQUITY INVESTING 3, 7 (Oct. 2017).
[64] *Id.*

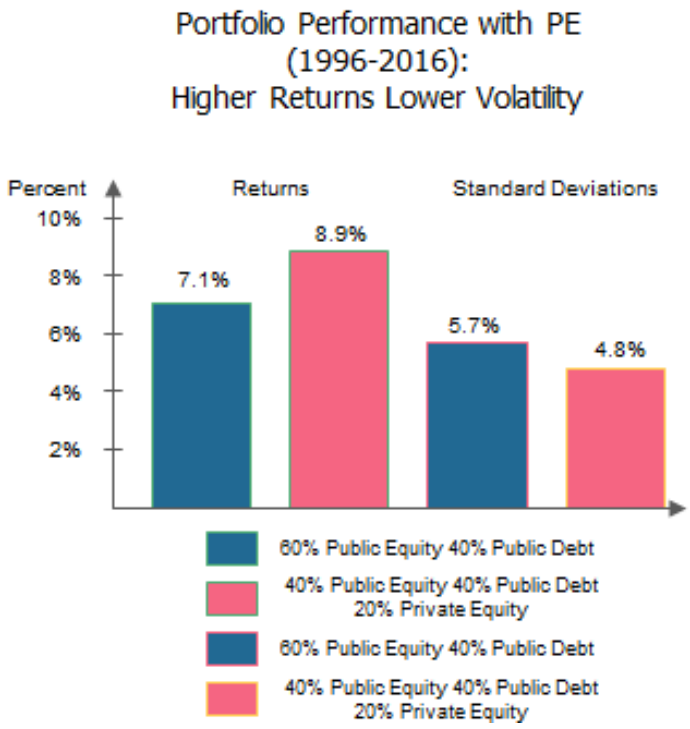
Figure 10[65]



While risk and return in isolation are important to evaluate, the most important consideration for an investment option is its net effect on an otherwise well-balanced portfolio. That is, does private equity provide diversification benefits that improve the risk and return of the overall portfolio? The answer is squarely in the affirmative. According to the Voya (2017) study, and as demonstrated by **Figure 11**, over the 20-year period 1996-2016, a hypothetical portfolio that consisted of 60% public equities and 40% public debt *without* a private equity component returned 7.1% annually with a standard deviation of 5.7%.[66] Alternatively, if a 20% private equity investment had been added to the portfolio by replacing 20% of the public equity investment (i.e. 40% public equity, 40% public debt and 20% private equity), then the portfolio return would have risen to 8.9% and its standard deviation would have dropped to 4.8%.[67] Therefore, the overall performance of the portfolio increases as a result of the private equity investment, while the riskiness of the portfolio decreases.

[65] *Id.*
[66] *Id.* at 8-9.
[67] *Id.* at 9.

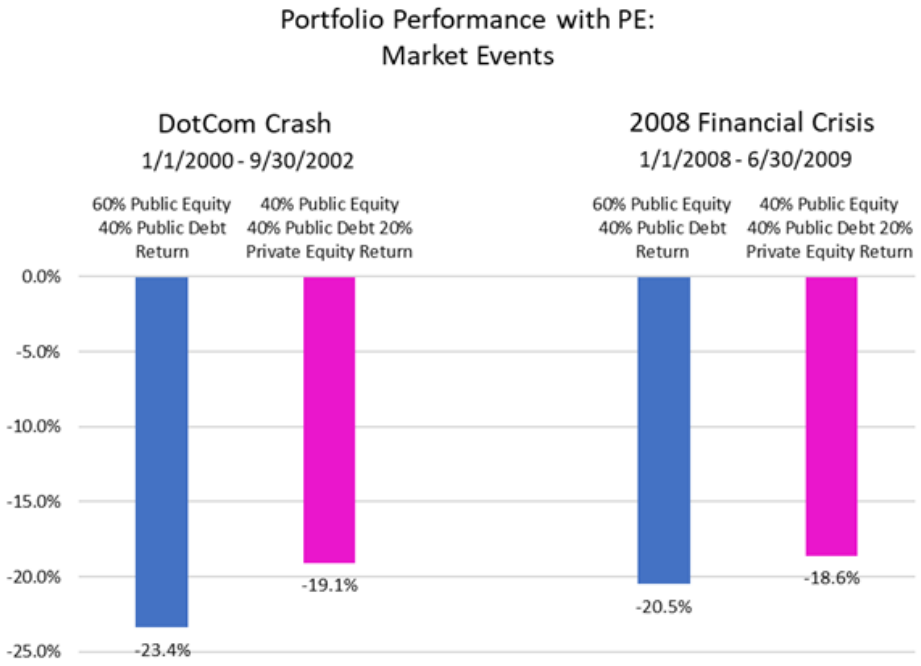
Figure 11[68]



Furthermore, adding a private equity component to an investment portfolio can provide protection in times of market stress. The same Voya (2017) study shows that during the dot-com crash from January 2000 to September 2002, a portfolio with a private equity component would have outperformed a portfolio without private equity by 4.3% (the portfolio with private equity returned -19.1%, while the portfolio without private equity returned -23.4%).[69] More recently, during the great recession from January 2008 through June 2009, the private equity portfolio outperformed the portfolio without private equity by nearly 2% (-18.6% for the portfolio with private equity and -20.5% for the portfolio without private equity).[70] **Figure 12** further illustrates that including private equity in an investment portfolio can reduce losses during market downturns.

[68] *Id.* at 8-9.
[69] *Id.*
[70] *Id.*

Figure 12[71]



[71] *Id*. at 9.

Long-Term Institutional Investors Increase Exposure to Private Equity

Major investors in private equity funds include defined-benefit pension plans, university endowments, sovereign wealth funds and private foundations. These long-term institutional investors are taking advantage of the strong and stable returns that private equity has to offer, as private equity makes up an increasingly significant component of their investment portfolios. For example, a recent Preqin survey of institutional investors in private equity found that 53% of these investors plan to increase their allocation to private equity funds over the longer term.[72] We briefly sample institutional investors' allocations to private equity funds below.

As of January 31, 2018, the largest investors in private equity funds were government (public) defined benefit pension plans, which account for 35% of the global aggregate capital invested in private equity, and private defined benefit pension plans, which account for 12% of the global aggregate capital invested.[73] As of January 2018, public defined benefit pension plans allocated 7.4% of their investments to private equity, up from 7.1% in 2013.[74]

Sovereign wealth funds have also increasingly engaged in private equity investing. As of January 31, 2018, sovereign wealth funds accounted for 8% of the global aggregate capital invested in private equity, and the average target allocation to private equity for sovereign wealth funds was 17% (up from 8% in 2013).[75] The sovereign wealth funds that are making these investments include some of the largest. For example, as of May 2018, the Kuwait Investment Authority and Abu Dhabi Investment Authority allocated $52.4 billion and $41.3 billion to private equity, respectively.[76] These investments represented 9% and 6%, respectively, of the funds' total assets under management.[77] Similarly, the Australian Future Fund has increased its private equity exposure to $22 billion as of 2017, accounting for 12% of the total fund portfolio.[78] The Alaska Permanent Fund, a sovereign wealth fund for the State of Alaska, has also recently increased its allocation to private equity, nearly doubling its private equity investments from 3% of its portfolio in 2010 to 7% in 2017.[79]

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[72] PREQIN, GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT 77 (2018).
[73] *Id.* at 73.
[74] *Id.* at 74.
[75] *Id.* at 73-74.
[76] PREQIN, PRIVATE EQUITY AND VENTURE CAPITAL SPOTLIGHT 3 (June 2018), http://docs.preqin.com/newsletters/pe/Preqin-Private-Equity-Spotlight-June-2018.pdf.
[77] *See id.*; Statista, *Largest Sovereign Wealth Funds Worldwide as of August 2018*, https://www.statista.com/statistics/276617/sovereign-wealth-funds-worldwide-based-on-assets-under-management/.
[78] AUSTRALIAN FUTURE FUND, ANNUAL REPORT (2016-2017), *available at* http://www.futurefund.gov.au/about-us/annual-reports. Australia's Future Fund defines private equity as "[e]xposure to corporate enterprise gained through private markets" which includes "[v]enture capital, growth capital, buyout, [and] distressed debt for control." *Id.* at 18.
[79] *See Report Archives*, ALASKA PERMANENT FUND CORP., https://apfc.org/report-archive/#12-annual-reports. The Alaska Permanent Fund's 2017 annual report states that "[p]rivate [e]quity refers to several different types of investments. Venture capital and growth equity investments support and nourish innovative, fast-growing companies" while the Fund's "buyouts strategy emphasizes robust, long-term partnerships with exceptional investors applying specialized skills to add value to the assets they acquire. In addition, the Fund's distressed and other specialized private equity strategies tend to focus opportunistically on countercyclical investments and narrowly focused industry opportunities." ALASKA PERMANENT FUND CORPORATION, ANNUAL REPORT 16 (2017), https://apfc.org/download/12/annual-reports/625/2017-apfc-annual-report.pdf.

Endowments also make material allocations to private equity.[80] As of January 31, 2018, endowments accounted for 6% of the global aggregate capital invested in private equity, and the average target allocation to private equity for endowments was 13% (up by nearly 1% since 2013).[81] Yale University, one of the first university endowments to engage in private equity investing, allocated 31% of its endowment fund to private equity in fiscal year 2017.[82] Other universities have followed Yale's lead. The University of Texas Investment Management Company, which manages the third-largest university endowment in the country, appears to have recently allocated as much as 40% of its portfolio to private equity investments,[83] while Princeton University has allocated at least 32% of its endowment portfolio to private equity in every year since 2009.[84] In 2000, the University of Pennsylvania had allocated only 1.4% of its endowment portfolio to private equity, but by 2016 Penn allocated 16.3% of its portfolio to private equity, a nearly 12-fold increase since 2000.[85] The University of California also recently doubled its allocation to private equity from 11.5% to 22.5%, citing the illiquidity premium of private equity as its rationale.[86]

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[80] Endowments are pools of assets that are invested and used for the benefit of a particular institution, often for a specified purpose (e.g. education). *See* JOHN DOWNES & JORDAN ELIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 230 (2014).

[81] GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT, *supra* n.72 at 73- 74.

[82] YALE UNIVERSITY, THE YALE ENDOWMENT (2017), https://static1.squarespace.com/static/55db7b87e4b0dca22fba2438/t/5ac5890e758d4611a98edd15/1522895146491/Yale_Endowment_17.pdf. The Yale endowment's 2017 report does not define private equity but states that Yale's leveraged buyout strategy "emphasizes partnerships with firms that pursue a value-added approach to investing. Such firms work closely with portfolio companies to create fundamentally more valuable entities, relying only secondarily on financial engineering to generate returns." *Id.* at 14. Yale's venture capital managers "identify opportunities and support talented entrepreneurs" *Id.* at 15.

[83] Michael McDonald, *Texas Endowment Hits Brakes on Private Equity as Values Rise*, BLOOMBERG (Sept, 20, 2017), https://www.bloomberg.com/news/articles/2017-09-20/texas-endowment-hits-brakes-on-private-equity-as-valuations-rise. According to recent financial statements from the University of Texas, the endowment's private equity strategy involves investing in investment pools that are "generally invested in limited partnerships with external investment managers or general partners who invest primarily in private equity securities." However, "private equity securities" is not further defined. *See* PERMANENT UNIVERSITY FUND FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORT 18 (2017), http://www.utimco.org/Funds/Endowment/PUF/PUF2017AuditedFinancials.pdf.

[84] Based on figures from the Reports of the Treasurer from 2009-2017, *available at* https://finance.princeton.edu/princeton-financial-overv/report-of-the-treasurer/index.xml. Princeton's 2016-2017 treasury report states that Princeton's private equity asset class "includes funds invested primarily in buyouts or venture capital" but does not further define "buyouts" or "venture capital." PRINCETON UNIVERSITY, REPORT OF THE TREASURER 37 (2016-2017).

[85] *Compare* UNIV. OF PA., ANNUAL FINANCIAL REPORT 21 (2016), *available at* http://www.finance.upenn.edu/vpfinance/AnnualRpt/Financial_Report_FY16.pdf, *with* UNIV. OF PA., ANNUAL FINANCIAL REPORT 23 (2000), *available at* http://www.finance.upenn.edu/vpfinance/AnnualRpt/Annual_Report_99-00.pdf. The 2016 financial statements state that "[i]nvestments in private equity are in the form of closed-end limited partnership interests" and that the fund managers of these limited partnerships "primarily invest in private investments for which there is no readily determinable market value." However, it does not further define the investment strategies of the limited partnerships. *See* UNIV. OF PA., ANNUAL FINANCIAL REPORT 34 (2016), *available at* http://www.finance.upenn.edu/vpfinance/AnnualRpt/Financial_Report_FY16.pdf.

[86] Meaghan Kilroy, *University of California Endowment Doubles Private Equity in New Asset Allocation*, PENSIONS & INVESTMENTS (Mar. 15, 2017), http://www.pionline.com/article/20170315/ONLINE/170319924/university-of-california-endowment-doubles-private-equity-in-new-asset-allocation. The University of California's 2016-2017

Major foundations also invest in private equity.[87] As of January 31, 2018, foundations accounted for 5% of the global aggregate capital invested in private equity, and the average target allocation for foundations was 12%.[88] Certain large foundations allocate an even greater portion of their capital to private equity. For example, the Hewlett Foundation invested 25% of its portfolio in private equity in 2016, a substantial increase from 16% in 2009.[89] The Ford Foundation invested 22% of its endowment in private equity in 2016,[90] while the Howard Hughes Medical Institute invested 18% in private equity in 2017.[91]

Lastly, while institutional investors, such as retirement plans, sovereign wealth funds, endowments and foundations, represent the vast majority of the aggregate capital invested in private equity funds, high-net worth individual investors can also invest in private equity funds and comprise a small but significant percentage. For example, according the SEC's private fund statistics, individual investors represent approximately 7.4% of the aggregate capital invested in large U.S. private equity funds.[92] We also note that family offices—wealth management advisory firms that serve high-net-worth investors—maintain an average target to private equity well above other investor types at 29.9% of total assets.[93] To be sure, these investors can allocate a greater percentage of their total assets to private equity than institutional investors as they have greater legal flexibility.

annual financial report states that private equity "include venture capital partnerships, buyout and international funds." UNIV. OF CAL., ANNUAL FINANCIAL REPORT 44 (2017), *available at* https://finreports.universityofcalifornia.edu/index.php?file=16-17/pdf/fullreport-1617.pdf.

[87] Foundations are nonprofit organizations that make investments and distribute the income from their investments for one or more specified purposes (typically charitable).

[88] GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT, *supra* n.72 at 73-74.

[89] *Compare* WILLIAM AND FLORA HEWLETT FOUNDATION, FINANCIAL STATEMENTS 19 (2009-2010), https://www.hewlett.org/wp-content/uploads/2016/08/Hewlett_Foundation_2010_Audited_Financial_Statements.pdf *with* WILLIAM AND FLORA HEWLETT FOUNDATION, FINANCIAL STATEMENTS 19 (2015-2016), https://www.hewlett.org/wp-content/uploads/2017/05/Hewlett-Foundation-2016-Audited-Financial-Statements.pdf. The 2016 financial statements describe private equity as a strategy that involves "venture and buyout [investments], in the U.S. and international[ly]." *Id.* at 22.

[90] THE FORD FOUNDATION, FINANCIAL STATEMENTS 10 (2015-2016), https://www.fordfoundation.org/media/3388/2016-audited-financial-statements-and-footnotes.pdf. The Ford Foundation uses an investment category for "Private Equity and Venture Capital" whose strategy is "investments in the equity and credit of primarily private companies through private partnerships and holdings companies." *Id.* at 14.

[91] HOWARD HUGHES MEDICAL INSTITUTE, FINANCIAL STATEMENTS 2, 18 (2016-2017), http://www.hhmi.org/sites/default/files/About/Financials/hhmi-fy2017-audited-statement.pdf. The 2017 financial statements note that private equity investments include "venture capital, buyout strategies, and energy-related investments usually structured as limited partnerships or other similar pass through vehicles. In general, these investments are held to the term of the investment and have limited liquidity. Distributions from these investments are primarily received through liquidation of the underlying assets." *Id.* at 11.

[92] *See* SEC, PRIVATE FUND STATISTICS: FOURTH QUARTER 2017 at 18 (Aug. 2, 2018).

[93] GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT, *supra* n. 72 at 74.

Part II: Expanding Investor Access to Private Equity Funds

In Part II, when we refer to "**private funds**," we are referring to investment funds that are exempt from the definition of an investment company under the Investment Company Act of 1940 (the "**1940 Act**") and that offer securities that are exempt from the registration requirements under the Securities Act of 1933 (the "**Securities Act**"). By contrast, when we refer to "**public funds**," we are referring to investment funds that are registered under the 1940 Act and that offer shares that are registered under the Securities Act. In Part II, we initially focus on the legal and regulatory restrictions on access to all private funds because these restrictions also apply to private equity funds, a subtype of private fund. The other well-known subtype of private fund is a hedge fund. This report does not focus on expanding access to hedge funds, because their primary investment strategy does not involve investing in the securities of private companies.

In Chapter 1, we explain the legal restrictions on access to private funds, including the accredited investor standard, the qualified purchaser standard and the qualified client standard. In Chapter 2, we explain the policy basis for the relevant legal restrictions on access to private funds. In our view, there are three distinct, but related policy concerns repeatedly highlighted by Congress and the SEC: (1) adequacy of disclosure by private funds, (2) investor sophistication and (3) ability to bear economic loss/heightened risk of investments in private funds. We evaluate whether these policy concerns apply to private equity funds and determine that they should not preclude access to private equity funds. We therefore recommend that Congress should expand direct access to investments in private equity funds and explain how Congress could do so with sufficient protections in place for all investors. Finally, in Chapter 3, we examine how public funds that are available to all investors could be used to expand access to private equity funds. Specifically, we evaluate whether mutual funds and closed-end funds are suitable for investing in private equity funds. We find that closed-end funds are well-suited for investing in private equity funds. We therefore recommend that the SEC expand access to public closed-end funds that primarily invest in private equity funds and explain how the SEC could design regulatory protections for such widely-available public closed-end funds.

