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Investor Access to Private Investment

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To: Junior Attorney for Chief of Staff of Gary Gensler, Chairman of the SEC
From: SEC Staff Attorney
Re: Private Investments
Date: March 2022

As you know, the Asset Management Advisory Committee has determined that the Securities and Exchange Commission (SEC) should consider how to amend the regulatory framework to provide wider access to private investments by retail investors while maintaining appropriate safeguards. The Advisory Committee also provided a set of Design Principles and Recommendations for increasing investor access.

Chairman Gensler is skeptical about the prudence of increased investor access to private investments. Publicly, he told a subcommittee to the U.S. House Appropriations Committee that the evolving industry creates "new risks for markets and investors" and that, as the primary regulator of private funds, the SEC "must grow and evolve with the industry."[1] This includes, among other reforms, enhanced reporting, and disclosure. He also mentioned that the SEC's enforcement division is continuing to focus on private fund advisers and recognizes that "it is important to hold investment advisors accountable when violations are found."[2] Despite this approach, the SEC recognizes that the private investment industry can be a valuable source of investment returns and diversification for investors. We have an interest in opening access to this investment pool, to the extent possible, while still providing protection for investors.

Regarding investor protection, in February 2022 the agency proposed new rules (Proposed Rules) under the 1940 Investment Advisers Act to enhance private fund investor protection. These Proposed Rules are

[1] Gary Gensler, *Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee*, https://www.sec.gov/news/testimony/gensler-2021-05-26.

[2] Id.

Written by Hannah Valentine, under the supervision of Howell E. Jackson, James S. Reid Jr., Professor of Law. Cases are developed solely as the basis for class discussion. They are not intended to serve as endorsements, sources of primary data, legal advice, or illustrations of effective or ineffective management.

designed to increase transparency, competition, and efficiency in the private investment marketplace.[3] Registered private fund advisers will be required to provide investors with quarterly statements detailing fund fees, expenses, and performance.[4] Among other miscellaneous protections, the Proposed Rules would also prohibit private fund advisers from providing preferential treatment unless, in some cases, it is disclosed to investors.[5]

We need to be prepared to make a presentation next week about the options that the agency has in its approach to private equity investment regulation. Particularly, we need to decide whether to make private investments available to investors who do not meet the definition of an accredited investor and, if so, how such investments should be structured. To guide our analysis, I have included some background material — (**Appendix A**), a memo written to Gensler during the Biden administration's transition into office; and (**Appendix B),** the report prepared by the Asset Management Advisory Committee. These two documents offer different perspectives on a path forward in this area. The goal of our meeting next week is to consider which of these paths the SEC should now take.

Questions to Consider:

1. An overarching question for the SEC is how important it is for retail investors to have access to private investments. Would access improve investment returns for retail investors?
2. To the extent that the SEC wants to increase retail investor access to private investment, how should that access be structured? For example should the SEC (a) facilitate retail investors to invest directly in private companies; (2) facilitate retail investors to invest directly in private equity funds, which in turn invest directly in private companies; (3) facilitate retail investors to invest in retirement funds through their 401(k) plans that will in turn devote some portion of their assets to private equity funds, which in turn invest directly in private companies; or (4) facilitate investment in private companies in some other way or combination of ways?
3. In formulating your answers to the preceding question, how important do you think it is that there be liquidity for retail investment in private companies (i.e., the ability to dispose of investments within a reasonable period of time at an appropriate price)? How can the SEC ensure that liquidity be available?
4. Some proposals for expanding retail investor access to private investment contemplate changes to the definition of accredited investor or qualified investor? To the extent that you recommend such changes, how does your approach ensure that retail investors retain an adequate financial cushion and not take on excessive risks?
5. Some proposals for expanded access to private equity contemplate the use of retirement vehicles such as 401(k) plans. To the extent that you favor this approach, do retirement plan sponsors have the right incentives to oversee such investments?
6. How might a significantly expanded capital base disrupt the current private equity industry? Would enhanced regulation aimed at protecting retail investors fundamentally change the industry? Could retail investors be assured of achieving the same returns that institutional investors have enjoyed in the past?

[3] SEC Proposes to Enhance Private Fund Investor Protection, Feb. 9, 2020, https://www.sec.gov/news/press-release/2022-19.

[4] Id.

[5] Id.

Appendix A

To: Gary Gensler, Financial Policy Transition Team Lead
From: Financial Policy Transition Team, Staff Attorney
Re: Private Investments
Date: December 2020

Summary

This memorandum provides background on the SEC's actions regarding private investment vehicles taken under Chairman Jay Clayton's leadership and