Chapter 1: The Restrictions on Access to Private Funds

The Accredited Investor Standard

Under the Securities Act, sales of securities must generally be registered with the SEC and subject to extensive public disclosure requirements. However, certain exemptions from the Securities Act's registration requirements exist, so long as securities are offered to a more limited audience. One of these exemptions is Regulation D ("**Reg D**"), which exempts sales of securities (including private fund interests[94]) from the Securities Act's registration and disclosure requirements if they are only made to "**accredited investors**."[95]

Investments in private funds are typically executed under Reg D and are therefore only made available to accredited investors.[96] The Securities Act directs the SEC to define an accredited investor,[97] and the SEC has established a wealth-based standard whereby individuals whose net worth exceeds $1 million (excluding the value of their primary residence) or whose income exceeds $200,000 (or $300,000 with a spouse) for at least two years are deemed accredited investors.[98] A recent Wall Street Journal analysis finds that approximately 87% of U.S. households do not meet the accredited investor standard.[99]

The Qualified Purchaser Standard

Not only must all investors in private funds be accredited, but the 1940 Act separately requires private funds to either take on: (i) no more than 100 persons; or (ii) only investors that are **"qualified purchasers."**[100] Private funds organized to meet the 100-investor requirement are Section 3(c)(1) funds, and private funds organized to meet the qualified purchaser requirement are Section 3(c)(7) funds. If a private fund does not satisfy one of these requirements, then it is considered an "investment company" and is subject to the 1940 Act's extensive disclosure

[94] Private funds are typically structured as limited partnerships. An investor in a private fund, referred to as a limited partner, is given interests—analogous to shares in a company—in the private fund in exchange for the investment.
[95] Private funds typically rely on Rule 506 of Reg D. *See* 17 C.F.R. § 230.506. Technically, under Rule 506 an issuer can sell to up to 35 unaccredited investors. However, in order to do so, the issuer must provide extensive disclosure—similar to that for a public offering—to any unaccredited investors. *See* 17 C.F.R. § 230.502(b). This disclosure requirement is quite burdensome, so as a practical matter private funds operating in compliance with Rule 506 of Reg D only allow accredited investors to invest.
[96] Additionally, to meet the private offering restrictions related to the 1940 Act, a private fund generally must only take on accredited investors to avoid being an "investment company" under the 1940 Act. The 1940 Act subjects investment companies to extensive disclosure requirements and restrictions on their investment activities, which private funds seek to avoid. Private funds typically avoid investment company status by falling under certain exemptions under the 1940 Act (discussed in more detail below). *See* 15 U.S.C. § 80a-3(c)(1) & (7). These exemptions require private funds to not publicly offer themselves to potential investors. Complying with Rule 506 of Reg D—including its accredited investor rules—meets this requirement.
[97] Subject to certain statutory limitations. *See* 15 U.S.C. 77b(a)(15).
[98] *See* 17 C.F.R. § 230.501(a).
[99] Jean Eaglesham, Coulter Jones, *Opportunities to Invest in Private Companies Grow,* Wall Street Journal (Sept. 24, 2018), https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023
[100] *See* 15 U.S.C. § 80a-3(c)(1) & (7).

requirements and applicable regulations.[101] These regulations include restrictions on affiliate transactions[102] and on charging performance fees,[103] both of which are incompatible with the business model of private equity funds.[104]

The 1940 Act defines a qualified purchaser to include "any natural person . . . who owns not less than $5,000,000 in investments."[105] Thus, for a private fund seeking to take on more than 100 investors, all investors must meet the $5 million investment test in addition to being accredited investors. We note that in practice the vast majority of private funds are Section 3(c)(7) funds, which only accept qualified purchasers.[106] Due to the greater prevalence of Section 3(c)(7) funds, access to these types of private equity funds is the sole focus of this report.

According to our review of Federal Reserve data, approximately 98% of U.S. households do not meet the qualified purchaser standard.[107] Going forward, for simplicity, we refer to investors

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[101] There are other exemptions that allow investment funds to avoid being deemed an investment company. However, Section 3(c)(1) and 3(c)(7) are the most used exemptions for private equity funds, venture capital funds and hedge funds.

[102] Pursuant to Section 17 of the 1940 Act and the applicable SEC regulations, any affiliate of a registered investment company, or any affiliate of such affiliate, is generally prohibited from (i) engaging in transactions (including loans or purchases/sales of property or securities) with the fund or a company it controls or (ii) participating in any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which the fund, or a company it controls, is a participant. *See* 15 U.S.C. § 80b-17(a) & (d); 17 C.F.R § 270.17a-6; 17 C.F.R § 270.17d-1. The SEC has, however, granted relief in this area regarding certain affiliate co-investments.

[103] Investment advisers to registered investment companies are generally prohibited from charging their clients performance fees. *See* 15 U.S.C. § 80b–5(a)(1). *But see id.* at (b)(2) (exempting fulcrum fees). *See also* 17 C.F.R. § 275.205-3 (exempting performance fees for qualified clients). Investment advisers to business development companies, on the other hand, can charge performance fees, subject to certain limitations. 15 U.S.C. § 80b–5(b)(3).

[104] A memo from Gardner, Carton & Douglas prepared for the Senate Subcommittee on Securities as part of the hearings on bills that became the Small Business Investment Incentive Act of 1980 noted that "venture capital companies, unlike traditional investment companies, are compelled to deal regularly with affiliated persons in the ordinary course of their doing business. Virtually any transaction of this kind . . . is therefore potentially in violation of Section 17(a) [of the 1940 Act]." *See Federal Securities Laws and Small Business Legislation: Hearings on S. 1533 Before the S. Subcomm. on Securities of S. Comm. on Banking, Housing, and Urban Affairs*, 96th Cong. 375–402 (1980). *See also* Steven M. Davidoff Solomon, *Black Market Capital*, COLUM. BUS. L. REV. 172, 176 (2008) ("The [SEC] has refused to accommodate the differing structure and operation of … private equity. Instead, the [1940] Act and its related regulation effectively prevent . . . private equity from accessing the public market for investors. [P]rivate equity consequently avoid[s] application of the [1940] Act . . . .").

[105] 15 U.S.C. § 80a-2(a)(51).

[106] Based on CCMR staff conversations with attorneys from Cleary Gottlieb Steen & Hamilton LLP.

[107] This estimate is based on Committee Staff review of IRS tax data and the Federal Reserve's Survey of Consumer Finances (SCF). The Committee Staff reviewed the IRS Tax Statistics for Top Wealthholders by Size of Net Worth, updated as of January 2018, which identifies 584,194 tax filers with net worth of $5 million or more. This translates to approximately 0.15% of U.S. individuals based on the total U.S. population as of January 1, 2018. The IRS Tax Statistics are available at https://www.irs.gov/statistics/soi-tax-stats-all-top-wealthholders-by-size-of-net-worth. U.S. Census Data is available at: https://www.census.gov/library/visualizations/interactive/population-increase.html. The Committee Staff also assessed the Federal Reserve's 2016 Survey of Consumer Finance (SCF), which is a survey of approximately 6,000 U.S. households. An analysis of the SCF finds that approximately 2.3% of U.S. households have net worth of $5 million or more. However, we note that the SCF oversamples wealthy households, as described in a Federal Reserve and IRS working paper on the differences between the SCF and IRS data, available at: https://www.irs.gov/pub/irs-soi/johnsmoore.pdf.

that do not meet the accredited investor standard or qualified purchaser standard as "**retail investors**."

The Qualified Client Standard

The Investment Advisers Act of 1940 ("**Advisers Act**") prohibits investment advisers from charging performance fees to clients.[108] Such performance fees are standard practice for private equity funds.[109] However, the SEC has exempted investment advisers from this prohibition to the extent that their clients are "qualified clients."[110] Section 3(c)(7) funds are qualified clients,[111] so the performance fee restriction does not apply to investment advisers to private equity funds that are Section 3(c)(7) funds. Additionally, the qualified client standard does not "look through" Section 3(c)(7) funds to investors in the fund.[112] A "look through" provision would mean that the investors in the fund would have to meet the qualified client standard in their own capacity. Accordingly, there is no reason to further address the Advisers Act's restriction on performance fees in this report as it does not restrict access to private equity funds.

[108] 15 U.S.C. § 80b-5(a)(1).
[109] *See infra* n.152 and accompanying text.
[110] *See* 17 C.F.R. § 275.205-3.
[111] The Section 3(c)(7) fund is the client of the investment adviser and so must meet the qualified client test. Qualified clients include: (i) individuals and companies with at least $1,000,000 under the management of the investment adviser; (ii) individuals and companies with a net worth of greater than $2 million; and (iii) individuals and companies that are qualified purchasers. *Id.* at (d).
[112] *See* 17 C.F.R. § 275.205-3(b) & (d). *See also* PROSKAUER, SEC AMENDS THE ADVISERS ACT PERFORMANCE FEE RULE TO TIGHTEN STANDARDS FOR "QUALIFIED CLIENTS" AND ADOPT "GRANDFATHERING" PROVISIONS (Mar. 8, 2012), https://www.proskauer.com/alert/sec-amends-the-advisers-act-performance-fee-rule-to-tighten-standards ("Look through is not necessary for funds that rely on the Section 3(c)(7) exemption from registration under the [1940] Act").

Chapter 2: The Policy Basis for Restricting Access to Private Funds

The Accredited Investor Standard

The legislative history of the Securities Act shows that Congress's primary goal was to provide full and fair disclosure to investors in connection with offers and sales of securities.[113] However, Congress recognized that there were certain situations in which the protections afforded by the Securities Act were not necessary. Indeed, the House Report for the Securities Act stated that "[t]he Act carefully exempts from its application certain types of . . . securities transactions where there is no practical need for its application or where the public benefits are too remote."[114] As a result, Congress included Section 4(2) of the Securities Act, which exempts "transactions by an issuer not involving a public offering."[115]

But what constitutes a "public offering," and thus when a transaction is exempt under Section 4(2), was not clear from the text of the Securities Act. In its 1953 *Ralston Purina* decision, the Supreme Court established the basic criteria for determining the availability of Section 4(2). The Court held that the main consideration is whether the offerees need the protection afforded by the Securities Act.[116] This is evidenced by, among other things, (1) whether investors are "able to fend for themselves" and (2) whether the offerees have "access" to the same kind of information that registration would disclose.[117]

After *Ralston Purina*, the SEC sought to establish bright-line rules for when an offering complies with Section 4(2). In 1974, in releasing one of the rules that preceded Reg D, the SEC stated that it "is of the view that the significant concepts in determining when transactions are deemed not to involve any public offering are access to the same kind of information that registration would disclose and the ability of offerees to fend for themselves so as not to need the protections afforded by registration."[118]

The accredited investor concept first appeared in Rule 242, a predecessor to Reg D that was adopted in 1980.[119] Under Rule 242, an "accredited person" included any person that purchased $100,000 or more of an issuer's securities sold pursuant to the rule.[120] In the Rule 242 release, the SEC noted that it tailored the definition to ensure that an accredited investor had "the economic bargaining power to obtain access to the information he requires to make an informed investment decision."[121]

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[113] Indeed, the preamble to the Securities Act states that it is an "Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."
[114] H.R. REP. No. 85 at 5 (1933).
[115] *See* 15 U.S.C. § 77d(a)(2).
[116] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).
[117] *Id.*
[118] "Transactions by an Issuer Deemed Not to Involve any Public Offering" SEC Securities Act Release No. 33-5487, 39 Fed. Reg. 15,261 (Apr. 23, 1974).
[119] *See* Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6,362 (Jan. 28, 1980).
[120] *Id.* at 6,368.
[121] *Id.* at 6,364.

Subsequent to Rule 242, Congress passed the Small Business Investment Incentive Act of 1980, which added the "accredited investor" definition to the Securities Act and gave the SEC the authority to define the term based on an investor's financial sophistication, net worth, knowledge, and experience in financial matters.[122] A report from the Senate Committee on Banking, Housing, and Urban Affairs noted that the addition of the accredited investor definition was "intended to give small businesses greater access to . . . sophisticated investors without the costs associated with the registration requirements."[123] In 1982, the SEC adopted Reg D, which rescinded Rule 242.[124] The original Reg D implemented an accredited investor standard that's highly similar to the one used today[125] Importantly, Reg D's current $1 million net worth threshold and $200,000 individual income threshold were adopted in the 1982 rule.[126] However, the SEC did not provide a policy explanation for these wealth-based standards, other than to note the statutory mandate given to the SEC by Congress in formulating the accredited investor definition.[127]

The SEC has more recently opined on the policy rationale for the accredited investor standard. In 2011, the SEC noted that "[o]ne purpose of the accredited investor concept [in Reg D] is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered . . . securities for an indefinite period and, if necessary, to afford a complete loss of such investment."[128] And in its 2015 review of the accredited investor standard, the SEC staff noted that the accredited investor standard is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."[129]

The Qualified Purchaser Standard

In 1996, Congress adopted the National Securities Markets Improvement Act of 1996 ("**NSMIA**"), which added the qualified purchaser standard to the 1940 Act for the purpose of creating the Section 3(c)(7) exemption from registration under the 1940 Act.[130] A House report on one of the bills that became the NSMIA noted that qualified purchasers "are deemed to be sophisticated investors."[131] Similarly, the Senate Banking Committee noted that, "the qualified purchaser [standard] reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the [1940 Act]'s protections."[132]

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[122] Small Business Incentive Act of 1980, PUB. L. NO. 96-477, § 602, 94 Stat. 2275 (1980). *See also* 15 U.S.C. § 77b(a)(15).
[123] S. REP. NO. 96-958, at 12 (1980).
[124] Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982).
[125] *See id.* at 11,262.
[126] *Compare id.* at 11,263 *with* 17 C.F.R. § 230.501(a)(5) & (6).
[127] *See id.* at 11,251, 11,253- 5.
[128] Net Worth Standard for Accredited Investors, SEC, Securities Act Release No. 33-9287, 76 Fed. Reg. 81,793 (Dec. 29, 2011).
[129] SEC, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" (Dec. 18, 2015).
[130] National Securities Markets Improvement Act of 1996, PUB. L. 104-290, § 209, 110 Stat. 3416 (1996).
[131] H.R. REP. NO. 104-622 (1996).
[132] S. REP. NO. 104-293 (1996).

After the passage of the NSMIA, the SEC adopted a number of rules defining certain terms for the purposes of the qualified purchaser definition.[133] While the SEC's release in connection with the adoption of these rules did not engage in a thorough analysis of the policy basis for the qualified purchaser standard, the SEC has subsequently weighed in on the policy rationale for the standard. In a 2001 release, the SEC stated that the qualified purchaser standard was set by Congress "consistent with the [1940 Act's] objective of addressing special risks associated with investments in pooled vehicles."[134] In a 2007 release, the SEC also noted that the accredited investor standard may not be sufficient "to safeguard investors seeking to make an investment in [private funds] in light of their unique risks, including risks with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such vehicles' anticipated returns."[135]

In our view, there are three distinct, but related policy concerns repeatedly highlighted by Congress and the SEC for establishing the accredited investor standard and qualified purchaser standard: (1) adequacy of disclosure, (2) investor sophistication and (3) ability to bear economic loss/higher risk of the investment.

[133] Privately Offered Investment Companies, 62 Fed. Reg. 17,512 (Apr. 9, 1997).
[134] Defining the term "Qualified Purchaser" under the Securities Act of 1933, SEC, Securities Act Release No. 33-8041, 66 Fed. Reg. 66,839 (Dec. 19, 2001).
[135] Revisions of Limited Offering Exemptions in Regulation D, SEC Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116 (Aug. 3, 2007).

Evaluating the Restrictions on Access to Private Equity Funds

In this next section, we evaluate the foregoing policy concerns regarding the adequacy of disclosure, investor sophistication, and the ability to bear economic loss/risk of investment as they apply to private equity funds and retail access to private equity funds.

Existing Disclosure Practices by Private Equity Funds

One of the primary reasons for excluding retail investors from investments in private funds is that private funds are subject to lower disclosure standards than public funds. However, we note that private equity funds *voluntarily* provide disclosures that are comparable to public funds, therefore investors in private equity funds have access to much of the disclosures applicable in public markets. Indeed, the private placement memorandum for private equity funds, the primary disclosure document for potential investors, typically includes much of the information that would be included in the prospectus of a registered offering.[136] This often includes information regarding:

- The structure of the fund;
- The fund's investment objectives and any investment restrictions that apply to it;
- The fund's track record;
- Biographies of the key members of the management team;
- Material management conflicts of interest;
- The key terms of the fund;
- The fund's material risks;
- The fund's valuation policy;
- Tax issues; and
- ERISA, and other regulatory and legal matters relevant to the fund.[137]

Almost all private equity funds also provide ongoing disclosures such as, annual audited financial statements and a quarterly performance analysis,[138] which typically provides an update on the fund's cumulative performance. These ongoing disclosures usually include a discussion of all material changes to the portfolio or carrying value of the portfolio during the current period.[139]

There are also a number of regulations that apply to the disclosure practices of private equity funds. First, under SEC Rule 10b-5, private fund managers cannot, when communicating with prospective investors, "make any untrue statement of a material fact or . . . omit to state a material fact necessary in order to make the statements made . . . not misleading."[140] Additionally, SEC Rule 206(4)-8 prohibits investment advisers to private funds from making "any untrue

[136] Comm. on Fed. Reg. of Securities, ABA Section of Business Law, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors – A Report*, 66 THE BUSINESS LAWYER 85, 112 (2010).
[137] EDWARDS S. NADEL, HEDGE FUNDS PRACTICE GUIDE 4-5 (2017), LexisNexis.
[138] Stephen Holmes, *Limited partner financial reporting*, THE INVESTOR RELATIONS MANUAL 64 (Kevin Albert, Pantheon, ed., 2011).
[139] *Id.*
[140] 17 C.F.R. § 240.10b-5. The Advisers Act's anti-fraud provisions apply to all investment advisers, whether or not they are SEC-registered. *See* 15 U.S.C. § 80b-6.

statement of a material fact or . . . omit[ting] to state a material fact" in ongoing reporting and disclosures to their investors.[141] Furthermore, SEC Rule 203-1 generally requires private equity fund managers that are SEC-registered investment advisers to file Form ADV with the SEC.[142] The Form ADV filing must include a brochure describing the fund manager and its business practices, fees and compensation, investment strategies and their material risks, and any conflicts of interest.[143] These brochures are publicly available to potential private equity fund investors on the Investment Adviser Public Disclosure website.[144] Further, being registered with the SEC means that disclosures by investment advisers are also subject to periodic exams by the SEC's Office of Compliance Inspections and Exams. Investment advisers are required to retain most disclosures made during the previous five years to investors or potential investors to facilitate such examinations.[145]

The existing disclosure practices by private equity funds are due in part to the demands of institutional investors. According to the SEC's private fund statistics,[146] institutional investors, such as pension plans, sovereign wealth funds, and insurance companies, beneficially own 87% of reporting private funds.[147] These sophisticated and well-resourced institutional investors demand fulsome disclosure. Some of these institutional investors—for example pension plans—invest money on behalf of others and owe fiduciary duties to their beneficiaries. This means that not only do they have the *means* to conduct a thorough investigation of the private funds that they invest in, but they also have a *duty* to do so. Finally, groups such as the Institutional Limited Partners Association, an organization that represents the interests of private fund investors, have created best practices for private equity reporting that are similar to public reporting requirements.[148]

Investor Sophistication: Wealth as a Proxy and the Complexity of Private Equity Investing

The existing wealth-based restrictions on access to private funds are based at least in part on the presumption—which individual retail investors have no ability to rebut—that wealth is an appropriate proxy for investor sophistication. As described earlier, approximately 98% of U.S. households do not meet the qualified purchaser standard. The vast majority of Americans are therefore presumed to lack the financial sophistication necessary to evaluate whether private equity funds are an appropriate investment for them. However, as the SEC staff itself noted in its 2015 report on the definition of accredited investor, "well informed investors who are not wealthy may

[141] *See* 17 C.F.R. § 275.206(4)-8.
[142] *See* 17 C.F.R. § 275.203-1.
[143] Part 2 of Form ADV contains the uniform requirements for asset managers' brochures. *See* Form ADV, Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf.
[144] SEC, *Fast Answers: Form ADV* (March 11, 2011), https://www.sec.gov/fast-answers/answersformadvhtm.html.
[145] *See* Investment Adviser's Act of 1940, Rule 204-2.
[146] The SEC's private fund statistics are based on Form PFs filed by private fund managers. Only SEC-registered advisers with at least $150 million in private fund assets under management must report to the SEC on Form PF. SEC-registered investment advisers with less than $150 million in private fund assets under management, SEC exempt reporting advisers, and state-registered investment advisers are not required to file Form PF. *See* SEC, PRIVATE FUND STATISTICS: SECOND QUARTER 2017 (Jan. 17, 2018).
[147] *Id.* at 15. Percentage is based on aggregate net asset value.
[148] *See* INST. LIMITED PARTNERS ASS'N, QUARTERLY REPORTING STANDARDS BEST PRACTICES (2011).

be in a position to take on risks that they understand well."[149] Despite the significant impact of the accredited investor and qualified purchaser standard, neither Congress nor the SEC has explained why less-wealthy investors are incapable of acquiring the expertise that they need to make informed investment decisions. Therefore, whether wealth is an appropriate proxy for investor sophistication is, at best, questionable.

Additionally, retail investors can seek outside advice from investment advisers or brokers that can provide them with the requisite sophistication to determine if a private equity fund is a suitable investment. Recent surveys suggest that between 40-50% of retail investors receive professional financial advice.[150] Additionally, investment advisers owe their clients a fiduciary duty and must act in their best interest when recommending investments.[151] And under current FINRA rules, brokers "must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through reasonable diligence . . . to ascertain the customer's investment profile."[152] The SEC has also recently proposed elevating the duty owed by brokers to their clients so that brokers must "act in the best interest of [a] retail customer at the time [a] recommendation is made."[153] Indeed, Reg D implicitly recognizes that retail investors with access to expert advice are de-facto sophisticated by allowing—subject to additional disclosure requirements—sales of unregistered securities to 35 non-accredited investors so long as they are represented by someone who "has such knowledge and experience in financial and business matters that he [or she] is capable of evaluating the merits and risks of the prospective investment."[154]

A related issue is whether investing in private equity funds is more complex than investing in public securities and public funds. If investing in private equity funds is not more complex than investing in public securities, then a heightened investor sophistication requirement for investing in private equity funds may be unnecessary.

In the past, the SEC and others have noted that the fee structures of private equity funds are more complicated than those of public funds.[155] For example, investors in a private equity fund must pay a management fee based on committed capital (typically 1.5%-2.0%) and an additional carried interest allocation of approximately 20% of the profits from the fund that is *only* due if the fund meets a minimum performance target, referred to as a "hurdle rate" (often an 8% annual

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[149] *See* SEC, *supra* n.129 at 94.
[150] *See* Penn Schoen Berland, Telephone Survey (2015), https://www.cfp.net/docs/default-source/news-events---research-facts-figures/2015-consumer-opinion-survey.pdf.; TIAA 2016 Advice Matters Survey (Sept. 29, 2016), https://www.tiaa.org/public/pdf/advicemattersexecsummary2016.pdf.
[151] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).
[152] *See* FINRA Rule 2111.
[153] *See* Regulation Best Interest, SEC Exchange Act Release No. 34-83062, 83 Fed. Reg. 21,574 (Apr. 18, 2018).
[154] *See* 17 C.F.R. §§ 230.501(i) & 506(b)(2)(ii).
[155] *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, SEC, Investment Advisers Act Release No. 33-8766, 72 Fed. Reg. 44,756 (Aug. 9, 2007); ACCREDITED INVESTORS IN CERTAIN PRIVATE INVESTMENT VEHICLES 17 (Dec. 27, 2006) (noting that retail investors "may find it difficult to appreciate the unique risks of [private funds], including those with respect to . . . complex fee structures . . . ."). *See also* Madison Marriage et al., *Fund Manager Performance Fees Under Attack*, FINANCIAL TIMES (July 8, 2017), https://www.ft.com/content/02b7d110-6246-11e7-91a7-502f7ee26895 (noting concerns about retail investors' ability to understand performance fees).

return).[156] Although this fee structure is somewhat more complicated than public funds, such as mutual funds, which generally only charge management fees, we believe that carried interest can easily be understood by retail investors equipped with existing disclosures. Indeed, according to a 2017 Preqin survey, fund transparency was not a principal concern of private equity investors.[157] And to the extent that the allocation of operating expenses or fees related to third-party intermediaries for private equity funds can be complicated, we believe that this can be mitigated by disclosure of, among other items, a total expense ratio, as is common for public funds.

The SEC and others have also argued that private equity funds' investment strategies are highly complex.[158] We disagree. As described in Part I, private equity buyout funds seek to acquire companies with a mix of their own capital and borrowed funds, improve the operations of these companies, and then sell them at a profit.[159] Venture capital funds seek to invest in early stage companies with high growth prospects and profit from their growth. Although investments in private equity buyout funds and venture capital funds are largely illiquid, fund managers can and do value them based on their "fair value," and typically disclose such valuations to their investors at least once per quarter.[160] Indeed, private equity's long-term investment strategies are less complex than many existing investment options available to retail investors. For example, retail investors can invest in "alternative" mutual funds, which use a variety of complex strategies such as arbitrage, distressed securities, derivatives, currencies, commodities and short-selling that are focused on short-term profits.[161] And of course, retail investors can invest in corporate conglomerates (for example, General Electric or Alphabet) whose operations are often more complex than the much smaller portfolio companies owned by private equity funds and venture capital funds.[162]

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[156] *See* PREQIN LTD., PREQIN SPECIAL REPORT: PRIVATE CAPITAL FUND TERMS (Nov. 2016). *See also* Barry Steinman, Presentation: Private Equity Fund Fees, DUANE MORRIS (Aug. 2014), https://www.duanemorris.com/site/static/private_equity_fund_fees.pdf.

[157] *See* Preqin, *supra* n.72 at 76 (2018) (noting that transparency was one of the lowest ranked areas of concern), We also note that 95% of the investors surveyed said that private equity's performance met or exceeded their expectations. *Id.*

[158] *See* SEC Release No. 33-8766, *supra* n.155 at 17 ("Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain."). *See also* Zachary Tracer, *Principal CEO Chuckles at Private Equity in 401(k)s*, BLOOMBERG (Apr. 25, 2014), https://www.bloomberg.com/news/articles/2014-04-25/principal-ceo-chuckles-at-private-equity-in-401-k-s ("Private equity funds are probably too complicated for the average investor's retirement account . . . ."); *After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?: Hearing Before the H. Subcomm. on Domestic Policy of the H. Comm. on Oversight and Government Reform*, 110th Cong. 100 (2007) (statement of Joseph Borg, President, Board of Directors of the North American Securities Administrators Ass'n) ("In light of the complexity . . . surrounding [alternative investments], allowing them to be offered to the public without appropriate regulatory protections poses serious risks to the investors.").

[159] *See supra* nn.20-34 and accompanying text.

[160] Nicholas G. Crain & Kelvin K. F. Law, *The Bright Side of Fair Value Accounting: Evidence from Private Company Valuation* 6-10 (Sept. 14, 2017), http://www.fmaconferences.org/Boston/16-05-29_Fair_value_accounting_and_information_production_-_Crain_Law.pdf.

[161] *See* Reshma Kapadia, *No Golden Opportunity in Multi-Alternative Funds*, BARRONS (April 6, 2013), https://www.barrons.com/articles/SB50001424052748704882404578390941654549284.

[162] *See* Solomon, *supra* n.104 at 256.

Ability to Bear Economic Loss/Riskiness of Private Equity Investing

Another reason for the existing wealth-based restrictions on retail investor access to private equity funds is that retail investors are less able to bear investment losses than wealthy investors. Although this is certainly true, the performance history of private equity funds suggests that retail investors are not more likely to bear losses from investing in private equity funds than they are from investing in public funds or other public securities. As described throughout this report, private equity funds have a long history of *outperforming* public equity markets (net of fees), [163] are historically less volatile than public equity markets,[164] and provide diversification benefits that can *decrease the risk* of an investment portfolio. [165] As a result, the ability to bear an economic loss provides no justification for treating private equity investments differently from those investments currently available to retail investors.

Moreover, the perceived risk of an investment is a questionable ground for excluding retail investors from an investment opportunity. Indeed, the SEC's primary purpose is to ensure investor safety through sufficient disclosures, not determining what investments are too risky to invest in, as the SEC is not equipped to meaningfully evaluate the risk of each security that's sold to the public. Additionally, if the SEC is expected to act as an arbiter of risk, then this can lead to the public perception that because the SEC allows an investment, it is safe. In fact, the SEC allows retail investors to invest in securities that are clearly high risk. For example, retail investors can trade over-the-counter ("**OTC**") stocks, which are not listed on a national exchange like the NYSE or the Nasdaq.[166] OTC stocks are not subject to the same governance requirements as listed stocks,[167] and some are not subject to SEC reporting requirements.[168] Perhaps most importantly, empirical research has shown that OTC stocks generate returns that are highly volatile and often *negative*.[169]

Considering that private equity funds provide extensive disclosures to investors, have outperformed public equity markets for decades, and can actually *reduce* portfolio risk, we do not believe that it makes sense to preclude 98% of U.S. households from investing in them.

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[163] *See supra* nn.41- 61 and accompanying text.
[164] *Id.*
[165] *See supra* nn.63-71 and accompanying text. Given that individual private equity investments, even within a fund, are idiosyncratic, their returns are not correlated with each other (unlike public stakes). This enhances risk diversification, even within just one fund and is a factor in private equity funds showing less return volatility than mutual funds that invest in public markets. In addition, incorporating private equity funds into an investment portfolio can reduce the overall risk and volatility of the portfolio. Moreover, as described in this section, private equity funds provide investors with extensive disclosures that enable investors to evaluate their riskiness. With this in mind, the fact that sophisticated institutional investors are increasingly competing to gain access to the high returns offered by a private equity fund is no surprise.
[166] SEC DIV. OF ECONOMIC AND RISK ANALYSIS, OUTCOMES OF INVESTING IN OTC STOCKS 2 (Dec. 16, 2016).
[167] *See, e.g.*, Nasdaq Rules 5601-40; NYSE Listed Company Manual §§ 301-15.
[168] *See* SEC DIV. OF ECONOMIC AND RISK ANALYSIS, *supra* n.166 at 2. *See also* Ulf Brüggemann et al., *The Twilight Zone: OTC Regulatory Regimes and Market Quality* 2-3 (Nat'l Bureau of Econ. Research, Working Paper No. 19358).
[169] *Id.*

How to Expand Direct Access to Private Equity Funds

We believe that the most prudent way to expand direct access to private equity funds would be for Congress to adopt legislation that would permit a retail investor to invest in private equity funds, so long as such access is provided by a financial professional with: (1) a duty to act in the investor's best interest; and (2) knowledge and experience in financial and business matters such that the professional is capable of evaluating the merits and risks of the prospective investment.[170] For example, this would include a registered investment adviser or a broker-dealer subject to the SEC's regulation best interest proposal. Moreover, the registered investment adviser that manages the private equity fund provides an additional layer of protection to a retail investor seeking to invest in private companies.

If additional hurdles were deemed appropriate, Congress could establish or empower the SEC to establish any such protections for retail investors that they deem necessary. For example, this could include additional minimum disclosure requirements for managers of private equity funds that provide retail investors with access. Or Congress or the SEC could only permit a private equity fund to accept retail investors if the assets managed by the affiliated manager include a material institutional component (e.g., more than 50%). Such a requirement would enable retail investors to leverage the demands of institutional investors. Finally, Congress or the SEC could further require that the affiliated manager of such funds meet additional threshold scale and experience criteria.

Although we believe that Congress should promptly act to expand retail investor access to private equity funds, we acknowledge that legislative reform is challenging in this political environment and therefore focus for the remainder of this report on regulatory reforms that could meaningfully expand access to private equity funds in the near-term, through public funds and 401(k) plans.

[170] Others have recommended similar reforms. *See, e.g.*, Investment Adviser Ass'n. Comment Letter on the Report on the Review of the Definition of "Accredited Investor" (June 29, 2016).

Chapter 3: Can Public Funds Invest in Private Equity Funds?

Public funds are registered as investment companies under the 1940 Act and issue shares that are registered under the Securities Act. As a result, retail investors may invest in public funds, and public funds are a potential vehicle for providing retail investors with exposure to private equity funds. However, not all public funds are necessarily appropriate for investing in private equity funds. Public funds generally fall into two broad categories—open-end funds and closed-end funds.[171] Under the 1940 Act, open-end funds, such as mutual funds, must issue redeemable shares to their investors, meaning that mutual funds must regularly provide their investors with the opportunity to exit their investment at the per-share net asset value of the fund.[172] The 1940 Act establishes a maximum seven-day period for a mutual fund to pay the proceeds from a redemption to an investor, and in practice mutual funds typically allow for redemptions on a daily basis.[173] Conversely, the 1940 Act does not impose any redemption requirements on closed-end funds.[174]

Can Mutual Funds Invest in Private Equity Funds?

Mutual funds can allow for daily redemption while still offering investors exposure to illiquid assets, such as private equity funds, so long as the mutual fund holds sufficient liquid assets to meet daily redemptions. In practice, mutual funds generally hold cash buffers to satisfy investor redemptions.[175] However, if a mutual fund lacks sufficient liquid assets to satisfy daily redemptions then it could be forced to quickly sell its illiquid assets at a significant discount, which would mean significant losses for its investors. In a severe case, a mutual fund may even need to request permission from the SEC to halt redemptions and liquidate.[176] Therefore, the SEC has determined that mutual funds generally cannot hold more than 15% of their net assets in illiquid investments, including private equity funds.[177] The purpose of the SEC's rule is to ensure that shares in mutual funds are in fact readily redeemable as mandated by statute.[178]

We believe that the existing 15% threshold on illiquid assets for mutual funds is appropriate, considering that investors frequently enter and exit their mutual fund investments. For example, according to a 2015 SEC staff study, monthly net outflows from mutual funds often exceed 10% of total assets.[179] We therefore do not recommend any regulatory changes to expand retail investor access to private equity funds through mutual funds.

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[171] 15 U.S.C. § 80a-5(a).
[172] 15 U.S.C. § 80a-5(a)(1) & 80a-2(a)(32). *See also* 17 C.F.R. § 270.22c-1.
[173] 15 U.S.C. § 80a-22(e). *See also* John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343, 347 (2013).
[174] *See* 15 U.S.C. § 80a-5(a)(1) & (2).
[175] *See* Investment Company Liquidity Risk Management Programs, SEC Investment Company Act Release No. 33-10233, File No. S7-16-15 at 28, n. 69 (Oct. 13, 2016).
[176] *See id.* at 31-32, 58.
[177] 17 C.F.R § 270.22e-4(b)(1)(iii) & (iv).
[178] *See* SEC RELEASE NO. 33-10233, *supra* n.175, at 281.
[179] *See* PAUL HANOUNA ET AL., LIQUIDITY AND FLOWS OF U.S. MUTUAL FUNDS 16, SEC (Sept. 2015).

Can Closed-End Funds Invest in Private Equity Funds?

Closed-end funds are well positioned to invest in illiquid assets because shareholders in closed-end funds generally have no right to redeem. Investors in closed-end funds typically can only obtain liquidity for their shares in secondary markets,[180] which does not require closed-end funds to liquidate any of their assets, including investments in illiquid private equity funds. We therefore believe that closed-end funds can be an effective publicly-available investment vehicle for providing retail investors with exposure to private equity funds. However, we must first assess whether the qualified purchaser standard and accredited investor standard restrict closed-end funds from providing retail investors with access to private equity funds.

Under the 1940 Act and applicable SEC rules, the qualified purchaser requirement "looks through" a public closed-end fund to its shareholders only if the closed-end fund was "formed for the specific purpose" of investing in a *specific* private fund.[181] A "look through" means that investors in a public closed-end fund must also be qualified purchasers and would therefore prevent retail investors from investing in such funds. In a no-action letter, the SEC indicated that the determination of whether an entity was formed "for the specific purpose" of investing in a specific private fund depends on a facts-and-circumstances analysis.[182] The SEC stated that whether an entity invests more than 40% of its committed capital in a specific private equity fund is relevant but not determinative.[183]

The Securities Act and the SEC's rule defining an accredited investor contain no provision that "looks through" to investors in a public fund.[184] However, the SEC has issued comment letters to closed-end funds indicating that only accredited investors may invest in a public closed-end fund that invests more than 15% of its assets in Section 3(c)(7) funds.[185] The SEC has not stated the legal or policy basis for effectively applying the accredited investor standard on a look through basis to such funds. We therefore find that the SEC severely restricts retail investor access to public closed-end funds that invest in private equity funds.

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[180] However, we note that certain closed-end funds do not trade in the secondary markets; most of these funds offer periodic liquidity for shareholders at net asset value.

[181] *See* 15 U.S.C. § 80a-2(a)(51)(A)(iii); 17 C.F.R. § 270.2a51-3(a) ("a company shall not be deemed to be a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a [Section 3(c)(7) fund] unless each beneficial owner of the company's securities is a qualified purchaser.").

[182] American Bar Ass'n, SEC No-Action Letter Ref. No. 97-666, at 19-20 (Apr. 22, 1999) (" [W]e believe that the determination that an entity is formed for the specific purpose of investing in a . . . Fund will depend upon an analysis of all of the surrounding facts and circumstances, and while the percentage of an entity's assets invested in the . . . Fund is relevant, exceeding a specified percentage level, by itself, is not determinative.").

[183] *See id. See also* Cornish & Carey, SEC No-Action Letter Ref. No. 96-105-CC, at 3 (June 2, 1996).

[184] *See* 15 U.S.C. § 77b(a)(15)(i); 17 C.F.R. 230.501(a)(1).

[185] *See, e.g.*, David Baum, Partner at Alston & Bird SEC Comment Response Letter (Dec. 17, 2014), https://www.sec.gov/Archives/edgar/data/1586009/000114420414074464/filename1.htm. *See also* Wildermuth Endowment Strategy Fund, SEC Comment Letter (October 11, 2013); Cross Shore Discovery Fund, SEC Comment Response Letter, (Sept. 17, 2015); Resource Real Estate Diversified Income Fund, SEC Comment Letter (Oct. 19, 2012); Oxford Lane Capital Corp., SEC Comment Response Letter, (Aug. 17, 2015). We note that the 15% limitation applies to all public funds. However, as a practical matter, given the liquidity limitations imposed on open-end funds by Rule 22e-4, any public fund that invests more than 15% of its assets in private equity funds is likely to be structured as a closed-end fund. *See* 17 C.F.R § 270.22e-4(b)(1)(iii) & (iv).

How to Expand Access to Closed-End Funds that Invest in Private Equity Funds

In our view, retail investors would benefit from access to public closed-end funds that invest more than 15% of their assets in private equity funds. Moreover, we believe that sufficient regulatory protections exist to ensure that retail investors can safely invest in these funds. We therefore recommend that the SEC should not apply the accredited investor standard on a look through basis to public closed-end funds that invest more than 15% of their assets in private equity funds. Below, we set forth the benefits to retail investors from access to public closed-end funds that invest more than 15% of their assets in private equity funds and explain why existing regulations—with a specific focus on disclosures—provide sufficient protections to retail investors interested in such access.

First, as explained in Part I, private equity funds have historically outperformed public equity markets, and including private equity funds in a portfolio can *reduce* the risk of the portfolio.[186] Indeed, the empirical studies that we reviewed in Part I show that a 20% allocation to private equity funds can lower the risk of a portfolio of assets.[187] And many investors in private equity, including university endowments, private foundations and family offices, have allocated over 20% of their assets to private equity funds.[188] Therefore, the 15% threshold prevents retail investors from obtaining the total exposure to private equity funds through public closed-end funds that is preferred by many sophisticated investors in private equity and that studies have shown can actually lower the risk of a portfolio of assets.

Second, the 15% cap prevents retail investors from investing in public closed-end funds that diversify their investments among private equity funds, so-called "**funds of private equity funds**," which seek to obtain returns that are more consistent with the performance of the private equity fund industry generally. Funds of private equity funds exist today and have $206 billion in assets under management, constituting approximately 12% of the total U.S. private equity fund industry.[189] Critically, the performance of funds of private equity funds has also been impressive. According to a 2017 National Bureau of Economic Research working paper, funds of private equity funds have provided returns after fees equal to or above their public market equivalent.[190] We note that funds of private equity funds are typically organized as private funds, however we have identified certain public closed-end funds that invest in private equity funds on a diversified basis. For example, the Altegris KKR Commitments Master Fund ("**Altegris fund**") is a public closed end fund investing in private equity on a diversified basis with approximately $380 million in net assets.[191] Of course, funds such as the Altegris fund are only available to accredited investors, because more than 15% of their assets are invested in private equity funds.

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[186] *See supra* nn.41-71 and accompanying text.
[187] *See supra* nn.66-71 and accompanying text.
[188] *See supra* nn.80-91 and accompanying text.
[189] Based on data from Preqin Ltd. as of December 31, 2017. Percentage calculated by dividing the assets under management of U.S. funds of private equity funds by the total assets under management of U.S. funds of private equity funds, buyout funds, growth funds and venture capital funds.
[190] Robert S. Harris et al., *Financial Intermediaries in Private Equity: How Well do Funds of Funds Perform?* (Nat'l Bureau of Econ. Research, Working Paper No. 23428, 2017).
[191] *See, e.g.*, Form N-2, Altegris KKR Commitments Master Fund (July 31, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1606789/000110465918048426/a18-17639_4pos8c.htm. *See also* Form

Third, there would be little reason for the SEC to raise liquidity concerns regarding public closed-end funds that invest in private equity funds. Congress has expressly determined that retail investors may invest in public closed-end funds, which, like the private equity funds that they would invest in, lack any redemption rights.[192] Public closed-end funds are also a well-established asset class for retail investors. As of December 2017, public closed-end funds had $275 billion in assets.[193] Congress has also permitted retail investors to invest in business development companies, a type of public closed-end fund that primarily invests in the debt securities of private companies.[194] As of December 2017, business development companies had roughly $36 billion in net assets.[195]

Fourth, a registered investment adviser to the public closed-end fund would make the determinations regarding which private equity funds to invest in and is prohibited from investing in private equity funds managed by itself or affiliates.[196] These investment advisers are financially sophisticated and have a fiduciary duty to the fund and its investors.[197] Therefore, retail investors investing in a public closed-end fund that invests in private equity funds would have the benefit of a financial professional with a fiduciary duty to them, which should address policy concerns regarding retail investors' financial sophistication.

One final issue is whether retail investors would have access to sufficient disclosures to determine whether to invest in a public closed-end fund that invests more than 15% of its assets in private equity funds. We firmly believe that the existing disclosure requirements that apply to public closed-end funds would ensure that retail investors have sufficient information to make an informed investment decision.

N-2, Pomona Investment Fund (July 16, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1616203/000114420418038534/tv497008-n2a.htm.

[192] We also note that public funds available to retail investors do not have any limitations on the type of securities in which they can invest, and many public closed-end funds invest in instruments in which retail investors are not otherwise qualified to invest.

[193] INVESTMENT COMPANY INSTITUTE, INVESTMENT COMPANY FACTBOOK 107 (2018), https://www.ici.org/pdf/2018_factbook.pdf.

[194] *See generally* MORRISON & FOERSTER, FREQUENTLY ASKED QUESTIONS ABOUT BUSINESS DEVELOPMENT COMPANIES (2018). Business development companies may invest in any type of securities of private U.S. issuers, but business development companies invest primarily in debt securities. *See Business Development Company Universe*, CLOSED-END FUND ADVISORS (last accessed May 9, 2018), http://cefdata.com/bdc/ (showing that the vast majority of business development company assets are invested in debt). Business development companies must hold 70% of their assets in certain types of investments, which do not include private funds, so business development companies cannot be a fund of private equity funds. *See* 15 U.S.C. § 80a–54(a).

[195] *See* John Cole Scott, Presentation: Quarterly Closed-End Fund & BDC Review and Outlook, CLOSED-END FUND ADVISORS (Jan. 18, 2018), http://cefadvisors.com/Download/2018-0118-CEFUpdate-Outlook.pdf.

[196] *See* 15 U.S.C. § 80a-17(a). We note however, that the current prohibitions on investments by public funds in affiliated private funds may be unduly restrictive. The safeguards associated with such public funds of affiliated public funds could be applied to public funds of affiliated private funds. While there are a few public funds of unaffiliated private funds that invest exclusively in funds of a single private equity sponsor, the requirement that an unaffiliated investment adviser be imposed upon public funds simply adds fees and other costs that are borne by retail investors that could be avoided in public fund of affiliated private funds structures.

[197] *See* SEC v. Capital Gains, 375 U.S. 180 (1963). *See also* 15 U.S.C. § 80a-35.

Public closed-end funds are subject to the extensive disclosure requirements of the 1940 Act and the Securities Act.[198] The SEC requires a public closed-end fund that invests in private equity funds to provide investors with disclosures as to its performance and its investment objectives and policies.[199] The SEC also requires that a public closed-end fund disclose the principal risk factors associated with its investment strategies[200] and, in its quarterly, semi-annual and annual reports filed with the SEC and available to the public, disclose its portfolio of investments at the end of the reporting period, including the name of each issuer and the value of each holding.[201]

For example, the Altegris fund provides extensive disclosure to investors on its investment objective, philosophy and strategies, including its expected portfolio allocation broken down by the type of private equity fund investment (e.g. primary vs. secondary), the strategy of the funds in which it invests (e.g., buyout vs. growth), and the funds' geographic region.[202] The Altegris fund also provides lengthy disclosure on the risks of the private equity funds in which it invests.[203] In its annual shareholder report, the Altegris fund provides an updated overview of its historical operating performance and the composition of its portfolio of private equity funds.[204]

The SEC has also established extensive disclosure requirements as to the fees charged by public closed-end funds. The registration statement for a public closed-end fund must include a summary of the fund's expenses in a fee table with total annual expenses listed as a percentage of net assets.[205] Public closed-end funds must also disclose an estimate of the expenses on a $1,000 investment, assuming a 5% annual return.[206] Additionally, if a public closed-end fund invests in other investments funds (including private equity funds), then the fee table must disclose the fees and expenses incurred indirectly by the public closed-end fund as a result of these investments.[207] Specifically, the public closed-end fund must disclose these fees as a percentage of its average net assets, based on the total annual operating expense ratio for each private equity fund, the average invested balance in each private equity fund, and the number of days invested in each private equity fund.[208] Public closed-end funds must also disclose any performance fees charged by the private equity funds in which they invest.[209]

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[198] *See generally* 15 U.S.C. §§ 77g, 80a-24 & 80a-29.
[199] *See* Form N-2 at Items 4 and 8, https://www.sec.gov/files/formn-2.pdf.
[200] *See id.* at Item 8, Instruction 3.
[201] *See* Form N-Q at Item 1, https://www.sec.gov/files/formn-q.pdf; Form N-CSR at Item 6, https://www.sec.gov/files/formn-csr.pdf. *See also* 17 C.F.R. §§ 210.12-12-14.
[202] *See* Form N-2, Altegris KKR Commitments Master Fund at 32-38, https://www.sec.gov/Archives/edgar/data/1606789/000110465918048426/a18-17639_4pos8c.htm.
[203] *See id.* at 41-55.
[204] *See* Form N-CSR, Altegris KKR Commitments Master Fund (June 5, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1606789/000158064218002910/altegriskkrmasterncsr.htm.
[205] *See* Form N-2 at Item 3.
[206] *Id.*
[207] *Id.* at Instruction 10; *Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses,* SEC (May 2007), https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm.
[208] Form N-2 at Item 3, Instruction 10.b.
[209] *Id.* at Instruction 10.g.

Table 1 below is the annual expenses portion of the Altegris fund's fee table and is intended to show that existing disclosures by public closed-end funds that invest in private equity funds are comprehensive and easy to understand.[210]

Table 1

Annual Expenses (as a percentage of the Altegris fund's net assets)

Management Fees	1.20%
Acquired Fund Fees and Expenses[211]	0.38%
Interest Payments on Borrowed Funds	0.02%
Other Expenses	0.58%
Total Annual Expenses	2.18%

In conclusion we recommend that the SEC should not apply the accredited investor standard on a look through basis to public closed-end funds that invest more than 15% of their assets in private equity funds. We believe that retail investors should have the opportunity to enhance their investment returns through these funds. To the extent additional protections for retail investors were deemed appropriate, we note that the SEC could adopt such protections by simply restricting the private equity funds that public closed-end funds could invest in. For example, the SEC could only allow public closed-end funds to invest in private equity funds with managers that are subject to additional minimum disclosure requirements or only in private equity funds where the assets managed by the affiliated manager include a material institutional component (e.g., more than 50%). Similarly, the SEC could further require that the affiliated manager of such private equity funds meet other threshold scale and experience criteria.

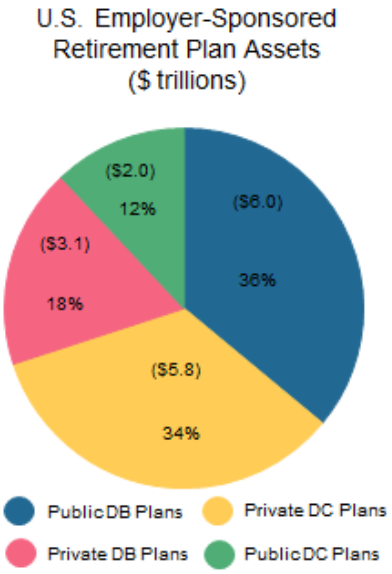
[210] *See* Form N-2, Altegris KKR Commitments Master Fund at 29, https://www.sec.gov/Archives/edgar/data/1606789/000110465918048426/a18-17639_4pos8c.htm.

[211] Represents estimated operating fees and expenses of the Investment Funds in which the Altegris fund invests. Some or all of the Investment Funds in which the Altegris fund invests charge carried interest, incentive fees or allocations based on the Investment Funds' performance. The Investment Funds in which the Altegris fund invests generally charge a management fee of 1.00% to 2.00% annually of committed or net invested capital, and approximately 20% of net profits as a carried interest allocation. The 0.38% shown as "Acquired Fund Fees and Expenses" reflects operating expenses of the Investment Funds (e.g., management fees, administration fees and professional and other direct, fixed fees and expenses of the Investment Funds) after refunds, excluding any performance-based fees or allocations paid by the Investment Funds that are paid solely on the realization and/or distribution of gains, or on the sum of such gains and unrealized appreciation of assets distributed in-kind, as such fees and allocations for a particular period may be unrelated to the cost of investing in the Investment Funds.

Part III: Enhancing Retirement by Expanding Access to Private Equity Funds

Retirement assets can be broadly categorized into two groups: individual retirement accounts ("**IRAs**") and employer-sponsored retirement plans. At the end of Q2 2018, IRAs held $9.3 trillion in assets, while employer-sponsored plans held $16.9 trillion in assets.[212] IRAs provide beneficiaries with complete control over their savings, as beneficiaries can choose from the full selection of investments that are otherwise available to them through a brokerage account. Our recommendations in Part II would therefore also apply to IRAs,[213] so we do not further address IRAs in Part III. On the other hand, employers play a more active role in selecting the investments that are available to beneficiaries of employer-sponsored plans. As a result, the Employee Retirement Income Security Act of 1974 ("**ERISA**") governs these plans and the Department of Labor ("**DOL**") applies ERISA. **Figure 13** further breaks down employer-sponsored retirement plans into assets held by government (public) and private defined benefit and defined contribution plans as of Q2 2018.[214] Our primary focus in Part III is on 401(k) plans, a subtype of private defined contribution plan with $5.3 trillion in AUM as of Q2 2018.[215]

Figure 13[216]



[212] Investment Company Institute, Quarterly Retirement Market Data (Q2 2018), a*vailable a*t https://www.ici.org/research/stats/retirement/ret_18_q2

[213] An IRA is accredited under Reg D only if its owner is an accredited investor. *See* 17 C.F.R. § 230.501(a)(8); SEC Compliance and Disclosure Interpretation 255.22 (last updated Nov. 6, 2017), *available at* https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm; SEC, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS at E.8 & E.9 (last accessed Dec. 14, 2017), *available at* https://www.sec.gov/interps/telephone/cftelinterps_regd701.pdf. Similarly, the SEC looks through an IRA to its owner when determining if an IRA is a qualified purchaser. *See* American Bar Ass'n, SEC No-Action Letter Ref No. at 14 (Apr. 22, 1999).

[214] Investment Company Institute, Quarterly Retirement Market Data (Q2 2018), *available at* https://www.ici.org/research/stats/retirement/ret_18_q2

[215] *Id.*

[216] *Id.*

Chapter 1: The State of Employer-Sponsored Retirement Plans

In Chapter 1, we describe at a very high level the two categories of employer-sponsored retirement plans: defined benefit ("**DB**") plans and defined contribution ("**DC**") plans. We then explain that private employer-sponsored retirement accounts have undergone a dramatic shift over the past few decades away from DB plans and towards DC plans. Finally, we show that DB plans outperform DC plans and that private equity funds contribute to this outperformance.

What are Defined Benefit Plans and Defined Contribution Plans?

An employer sponsoring a DB plan promises to pay participants in the plan a certain amount of benefits upon retirement regardless of the performance of the investments that the plan holds.[217] These plans typically determine the amount of benefits that a participant is entitled to receive based on the participant's years of service, age and salary.[218] Participants generally receive a fixed amount per month after retirement for the remainder of their life.[219] Typically, an internal investment committee and one or more external asset managers will manage the assets of a DB plan.[220] The managers of a DB plan pool assets together for all participants and invest them to earn a return that is then used to help meet the obligations owed to plan participants.[221]

Unlike DB plans, the amount that a participant in a DC plan is entitled to receive in retirement depends on the value of an account established for the participant under the plan.[222] The value of the account is determined by four factors: (1) the amount of contributions; (2) the expenses incurred by the plan; (3) the asset allocation decisions made by the participant among the investment options made available in the plan; and (4) the performance of the investments in the account over time.[223] Participants in DC plans typically make contributions to their plan account as part of their regular payroll, and employers often contribute a certain additional amount—for example, by "matching" the amount contributed by each participant.[224]

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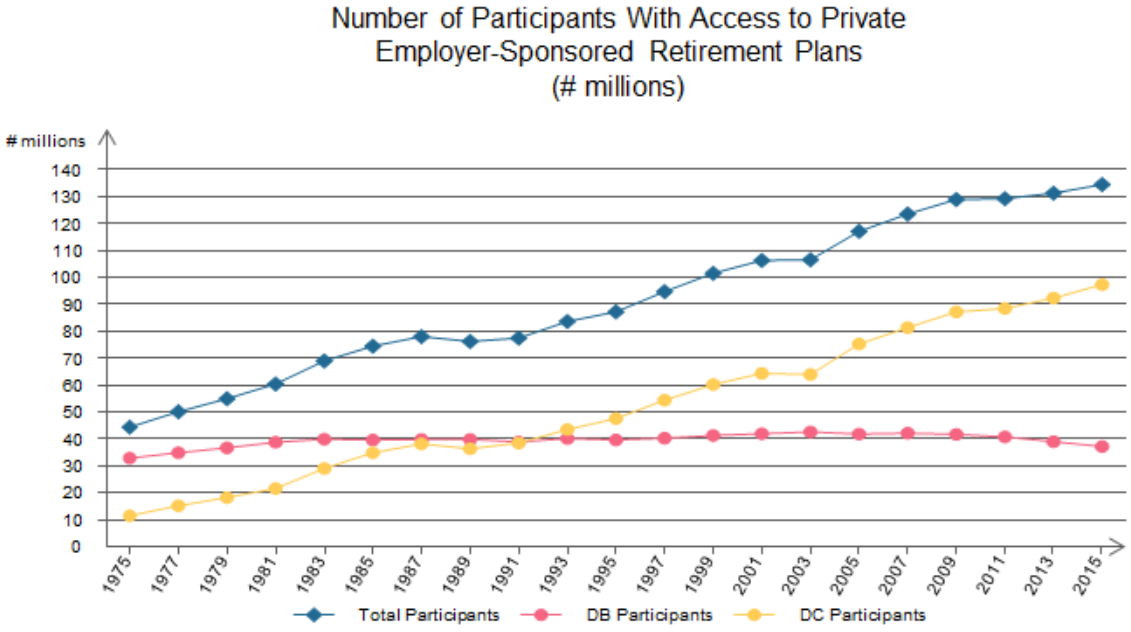
[217] U.S. GOV'T ACCOUNTABILITY OFF., GAO-18-111SP, THE NATION'S RETIREMENT SYSTEM: A COMPREHENSIVE RE-EVALUATION IS NEEDED TO BETTER PROMOTE FUTURE RETIREMENT SECURITY at 12 (Oct. 2017).
[218] *See Id.* at 9-11.
[219] *Id.*
[220] According to a recent Towers Watson survey, 33% of DB plan sponsors outsource at least one aspect of their investment services, such as manager selection and implementation. WILLIS TOWERS WATSON, EVOLVING RISKS, STRUCTURE AND STRATEGIES IN RETIREMENT PLAN GOVERNANCE: HIGHLIGHTS FROM THE 2016 WILLIS TOWERS WATSON U.S. RETIREMENT PLAN GOVERNANCE SURVEY 2-3 (2016), https://www.willistowerswatson.com/-/media/WTW/PDF/Insights/2016/05/wtw-retirement-plan-governance-ExecSummary.pdf.
[221] *See id. See also* Kathryn Moore, *An Overview of the U.S. Retirement Income Security System and the Principles and Values it Reflects*, 33 COMP. LAB. L. & POL'Y J. 5, 20 (2011).
[222] *See* GAO, *supra* n.217 at 12.
[223] *See id.*
[224] *See* Moore, *supra* n.221 at 20.

The Decline of Defined Benefit Plans and the Rise of Defined Contribution Plans

In this section, we review the DOL's most recent survey of private retirement plans to show that private employer-sponsored retirement accounts have undergone a dramatic shift over the past few decades away from DB plans and towards DC plans. We focus on *private* plans because government employers still predominantly offer DB plans.[225]

Figure 14 demonstrates that the number of U.S. workers with access to private DB plans was twice the number of U.S. workers with access to private DC plans in 1975—the year after ERISA was passed.[226] However, as of 2015 the number of U.S. workers with access to private DC plans was 2.5 times the number of U.S. workers with access to private DB plans: 97.6 million participants with access to private DC plans as compared to just 37.3 million with access to private DB plans.[227]

Figure 14[228]



[225] *See* U.S. DEPT. OF LABOR, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE U.S. 379 (Mar. 2017), *available at* https://www.bls.gov/ncs/ebs/benefits/2017/ebbl0061.pdf (noting that 86% of state and local government workers have access to a defined benefit plan). Federal workers also generally have access to a defined benefit plan. *See* GAO, *supra* n.217 at 9, n.13.

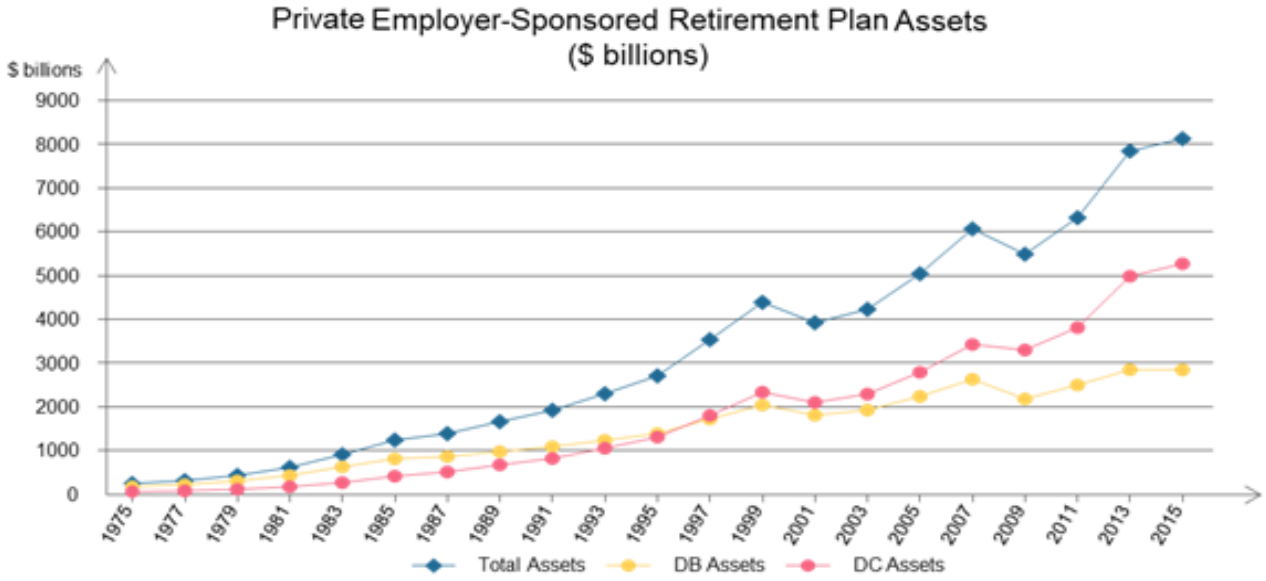
[226] U.S. DEPT. OF LABOR, EMPLOYEE BENEFITS SECURITY ADMIN., PRIVATE PENSION PLAN BULLETIN HISTORICAL TABLES AND GRAPHS 1975-2015 at 5 (Feb. 2018). https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf.

[227] *Id.*

[228] *Id.*

Figure 15 shows a dramatic increase in the total assets held by private employer-sponsored retirement plans in recent decades and that, as of 2015, the total assets held by private DC plans are over $5 trillion, almost twice the total assets held by private DB plans.[229]

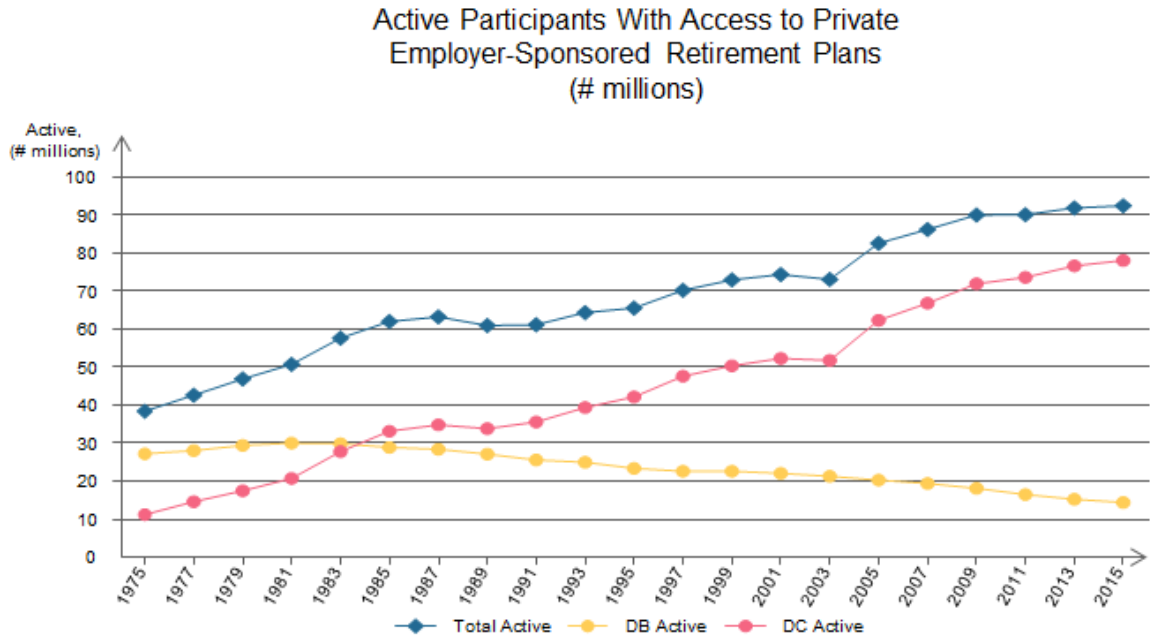
Figure 15[230]



The number of active participants with access to employer-sponsored retirement plans—workers that can still earn or retain credited service under a plan—is a forward-looking indicator of future trends in retirement plan assets. **Figure 16** on the next page shows that recent trends are likely to continue. As of 2015, the number of active participants with access to private DC plans was nearly 80 million, which is over five times the 14 million active participants with access to private DB plans.[231]

[229] *Id.* at 13.
[230] *Id.* at 14.
[231] *Id.* at 9.

Figure 16[232]



There are several factors driving the rise of private DC plans. For example, 401(k) plan sponsors are increasingly including auto-enrollment features whereby new employees at these companies are enrolled in a 401(k) plan by default, meaning a higher proportion of the workforce participates in them.[233] These features were made available through legislative changes enacted in the Pension Protection Act of 2006, with the express intent of encouraging employees who might not affirmatively enroll in a 401(k) plan to take advantage of the opportunity to build savings for their retirement. These provisions allow the employee to opt out of participation, but also provide for automatically increasing levels of contributions over time once the participants have become accustomed to and comfortable with the benefits of participation.[234] As more employers have added such features to their plans without adverse employee reaction, they have gained wider acceptance among 401(k) plan sponsors.

Recent tax reform measures have also increased companies' post-tax earnings, encouraging many employers to increase their 401(k) contributions, which further incentivize workers to enroll.[235] Other recently-proposed legislative initiatives, such as the Retirement Enhancement and

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[232] *Id.* at 10.

[233] *See* Paula Aven Gladych, *Employers Adding 401(k) Auto-enrollment in Record Numbers*, EMPLOYEE BENEFIT NEWS (Feb, 27, 2018), https://www.benefitnews.com/news/employers-adding-401-k-auto-enrollment-in-record-numbers.

[234] *See* 26 U.S.C. § 401(k)(13). These provisions were added by Section 902(a) of the Pension Protection Act. Pension Protection Act of 2006, PUB. L. 109-280, § 902, 120 Stat. 780 (2006).

[235] *See* Press Release, Willis Towers Watson, Tax Law Fueling Changes to Employer Benefits and Compensation Programs (Jan. 25, 2018), https://www.willistowerswatson.com/en/press/2018/01/tax-law-fueling-changes-to-employer-benefits-and-compensation-programs. *See also* Anne Tergesen, *With Tax Savings, Some Employers Will*

Savings Act,[236] and the Universal Savings Account, originally proposed by Representative Brat and included in the House Republicans proposed Tax Reform 2.0,[237] would also provide mechanisms for smaller employers to pool together to offer cost-effective 401(k) plan options to their employees and to make enhanced tax qualified savings vehicles available for all individuals. Finally, President Trump issued an Executive Order, Strengthening Retirement Security in America, on August 31, 2018 that requires that the DOL examine regulatory actions that would make it easier for smaller employers to offer retirement plans and reduce the cost of retirement plans.[238]

Boost 401(k) Contributions, WALL ST. J. (Jan. 18, 2018), https://www.wsj.com/articles/with-tax-savings-some-employers-will-boost-401-k-contributions-1516302593.

[236] Retirement Enhancement and Savings Act of 2018, S.B. 2526, 115th Cong. (2018). The Act was originally introduced in 2016 and approved by the Senate Finance Committee that fall. *See* Precious Abraham & Ann Marie Breheny, *Senate Committee Gives Retirement Savings Bill Unanimous Backing*, WILLIS TOWERS WATSON (Oct. 29, 2016), https://www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2016/10/senate-committee-gives-retirement-savings-bill-unanimous-backing.

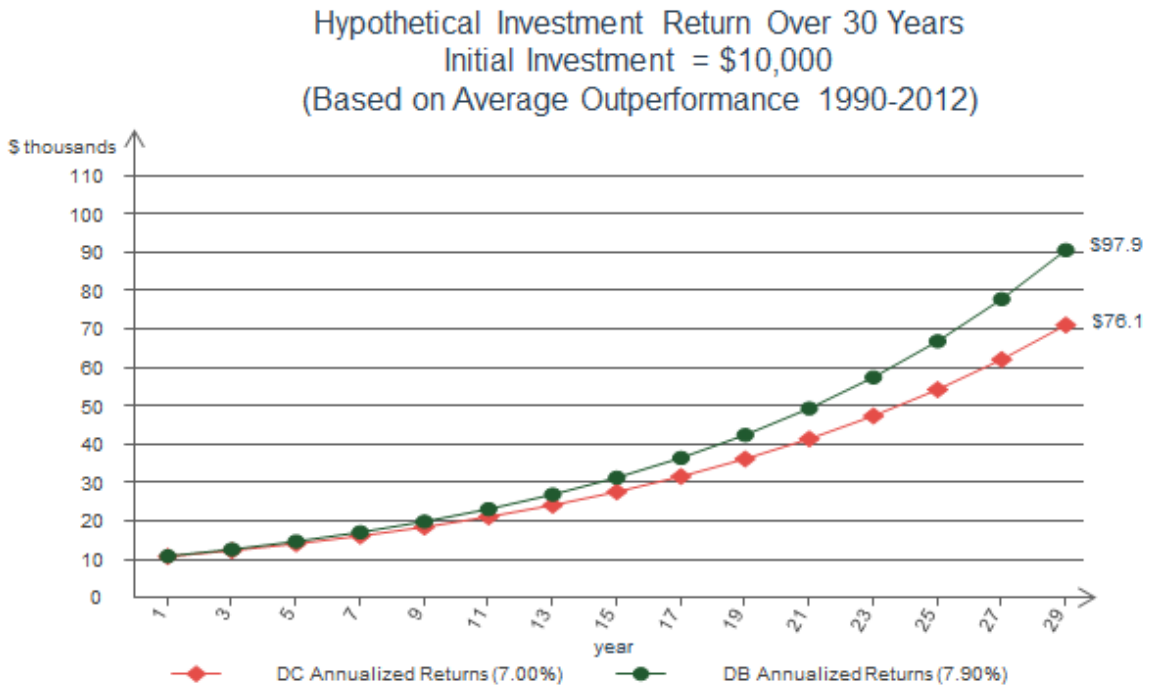
[237] *See* Ted Godbout, *'Tax Reform 2.0' to Include Universal Savings Accounts*, AM. SOC'Y OF PENSION PROF. & ACTUARIES (July 25, 2018), https://www.asppa.org/News/Article/ArticleID/10137; *The Universal Savings Account Act*, U.S CONGRESSMAN DAVE BRATT, https://brat.house.gov/legislation/the-universal-savings-account-act.htm (last accessed Aug. 7, 2018). On September 10, 2018, the House Ways & Means Committee introduced the Family Savings Act of 2018, which is intended to enhance access to retirement plans for employees of smaller businesses. *See* H.R. 6757, *available at:* https://waysandmeans.house.gov/wp-content/uploads/2018/09/H.R.-6757-Bill-Text.pdf.

[238] Executive Order on Strengthening Retirement Security in America, August 31, 2018, *available at* https://www.whitehouse.gov/presidential-actions/executive-order-strengthening-retirement-security-america/

Defined Benefit Plans Outperform Defined Contribution Plans

Studies examining the performance of DB plans and DC plans show that DB plans outperform DC plans. Therefore, the shift away from private DB plans and towards private DC plans may be negatively impacting retirees. For example, a 2015 study by the Boston College Center for Retirement Research found that private DB plans outperformed private DC plans by 90 basis points annually from 1990-2012 (7.9% average annual returns for DB plans versus 7.0% average annual returns for DC plans).[239] **Figure 17** shows that for a $10,000 investment over a 30-year period, a 7.0% annual return yields an ending balance of $76,100, while a 7.9% annual return yields $97,900, a substantial increase in retirement savings of 29%.

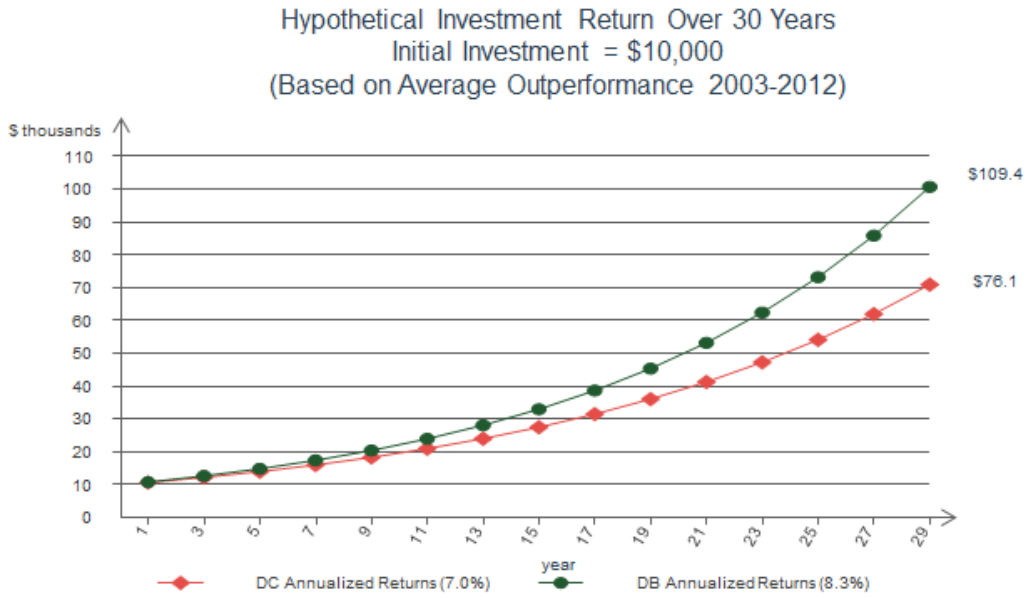
Figure 17[240]



According to the 2015 Boston College study, the spread between private DB plan performance and private DC plan performance has increased more recently, growing to 1.30% from 2003-2012 (vs. 0.9% from 1990-2002).[241] **Figure 18** on the next page shows the hypothetical 30-year returns from a private DB plan as compared to a private DC plan using this more recent differential in performance.

[239] ALICIA H. MUNNELL ET AL., INVESTMENT RETURNS: DEFINED BENEFIT VS. DEFINED CONTRIBUTION PLANS, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE 3 (Dec. 2015), *available at* http://crr.bc.edu/wp-content/uploads/2015/12/IB_15-211.pdf.
[240] *Id.*
[241] *Id.*

Figure 18[242]



The outperformance of private DB plans over private DC plans is even greater for larger retirement funds. From 2003-2012, private DB plans with more than $100 million of assets outperformed similarly sized private DC plans by 1.50% annually.[243]

One critical difference between private DB plans and private DC plans is that private DB plans invest in private equity, among other alternative investments, whereas private DC plans generally do not.[244] As noted in Part I, as of January 2018, private DB plans globally have an average target allocation to private equity of 6.1%.[245] Considering the strong performance of private equity funds demonstrated in Part I, private equity funds are likely contributing to the relative outperformance of private DB plans over private DC plans.

A 2017 Boston College Center for Retirement Research study provides specific insight as to the role of private equity funds in the strong performance of *public* DB plans.[246] The 2017 Boston College study likely focused on public DB plans, because these plans provide granular

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[242] *Id.*

[243] *Id.*

[244] Based on CCMR staff conversations with representatives from Preqin, a provider of data on the private equity industry. *See also*, Scott Higbee, *It's Time To Let 401(k) Holders Invest Like the Pros*, WALL ST. J. (Jan. 30, 2014), https://www.wsj.com/articles/it8217s-time-to-let-401k-holders-invest-like-the-pros-1391126566?tesla=y ("[401(k)] plans generally don't provide investors with the opportunity to add a range of alternative assets to the mix."); Frances Denmark, *Private Equity Tries to Break the 401(k) Barrier*, INSTITUTIONAL INVESTOR (Apr. 19, 2017), https://www.institutionalinvestor.com/article/b1505q632mxb1s/private-equity-tries-to-break-the-401k-barrier ("DC gatekeepers — retirement plan sponsors and their investment consultants — continue to keep [private equity funds] off 401(k) plans.").

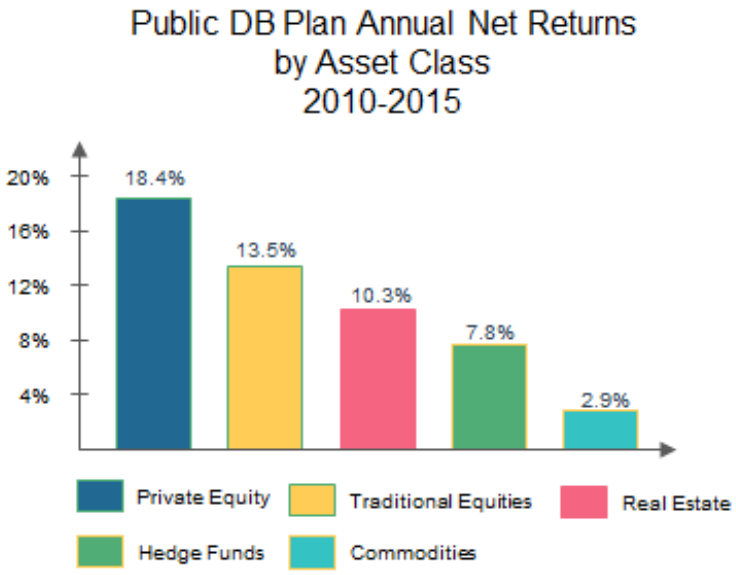
[245] PREQIN, *supra* n.72 at 74.

[246] Jean-Pierre Aubry et al., *A First Look at Alternative Investments and Public Pensions*, 55 STATE AND LOCAL PENSIONS (July 2017), *available at* http://crr.bc.edu/wp-content/uploads/2017/06/slp_55.pdf. The study defined private equity as "funds that buy, restructure, and sell companies."

disclosures as to the performance of their specific asset allocations. We believe that the performance of private equity in the portfolios of public DB plans is likely indicative of the performance of private equity in the portfolios of private DB plans.

Figure 19 below is based on data from the 2017 Boston College Study and shows the average annual returns for public DB plans across various asset classes from 2010 through 2015.[247] Not only did the returns from private equity investments outperform other classes of alternative investments, but private equity also outperformed traditional equity investments by a significant amount, 18.4% for private equity versus 13.5% for traditional equities.[248] This outperformance by private equity is consistent with our review of private equity returns in Part I.

Figure 19[249]



While private equity investments have provided significant boosts to the overall returns of public DB plans, an important question remains whether the risk exposure of public DB plans has increased as well. The 2017 Boston College study finds that based on the sample of public DB plan returns from 2005-2015, increasing allocations into private equity investments does not have a statistically significant effect on the volatility of returns.[250] Therefore, while private equity investments serve to increase the overall returns of public DB plans, there is not a significant corresponding increase in overall risk. However, we note that the Voya (2017) study reviewed in Part I shows a *reduction* in overall risk to a portfolio from investments in private equity funds. A key difference between the 2017 Boston College study and the Voya (2017) study is that the public DB plans included in the 2017 Boston College study have allocated only 8% of their portfolio to

[247] *Id.* at 7.
[248] *Id.*
[249] *Id.*
[250] *Id.*

private equity funds, as compared to the 20% allocation to private equity funds in the Voya (2017) study.[251]

The Boston College studies are consistent with the findings of a recent study by the Georgetown Center for Retirement Initiatives that evaluated the impact of adding alternative investments to target date funds.[252] A target date fund is an investment vehicle with a portfolio of assets that changes over time, becoming more conservative as an investor approaches the age of retirement. The study found that allocating 20% of a target date fund's portfolio to private equity can increase median retirement income by 13% compared to a baseline portfolio without private equity.[253] It also found that, in the case of some of the worst market outcomes (the fifth percentile of results), such a private equity allocation still improves retirement income by 12% compared to the baseline.[254]

We therefore conclude that the performance of private equity funds is likely contributing to the outperformance of DB plans compared to DC plans.

[251] *See supra* nn.66-71 and accompanying text.
[252] GEO. CTR. FOR RET. INITIATIVES, THE EVOLUTION OF TARGET DATE FUNDS: USING ALTERNATIVES TO IMPROVE RETIREMENT PLAN OUTCOMES (June 2018).
[253] *Id.* at 11-13.
[254] *Id.*

Chapter 2: Can 401(k) Plans Invest in Private Equity Funds?

In Chapter 2, we shift our focus to 401(k) plans—a subtype of private DC plan with $5.3 trillion in AUM as of Q2 2018, representing approximately 91% of private DC plan assets.[255] We begin Chapter 2 by explaining how 401(k) plans invest retirement assets. We then examine the accredited investor standard and qualified purchaser standard as they would apply to 401(k) plans that invest in private equity funds. Finally, we explain that legal risks are deterring the employers that sponsor 401(k) plans from investing in private equity funds.

What is a 401(k) Plan?

401(k) plans are private employer-sponsored retirement plans that are structured to enable employees (or "**plan participants**") to invest part of their wages for retirement on a *pre-tax* basis. However, in order to maintain tax favored status, there are significant limitations on participants' ability to make withdrawals from their 401(k) plan accounts. A 401(k) plan must not allow for distributions unless: (i) the participant dies or becomes disabled; (ii) the plan terminates and no successor plan is established; or (iii) the participant reaches age 59½ or incurs a financial hardship.[256] If a distribution before the age of 59½ is allowed by the employer because the employer determines that one of the other requirements has been satisfied, then the distribution is often subject to a 10% tax in addition to ordinary income tax.[257]

Despite the restrictions on participant withdrawals from 401(k) accounts, a majority of 401(k) plans allow participants to take out loans of up to $50,000 against their retirement accounts in order to provide participants with liquidity.[258] As of 2015, approximately 18% of eligible 401(k) participants had such loans outstanding.[259] These loans are generally not considered taxable distributions. Additionally, when a plan participant's employment with a specific employer ends before the age of 59½, he or she has the opportunity to liquidate the full 401(k) account balance, subject to ordinary income taxes and the 10% additional tax.[260] Alternatively, a plan participant has the option to "roll over" their 401(k) account into a new employer's 401(k) or into an IRA.[261] These features make 401(k) plans more liquid than DC plans in other countries. Indeed, a paper by the National Bureau of Economic Research comparing DC systems internationally found that

[255] INV. CO. INST., QUARTERLY RETIREMENT MARKET DATA (Q2 2018), *available at* https://www.ici.org/research/stats/retirement/ret_18_q2
[256] *See* 26 U.S.C. § 401(k). *See also* 26 C.F.R. § 1.401(k)-1(d)(3) (regarding hardships). For a useful resource explaining 401(k) plans and how they operate, see THE 401(K) HANDBOOK (Arris Murphy & Paul Hamburger eds. 2018).
[257] *See* 26 U.S.C. § 72(t). *See also* 401(K) HANDBOOK, *supra* n.256 at ¶263.
[258] Sarah Holden et al. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2015*, 23 ICI RESEARCH PERSPECTIVE 1, 47 (Aug. 2017), https://www.ici.org/pdf/per23-06.pdf. In 2015, approximately 53% of 401(k) plans offered a loan feature. However, loan features were much more prevalent—closer to 90%—among the largest 401(k) plans. *Id.*
[259] *Id.* at 48.
[260] *See* 401(K) HANDBOOK, *supra* n.256 at ¶262.
[261] *See id.* at 263. *See also* 26 U.S.C. 402(c).

the DC systems in the United Kingdom, Canada, Australia, Singapore and Germany were "overwhelmingly illiquid" as compared to 401(k) plans in the United States.[262]

Employee-Directed 401(k) Plans

Approximately 92% of 401(k) plans are "employee-directed plans", and that is our focus in this report.[263] In an employee-directed 401(k) plan, an individual employee chooses to allocate his or her contributions among several investment options ("**Investment Options**") that are part of the 401(k) plan (together, the "**Investment Menu**"). The employer sponsoring the plan—often through an investment committee made up of finance and human resources employees—is generally responsible for determining the Investment Options that are included in the Investment Menu.[264] However, the employer sponsor can appoint an external asset manager to determine the Investment Options and Investment Menu.[265] The assets of a 401(k) plan are legally owned by a plan trustee that is also appointed by the employer sponsor, and the plan trustee holds the 401(k) plan assets for the benefit of the participants.[266]

As demonstrated by **Figure 20** on the next page, each Investment Option holds a portfolio of assets (e.g. stocks and bonds) that are typically managed by a third-party asset manager within certain parameters.[267] Investment Options can be structured using a number of different investment vehicles or "wrappers," including mutual funds, collective investment trusts ("**CITs**") and separate accounts. CITs are pooled investment vehicles that are organized as trusts and maintained by a bank or a trust company.[268] A separate account is an account managed with a distinct strategy for a 401(k) plan; the concept is similar to holding shares in a fund, but there is no separate entity that issues shares.[269] Based on a 2016 Callan survey of 401(k) plan sponsors, 84% of respondents said they offered mutual funds in their Investment Menu, while 65% and 40% offered CITs and separate accounts, respectively.[270]

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[262] *See generally* John Beshears et al., *Liquidity in Retirement Savings Systems: An International Comparison* (Nat'l Bureau of Econ. Research Working Paper 21,168, May 2015).

[263] *See* U.S. DEPT. OF LABOR, *supra* n.226, at 31. The remainder of 401(k) plans are trustee-directed plans under which participants do not have any control over their investments. We do not focus on these plans because they are much less common than employee-directed plans, and participants in trustee-directed plans represent a very small portion (roughly 2%) of the total participants in 401(k) plans. *See id.* at 52.

[264] *See generally* 401(K) HANDBOOK, *supra* n.256 at ¶¶ 410-411.

[265] 29 U.S.C. § 1102(c).

[266] *See* 29 U.S.C. § 1103.

[267] *See generally* DEFINED CONTRIBUTION INST'L INV. ASS'N, A GUIDE TO COMMONLY USED DC PLAN INVESTMENT VEHICLES (2017), *available at* https://www.ctfcoalition.com/portalresource/a-guide-to-commonly-used-investment-vehicles_final.pdf.

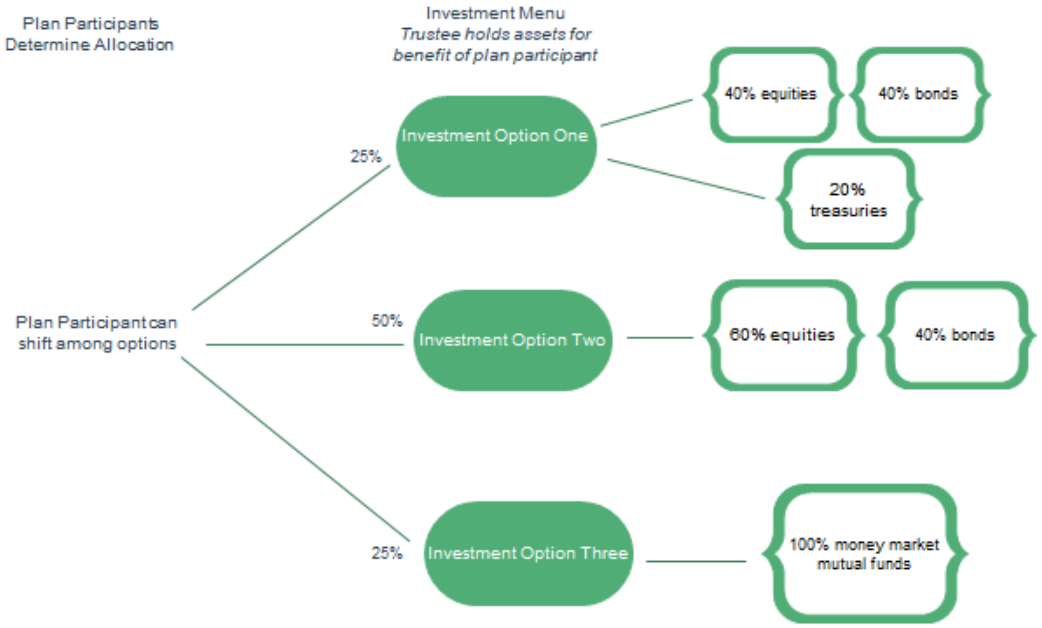
[268] *See* COAL. OF COLLECTIVE INV. TRUSTS, COLLECTIVE INVESTMENT TRUSTS 3 (2015), https://www.ctfcoalition.com/portalresource/CollectiveInvestmentTrustsWhitePaper.pdf. The bank acts as a fiduciary for the CIT and holds legal title to the CIT's assets for the benefit of CIT investors. CITs provide the advantages of not being subject to the restrictions on holding illiquid assets that otherwise apply to mutual funds registered under the 1940 Act.

[269] *See generally* DEFINED CONTRIBUTION INST'L INV. ASS'N, *supra* n.267 at 6, 14. Separate accounts can be "unitized" where the holdings are divided into units that represent interests in the underlying assets of the account. *See* BlackRock Comment Letter to the Dept. of Labor, at 19, n.53 (July 21, 2015), https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00684.pdf.

[270] CALLAN, DEFINED CONTRIBUTION TRENDS 29 (2017), https://www.callan.com/wp-content/uploads/2017/01/Callan-2017-DC-Survey.pdf.

Critically, plan participants can shift their allocations among Investment Options (without any tax or penalty), as also demonstrated by **Figure 20**. For example, if a plan participant has 100% of his or her 401(k) plan allocated to Investment Option One, she can move it, in part or entirely, into Investment Option Two. When this happens, the participant redeems her interests in Investment Option One, highly liquid assets in Investment Option One's portfolio are typically sold, and the funds from the redemption are moved to Investment Option Two, which typically uses the additional cash to purchase assets as determined by its asset allocation. Of course, the cash that a plan participant is entitled to shift to Investment Option Two is based on the net asset value of Investment Option One at the time of redemption.

Figure 20



The majority of 401(k) plan participants allocate their savings to Investment Options that are target date funds.[271] As noted earlier, a target date fund is an investment vehicle with a portfolio of assets that changes over time, becoming more conservative as an investor approaches the age of retirement. Target date funds, and Investment Options in general, can be "off-the-shelf" products, which are based on an existing investment strategy used by an asset manager,[272] or an asset manager can build a "custom" Investment Option based on a particular asset allocation chosen by the 401(k) plan sponsor. According to a 2017 survey by Willis Towers Watson, custom

[271] *See* VANGUARD, HOW AMERICA SAVES 2018 at 4, https://pressroom.vanguard.com/nonindexed/HAS18_062018.pdf.
[272] *See* DEFINED CONTRIBUTION INST'L INV. ASS'N, *supra* n.267, at 16-17.

implementations are increasing in the large DC plan market, as 38% of plans with $5 billion or greater offer custom target date funds as Investment Options.[273]

Applying the Accredited Investor and Qualified Purchaser Standards to 401(k) Plans

We now consider whether 401(k) plans with retail investors as participants can legally invest in private equity funds. In other words, does the accredited investor standard or qualified purchaser standard prohibit such 401(k) plans from investing in private equity funds? We find that under the 1940 Act, 401(k) plans are qualified purchasers, and under the Securities Act, 401(k) plans are also accredited investors.[274] However, as discussed in Part II, if the accredited investor or qualified purchaser standard were to "look through" to the participants in the plan then 401(k) plans with retail investors as participants could not invest in private equity funds. We find that the accredited investor standard does *not* "look through" a 401(k) plan to its participants.[275] Similarly, the qualified purchaser standard does *not* "look through" a 401(k) plan to its participants in certain circumstances.[276]

The SEC's *Standish and H.E.B.* no-action letters clarify when the qualified purchaser standard looks through a 401(k) plan to its participants.[277] They provide that 401(k) plans can invest in private funds without a look through of the qualified purchaser standard so long as several conditions are met. First, the 401(k) plan must not have been formed for the specific purpose of acquiring the securities offered by a *specific* private fund.[278] Second, plan participants cannot choose the *specific* private fund to invest in and no representations can be made to plan participants that investments will be made in any specific private fund.[279] And finally at least 50% of the assets in an Investment Option must consist of securities or property other than the securities of a specific private fund.[280] If structured in accordance with these requirements, then 401(k) plans can invest in private equity funds without a look through of the qualified purchaser standard to plan participants.

Therefore, we conclude that neither the accredited investor standard nor the qualified purchaser standard prohibits 401(k) plans with retail investors as beneficiaries from investing in private equity funds.

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[273] *See* GEO. CTR. FOR RET. INITIATIVES, THE EVOLUTION OF TARGET DATE FUNDS 9 (JUNE 2018).
[274] Any person, acting for its own account, who in the aggregate owns and invests on a discretionary basis over $25 million in investments is a qualified purchaser. *See* 15 U.S.C. § 80a-2(a)(51)(A). An employee benefit plan is an accredited investor so long as the plan's investment decisions are made by a plan fiduciary which is either a bank, savings and loan association, insurance company, or registered investment adviser, the plan has total assets in excess of $5,000,000 or, if a self-directed plan, the plan's investment decisions are made solely by persons that are accredited investors. 17 C.F.R. § 230.501(a)(1).
[275] *See* 15 U.S.C. § 77b(a)(15)(i) and 17 C.F.R. § 230.501(a).
[276] We also note that the Advisers Act's restriction on performance fees does not preclude 401(k) plans from investing in Section 3(c)(7) private equity funds. *See supra* nn.110-112 and accompanying text.
[277] *See* Standish, Ayer & Wood, Inc. Stable Value Group Trust, SEC No-Action Letter Ref. No. 95-423-CC (Dec. 28, 1995); H.E.B. Investment and Retirement Plan, SEC No-Action Letter Ref. No. 20001171143 (May 18, 2001). *See also* PanAgora Group Trust, SEC No-Action Letter Ref. No. 93-212-CC (Apr. 29, 1994).
[278] *See* H.E.B. Investment and Retirement Plan, *supra* n.277.
[279] *Id.*
[280] *Id.*

Legal Risks Deter Plan Sponsors from Offering Exposure to Private Equity Funds

401(k) plan sponsors and their appointees are subject to ERISA fiduciary duties and including Investment Options with exposure to private equity funds could lead to allegations of fiduciary violations (e.g. lack of due care or prudence). In practice, the risk of such allegations has discouraged plan sponsors and their appointees from including Investment Options with exposure to private equity funds in 401(k) plans.

ERISA's Fiduciary Duties

ERISA imposes fiduciary duties on any person that: (i) exercises any discretionary authority or control respecting management of a 401(k) plan or its assets; (ii) renders investment advice for a fee with respect to any assets of the plan; or (iii) has any discretionary authority or responsibility in the administration of the plan.[281] We refer to such persons as "**plan fiduciaries**." Plan fiduciaries can appoint others to carry out some of their responsibilities under the plan. However, a plan fiduciary who has appointed another plan fiduciary has the ongoing responsibility to monitor and review the performance of such appointee at reasonable intervals, including the regular review of the appointee's fees and expenses to ensure that they are reasonable.[282]

Of course, selecting Investment Options and an Investment Menu involves exercising discretionary authority and control respecting the management of plan assets. As a result, whoever constructs the Investment Options and Investment Menu is a plan fiduciary. In addition, anyone who appoints the person/group responsible for the Investment Options or Investment Menu is also responsible for monitoring their performance.[283] Thus, employers that sponsor 401(k) plans, plan trustees and investment managers that help select the Investment Menu and Investment Options are all plan fiduciaries under ERISA.

ERISA establishes five basic duties for plan fiduciaries:

> (1) act solely in the interest of plan participants and their beneficiaries;
>
> (2) act for the exclusive purpose of providing benefits to plan participants and their beneficiaries and defraying reasonable expenses of administering the plan;
>
> (3) act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims;

[281] 29 U.S.C. § 1002(a)(21) ("[A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.").
[282] *See* 29 C.F.R. § 2509.75-8 at FR-17.
[283] *Id.*

> (4) diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (5) act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with ERISA.[284]

The DOL has not specified the investments that plan fiduciaries may include in an Investment Option. As a result, plan participants can bring a claim alleging that offering certain investments in an Investment Option was imprudent based on the underperformance of an Investment Option. Plan participants can also bring claims that certain Investment Options charged excessive fees. Private equity funds are particularly exposed to claims on the basis of higher fees, as they generally charge higher fees than traditional mutual funds. The cost and distraction from defending any such action has been sufficient to discourage virtually all 401(k) plan sponsors from introducing an Investment Option with private equity funds into their Investment Menu, regardless of whether they believe that they and other fiduciaries would ultimately prevail in such a suit.

A recent lawsuit against Intel's plan fiduciaries in 2015 illustrates this risk. The suit was largely premised on the inclusion of Investment Options with exposure to private funds, including private equity funds.[285] Participants in Intel's 401(k) plan sued Intel's investment committee and other plan fiduciaries when Investment Options that allocated significant amounts to private funds allegedly underperformed.[286] The argument that Intel violated its fiduciary duties by offering plan participants exposure to private funds, like private equity funds, is weak, given that DB plans—which are also subject to ERISA—routinely invest in these types of assets. Nonetheless, these plan participants argued that the defendants violated their fiduciary duties because the private fund investments were imprudently risky and subject to excessive fees.[287] Although this lawsuit was dismissed in 2017 on the basis of the statute of limitations, it is still pending appeal, and many other companies, including International Paper, Boeing, Novant Health, Lockheed Martin, International Edison and Nordstrom, have in recent years experienced lawsuits against plan fiduciaries that alleged excessive fees.[288]

In our view, offering exposure to private equity funds is consistent with ERISA's fiduciary duties. As demonstrated in Part I, the volatility of private equity returns has been lower than the volatility of returns in public markets, and incorporating private equity funds into an investment portfolio can *reduce* the overall risk and volatility of the portfolio.[289] Additionally, the data on private equity returns—which is *net of fees*—shows that private equity funds have consistently outperformed public markets.[290] However, the *potential* for lawsuits—whether or not they have

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[284] *See* 29 U.S.C. § 1104(a).
[285] *See, e.g.*, Complaint at ¶ 1, Sulyma v. Intel Corp. Inv. Policy Comm., No. 15-CV-04977 NC, 2017 WL 1217185, at *1 (N.D. Cal. Mar. 31, 2017).
[286] *Id.* at ¶ 14.
[287] *Id.* at ¶ 1.
[288] *See* Compliant, Beesley v. Int'l Paper Co., 2006 WL 2791656 (S.D.Ill.); Complaint, Spano v. Boeing, 2006 WL 3226160 (S.D.Ill.); Complaint, Kruger v. Novant Health Inc., 2014 WL 1219198 (M.D.N.C.); Compliant, Abbott v. Lockheed Martin, 2006 WL 2791655 (S.D.Ill.); Complaint, Tibble v. Edison Int'l, 2008 WL 7092531 (C.D.Cal.); McCorvey v. Nordstrom, Case 2:17-cv-08108-MWF-AFM (2017).
[289] *See supra* nn.66-71 and accompanying text.
[290] *See supra* nn.41-56 and accompanying text.

merit—has been sufficient to discourage plan sponsors from offering Investment Options that include exposure to private equity funds.

Chapter 3: How to Minimize Legal Risks and Safely Enhance Returns for U.S. Retirees.

In Chapter 3, we further address the ERISA provisions and DOL regulations that expose 401(k) plan fiduciaries to litigation risk for offering Investment Options with exposure to private equity funds. First, we address the requirements that apply under ERISA's Section 404(c) safe harbor, which protects plan fiduciaries from legal risk from decisions made by plan participants. Most importantly, these provisions require that plan participants have the control necessary to shift among a broad alternative of Investment Options. As a result, plan fiduciaries offer plan participants the ability to shift assets among Investment Options on a *daily* basis. We then explain how a 401(k) plan could invest in private equity funds while still providing participants with the ability to shift among Investment Options on a daily basis. Ultimately we recommend that the DOL provide guidance as to how a plan fiduciary can offer Investment Options with exposure to private equity funds while qualifying for the Section 404(c) safe harbor. Second, we address the legal risk that a plan fiduciary can face from investment decisions made by plan fiduciaries, such as investing in an asset class with higher gross fees or one that suffers performance below expectations. We recommend that the DOL establish a new safe harbor for such legal risk that should apply if plan fiduciaries have complied with a diligent and independent process for selecting investments.

Legal Risk from Decisions Made by Plan Participants

The vast majority of 401(k) plans are designed and operated to meet the requirements of ERISA's Section 404(c) safe harbor,[291] because Section 404(c) provides that no plan fiduciary is liable under ERISA for any losses that result from a plan participant's exercise of investment control.[292] DOL regulations provide that a 401(k) plan complies with Section 404(c) so long as the plan gives participants the opportunity to: (1) choose from a broad range of Investment Options (the "**Broad Alternatives Requirement**"); and (2) exercise control over the assets in their individual accounts (the "**Control Requirement**").[293] However, plan fiduciaries lack DOL guidance as to how an Investment Option could include exposure to private equity funds while complying with these requirements. The resulting uncertainty presents an inviting opportunity for a litigant to pursue a case that would survive procedural challenges and subject plan fiduciaries to extensive and costly discovery. We briefly review the Broad Alternatives Requirement and Control Requirement below to illustrate their relevant complexities.

Broad Alternatives Requirement

To satisfy the Broad Alternatives Requirement, DOL regulations require that a 401(k) plan's Investment Menu provide the participant with a reasonable opportunity to: (a) materially affect the potential return and the degree of risk in his individual account; (b) choose from at least three diversified Investment Options, each of which has materially different risk and return characteristics (the "**Core Options**"); and (c) diversify the individual account so as to minimize

[291] *See* CALLAN, *supra* n.270 at 7.
[292] 29 U.S.C. § 1104(c).
[293] 29 C.F.R. § 2550.404c-1(b).

the risk of large losses.[294] Each of the Core Options, when combined with the investments in the other Investment Options, must tend to minimize through diversification the overall risk of a participant's portfolio.[295] In addition, the Core Options must in the aggregate enable the participant to achieve a portfolio with aggregate risk and return characteristics at any point within the range "normally" appropriate for the participant.[296]

Control Requirement

To satisfy the Control Requirement, DOL regulations require that a 401(k) plan give participants: (1) the opportunity to obtain sufficient information to make informed investment decisions; and (2) a reasonable opportunity to give investment instructions with respect to the available Investment Options.[297]

The DOL's Control Requirement also contains three specific mandates concerning the frequency with which participants must be allowed to shift their assets among Investment Options.[298] First, the regulation's "general volatility rule," requires that participants be given an opportunity to give investment instructions with a frequency which is "appropriate in light of the market volatility to which the investment may reasonably be expected to be subject."[299] Second, under the regulation's "3-month minimum rule," at least three of the Core Options must permit investment instructions at least once within any three-month period.[300] Third, the regulation's "volatile investment transferability rule," addresses transfers into the Core Options and effectively requires that a safe alternative be open to receive transfers from other Investment Options.[301]

Due in part to the general volatility rule, 401(k) plans typically provide participants with the ability to shift assets among Investment Options on a ***daily*** basis,[302] even though daily liquidity is not a statutory or regulatory requirement. 401(k) plan sponsors are hesitant to deviate from this practice for fear that, as a result, they will not qualify for the Section 404(c) safe harbor. Indeed, the prevalence of the right to make daily transfers could, in and of itself, form the basis for an allegation that any restriction on this daily right to transfer is imprudent and not in the best interests of plan participants. A plan participant's ability to shift among Investment Options on a daily basis

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[294] *See id.* at (b)(3).
[295] *See id.* at (b)(3)(i)(B)(4).
[296] *See id.* at (b)(3)(i)(B)(3).
[297] *See id.* at (b)(2)(i).
[298] *See id.* at (b)(2)(ii)(C).
[299] *Id.*
[300] *Id.* at (b)(2)(ii)(C)(1).
[301] *See id.* at (b)(2)(ii)(C)(2).
[302] *See* PARTNERS GROUP, ADDING PRIVATE MARKETS TO DC PENSION PLAN PORTFOLIOS – A CASE STUDY 11 (Jan. 2017), https://www.partnersgroup.com/fileadmin/user_upload/Documents/Research_PDF/20170123_Adding_private_markets_to_DC_pension_plan_portfolios.pdf ("DC plans typically require investment funds to meet certain eligibility criteria, such as . . . daily pricing, [and] daily subscriptions and redemptions at NAV . . . ."). *See also* John Manganaro, *DCIIA Says Illiquid Assets 'Manageable' in DC Plans*, PLAN SPONSOR (Sept. 16, 2015), https://www.plansponsor.com/dciia-says-illiquid-assets-manageable-in-dc-plans/ ("There is a perception that you have to have daily liquidity … in a DC plan.").

is important for our purposes, because as we have described throughout this report, private equity funds are illiquid assets.

In the next section, we explain how a 401(k) plan could include an Investment Option with exposure to private equity funds while still offering plan participants the ability to shift assets among Investment Options on a daily basis.[303] We then set forth a recommendation for how the DOL could better clarify the Section 404(c) safe harbor so as to safely provide plan participants with enhanced returns on their retirement savings.

401(k) Investment Option: Private Equity Exposure with Daily Liquidity

An Investment Option with exposure to private equity funds can still provide plan participants with the ability to switch into or out of the Investment Option on a daily basis, so long as the Investment Option holds sufficient liquid assets. For example, suppose a hypothetical 401(k) plan offers "Investment Option X," with $100 million in assets, 10% in cash, 80% in publicly-traded stocks and bonds, and 10% in private equity funds. In order to provide plan participants with daily liquidity, the manager of Investment Option X could simply rely on the cash or selling the liquid stocks and bonds when participants switch out of the Investment Option.

However, this "liquidity buffer" approach has its limits. Suppose that on a given day, plan participants representing 20% of the assets (or $20 million) in Investment Option X decide to shift their allocation to Investment Option Y. Drawing down the cash and selling public stocks and bonds to generate the necessary liquidity would mean that the plan participants remaining in Investment Option X would have greater exposure to illiquid private equity assets and fewer liquid assets to meet future short-term redemptions.

In practice, this concern is mitigated by the fact that plan participants very rarely exercise their right to shift assets among Investment Options. For example, according to Alight Solutions, a benefits administrator that tracks the 401(k) trading activity of over 2 million U.S. retirees with more than $200 billion in collective assets, average monthly transfers represented only 0.18% of 401(k) balances from April 2017 to June 2018.[304] And the volume of daily transfers is even lower. In Q2 2018, on average only 0.015% of balances were traded daily.[305] Experience also shows that asset shifting in 401(k) accounts is subdued even when markets are tumultuous. According to a 2009 survey conducted by the Investment Company Institute, 401(k) participant activity during 2008 was in line with historical norms.[306] Thus, by keeping an Investment Option's allocation to

[303] While we have not specifically recommended a safe harbor to allow plan sponsors to depart from daily liquidity (e.g. quarterly), we have reservations about whether daily liquidity is well-suited to the approximately 30-year investment horizon of 401(k) participants, particularly if they are simply provided the option of selecting less liquid investments. Moreover, capital investments that are committed for relatively long periods of time reduce the likelihood of participants selling at the wrong time when markets have a steep decline.

[304] *See Alight Solutions 401(k) Index*, ALIGHT SOLUTIONS, https://ideas.alight.com/health-wealth-solutions/alight-solutions-401-k-index-reports (last accessed June 16, 2018). Based on the average monthly transfers, as reported by Alight in its monthly *Observations*.

[305] *Id.* Based on the average daily trading activity reported by Alight for April, May and June.

[306] *ICI 401(k) Participant Activity Study Shows 2008 Activity in Line with Historical Data*, INV. CO. INST. (Mar. 9, 2009), https://www.ici.org/401k/news/09_news_recordkeeping.

private equity investments modest, plan fiduciaries can be highly confident that short-term flows into or out of an Investment Option will not result in excessive exposure to illiquid private equity funds.[307] As noted in Part II, mutual funds have significantly more volatile investor inflows and outflows than 401(k) plans, yet they are still permitted by the SEC to invest up to 15% of their net assets in illiquids.

Another point to consider is that Investment Options generally provide plan participants with disclosures as to their target asset allocations and seek to stay within these parameters. Even with modest inflows and outflows, it is possible that an Investment Option with exposure to private equity funds (or other illiquid assets) could deviate from highly specific investment parameters. In practice, however, Investment Options are designed with flexible asset allocations to account for this possibility.[308] Therefore, a plan sponsor could design an Investment Option with a target asset allocation to private equity funds in the range of 7.5% to 12.5%, for example. That would give the manager of the Investment Option's portfolio leeway to manage flows into and out of the Investment Option on any given day while planning future purchases and sales of private equity investments on a quarterly or bi-annual basis to bring the allocation to private equity funds back to the middle of the target range.

Additionally, the lack of daily valuations for private equity funds should not present a problem. Although private equity funds typically report valuations on a quarterly basis,[309] an Investment Option with private equity exposure can still report a daily net asset value by simply relying on the most recent valuation information available for the private equity investment.[310]

Of course, the ability to switch *out* of an Investment Option with exposure to private equity on a daily basis is not the only practical challenge to investing in private equity. There are also challenges regarding the mechanics of plan participants being able to switch *into* an Investment Option with private equity exposure on a daily basis. In particular, because private equity funds only take on new investors during defined periods of time, new cash shifted into an Investment Option with private equity exposure may not be immediately deployed into private equity funds.

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[307] In addition to a shift in participant investment allocations, another area of potential strains on liquidity are in service withdrawals, loan activity and separation from service. According to a 2018 Vanguard study ("How America Saves"), however, these represent a relatively small amount of leakage as, during 2016, only 2% of aggregate plan assets were borrowed, only 3% of participants took in service withdrawals, and 82% of participants who separated from service either remained in their employer's plan or rolled over their savings to an IRA or new employer plan. In terms of assets, 97% of all plan assets available for distribution were preserved and only 3% were taken in cash. Moreover, any potential liquidity issues, in any healthy company, are mitigated with new entrants that provide liquidity for the relatively small amount of leakage suggested by the Vanguard study. *See* Vanguard, *How America Saves 2018*, https://pressroom.vanguard.com/nonindexed/HAS18_062018.pdf.

[308] *See, e.g.*, MASSMUTUAL RETIRESMART[SM] 2030 FUND, SUMMARY PROSPECTUS at S-3 (Apr. 1, 2014), *available at* https://www.sec.gov/Archives/edgar/data/916053/000119312514138843/d703915d497k.htm ("[The adviser to the Fund] periodically reviews the target asset allocation and underlying investment options and may, at any time, in its discretion, change the target asset allocation or deviate from the target asset allocation. Under normal circumstances, the Fund's asset allocation among equity, fixed income and certain other asset classes is generally expected to vary by no more than plus or minus ten percentage points from the target asset allocation at that time.").

[309] *See* Holmes, *supra* n.138 at 62-65.

[310] *See* PARTNERS GROUP, *supra* n.302 at 12; THE INV. ASS'N, PUTTING INVESTMENT AT THE HEART OF DC PENSIONS 12-13 (June 2018).

Another issue is that private equity funds often charge management fees on committed capital that has not yet been deployed. As a result, plan participants in an Investment Option with exposure to private equity funds could pay high fees before the private equity fund deploys its capital. However, plan fiduciaries can address both issues by purchasing interests in existing private equity funds (i.e. already deployed capital) in the secondary market.

We therefore believe that a 401(k) plan could offer plan participants an Investment Option with exposure to private equity funds while still providing plan participants with the ability to switch into and out of Investment Options on a daily basis. For example, plan fiduciaries could do so by creating a custom Investment Option that allocates an appropriate percentage of participant contributions to private equity funds.[311]

Recommendation: Clarify that the Section 404(c) Safe Harbor Applies to Private Equity Funds

We recommend that the DOL clarify how plan fiduciaries can incorporate exposure to private equity funds into an Investment Option while complying with the requirements of Section 404(c). Specifically, the DOL should make clear that including private equity funds in an Investment Option would satisfy the requirements of Section 404(c), so long as there is sufficient liquidity at the Investment Option to provide for daily investment instructions. Without such guidance, the lack of clarity regarding the current ERISA liability framework will continue to unnecessarily force 401(k) participants—most of which are long-term investors—into foregoing returns from illiquid assets, such as private equity funds.[312]

Legal Risk from Decisions Made by Plan Fiduciaries

Given the breadth of the duties imposed on them under ERISA, plan fiduciaries can be exposed to legal risk and burdensome and costly litigation for constructing Investment Options that are alleged to underperform or charge excessive fees. In practice, plan fiduciaries can be exposed to liability from losses or excessive fees from *any* type of investment, including private equity funds, even if the intent and purpose of providing access to such investments is to enhance net returns available to participants. Plan fiduciaries have therefore developed best practices for selecting Investment Options that seek to avoid investing in assets that could be perceived to be excessively risky or have excessive fees.[313] However, without a safe harbor, which would serve to protect prudent fiduciaries from claims that lack merit, the uncertainty surrounding potential liability discourages plan fiduciaries from offering plan participants exposure to private equity funds and the corresponding opportunity for superior returns.

[311] *See generally* DEFINED CONTRIBUTION INST'L INVESTMENT ASS'N, CONSIDERATIONS FOR IMPLEMENTING A CUSTOM TARGET DATE APPROACH: A GUIDE FOR DEFINED CONTRIBUTION PLAN SPONSORS (2018).
[312] *See supra* nn.27-28 and accompanying text.
[313] Based on Committee staff conversations with Arthur Kohn, a partner at Cleary Gottlieb Steen & Hamilton LLP, and Lawrence K. Cagney, a partner at Debevoise & Plimpton LLP.

Recommendation: Reduce Risks for Selecting Investment Options: Mandating Best Practices

We recommend that the DOL develop a new safe harbor from ERISA fiduciary liability that would enable plan sponsors to prudently make available Investment Options that offer the opportunity for superior returns over the longer term, even if such investments might have an adverse impact on liquidity and be more expensive on a gross basis, so long as the net returns from such investments are expected to justify such higher costs.

Such a safe harbor could be principles-based, requiring that plan sponsors who wish to provide such an Investment Option conduct an appropriate review of the investment opportunities, the net returns that would be anticipated, and any potential impacts on the ability of participants to gain liquidity, all taking into account their duties of prudence and loyalty as ERISA fiduciaries. Alternatively, given that a principles-based approach could produce ambiguities that introduce legal risks that might impede the objectives of such a safe harbor, a more specific approach could be adopted by incorporating the existing best practices that plan sponsors use in evaluating Investment Options for 401(k) plans, as described below. Without excluding other possibilities, we have set forth a list of existing best practices for a 401(k) plan's investment committee.[314] Under the more specific approach, the safe harbor would provide that, so long as plan fiduciaries follow such enumerated best practices—including avoiding taking actions motivated by any potential conflict of interest—in the process of selecting Investment Options, then they will not be subject to ERISA fiduciary liability for any losses or higher fees associated with those investments.

In either case, in order to provide an additional safety net for participants, we suggest additional requirements that the DOL should apply to private equity funds in order to qualify for any safe harbor, including requiring that 401(k) plans only invest in private equity funds that meet threshold scale and experience criteria and that such private equity funds are affiliated with a manager that has an investor base with a material institutional component. The latter allows "retail" to leverage off of the protections negotiated by institutions. The intent would be that, under either of these alternative approaches, plan fiduciaries that qualify for the new safe harbor could not be held liable for offering plan participants an Investment Option with exposure to private equity funds, if the participant deemed such investment appropriate for his or her personal circumstances.

We further believe that it would be beneficial for the DOL to promulgate specific guidance regarding the disclosures required for carried interest fees. Such guidance should appropriately address carried interest as part of the annual fee disclosure, as well as the manner in which carried interest fees would be presented in other disclosures to participants designed to help them understand fees and expenses.

Finally, we note that our recommendation is consistent with recent efforts by the DOL to increase the availability of annuities in DC plans. Annuities are products offered by insurance companies that guarantee payments to participants for a period of time (often the rest of a

[314] Based on Committee staff conversations with Arthur Kohn, a partner at Cleary Gottlieb Steen & Hamilton LLP. *C.f.* Jeffrey Liberman, *Addressing Retirement Plan Investment Committee Issues*, LEXISNEXIS (Oct. 31, 2017), https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/archive/2017/10/31/addressing-retirement-plan-investment-committee-issues.aspx.

participant's life).[315] In 2007, the DOL noted that the potential for fiduciary liability under ERISA was discouraging plan sponsors from offering participants an annuity distribution option.[316] In 2008, the DOL established a fiduciary safe harbor for plan sponsors for the selection of annuity providers under DC plans.[317] However, to avail themselves of the safe harbor, plan sponsors are required to, among other things, "appropriately consider[] information sufficient to assess the ability of the annuity provider to make all future payments" and "[a]ppropriately conclude[] that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract."[318] Although the goal of the DOL safe harbor was to encourage more plans to offer an annuity option,[319] these vague requirements precluded its intended effect.

In 2016, the Government Accountability Office ("**GAO**") released a report, noting that concerns about legal risks were still deterring many plan sponsors from offering annuities. Specifically, plan sponsors lack certainty as to what steps are necessary to assess "sufficient" information to "appropriately" conclude that the annuity provider will be financially able to make all future payments.[320] As a result, the GAO recommended that the DOL clarify the safe harbor by providing sufficiently detailed criteria to better enable plan sponsors to comply with the safe harbor requirements.[321] Our best practices approach would essentially follow the GAO's suggestion to provide greater clarity through greater specificity.

Although the DOL has yet to act on the GAO's recommendation, a bill introduced in the U.S. Senate in March of 2018 would establish a new statutory safe harbor under ERISA for the selection of annuity providers.[322] Congress and the DOL's 2008 attempts to create a safe harbor for annuities show that policymakers understand that the risk of liability can reduce options for retirees and that "safe harbors" can address this risk for valuable retirement products. We believe that private equity funds are an asset class that warrants such treatment. Moreover, consistent with the GAO's recommendation in its 2016 report, we believe that a best practices safe harbor would provide sufficient detail to make it readily usable by plan sponsors.[323]

Best Practices:

- All investment committees should have a written investment policy statement that sets forth the processes to be used in selecting and monitoring Investment Options, the objectives of the plan, and the rationale for adding any new funds or Investment Options to the plan.

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[315] *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO- 16-433, 401(K) PLANS: DOL COULD TAKE STEPS TO IMPROVE RETIREMENT INCOME OPTIONS FOR PLAN PARTICIPANTS 4 (Aug. 2016).
[316] *See* Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. 52,021, 52,023 (Sept. 12, 2007).
[317] *See* Selection of Annuity Providers—Safe Harbor for Individual Account Plans, 73 Fed. Reg. 58,447 (Oct. 7, 2008). The DOL later provided additional guidance on the annuity safe harbor. *See* U.S. DEP'T OF LABOR, FIELD ASSISTANCE BULLETIN 2015-02 (July 13, 2015).
[318] 29 C.F.R. § 2550.404a-4(b).
[319] *See* Selection of Annuity Providers for Individual Account Plans, *supra* n.316 at 52,023.
[320] *See* GAO, *supra* n.315 at 26-27.
[321] *Id.* at 55.
[322] *See* Retirement Enhancement and Savings Act of 2018, S. 2526, 115th Cong. § 204 (2018).
[323] While our preferred path is a relatively detailed set of best practices, we recognize that another alternative is a more principles-based approach.

- The investment committee should have either the plan sponsor's investment staff or an independent consultant with expertise in evaluating investment risk and performance conduct an initial analysis and offer options for the committee to consider in selecting each particular Investment Option (i.e., if the investment committee is interested in offering a large-cap stock fund option, then the sponsor's investment staff or an independent investment consultant should provide the committee several options of such funds to consider).
    - For private funds or alternative investments, the investment committee should ensure that the plan sponsor's investment staff or investment consultant has the expertise and capability to evaluate and monitor alternative investments.
- In choosing an Investment Option, the investment committee should evaluate the past performance of each of the options presented to it.
    - The committee should compare past performance to a benchmark. For example, for stock funds, benchmarks could include the S&P 500 or another appropriate equity index. For alternative investments, including private funds, the committee should find or develop an appropriate benchmark.
- The investment committee should evaluate the fees of the options presented to it on a net basis to determine if they're reasonable and appropriate given the plan's overall objectives and the particular Investment Option's objectives and role in the plan.
- The investment committee should also consider the following:
    - Whether an alternative Investment Option would provide adequate liquidity for the plan to meet benefit-responsive requests under plan documents (e.g., if the plan allows for hardship withdrawals, would participants invested in the option be able to access cash for such a withdrawal), taking into account the plan's cash flow from current contributions and historical demand for access to liquidity, including unplanned events such as reductions in force; and
    - Whether any restriction or limitation on a participant's ability to obtain immediate access to liquid assets is offset by the opportunity for improved net investment returns from such Investment Option's longer-term investment strategies.
- The investment committee should monitor the Investment Option on a forward-looking basis to determine if the option should continue to be offered as part of the plan, taking into account the criteria applied in making the initial decision to offer the Investment Option, including how well such Investment Option has performed compared to the applicable benchmarks and the historical performance assessed in the initial evaluation, and the economic effects on plan participants of discontinuing such Investment Option.
- With respect to each Investment Option, the investment committee should ensure that plan participants are provided with sufficient ongoing disclosures such that a plan participant can continuously evaluate whether such Investment Option is appropriate for the plan participant. With regards to Investment Options that include private equity funds, such disclosures should appropriately address carried interest as part of the annual fee disclosure, as well as the manner in which carried interest would be presented in other disclosures to participants designed to help them understand fees and expenses.
- The investment committee should only invest in private equity funds where:

(i) the private equity fund and its manager and affiliates had under management, as measured on the last day of the private equity fund's last three completed fiscal years, assets in an average amount at least equal to: (i) $10 billion with respect to a private equity fund and its affiliates primarily investing in private equity investments and (ii) $1 billion with respect to a private equity fund and its affiliates primarily investing in venture capital investments; and

(ii) at least a majority of such assets were managed on behalf of third party investors (other than defined contribution plans) that are qualified institutional buyers within the meaning of Rule 144A as promulgated under Securities Exchange Act of 1933, as amended.

Conclusion

Throughout this report, *Expanding Opportunities for U.S. Investors and Retirees: Private Equity,* we have demonstrated that expanding retail investor access to private equity funds is both desirable and achievable through three primary means.

First, Congress should allow retail investors to invest directly in private equity funds, so long as such access is provided to retail investors by a financial professional with a duty to act in the best interest of the investor. Second, the SEC should allow retail investors to invest in public closed-end funds that invest more than 15% of their assets in private equity funds. We note that public closed-end funds are required to provide retail investors with disclosures as to their principal risk factors, allocations to specific private equity funds and the fees that investors would be charged. And third, the DOL should issue guidance and create a safe harbor that would ensure that 401(k) plan sponsors can offer investment options with exposure to private equity funds without being exposed to legal claims that lack merit and impose substantial burdens. We specifically note that 401(k) plans could continue to provide plan participants with daily liquidity while offering investment options with exposure to private equity funds.

We further note that each of our proposals would provide access to private equity funds, and the private companies in which they invest, with the benefit of a registered investment adviser and, in appropriate cases, a financial professional advising the individual retail customer. Additionally, as we note throughout the report, policymakers could apply additional regulatory standards to private equity funds that are available to retail investors and 401(k) plans that would further protect retail investors and retirees, such as mandating threshold scale and experience criteria for such private equity funds.

Finally, although our first recommendation would require legislative action, the SEC and the DOL could implement each of our other recommendations through regulatory reforms. We encourage them to do so on a timely basis, as retail investors are missing out on the returns and safety that private equity funds, and the private companies in which they invest, can offer a well-balanced portfolio.

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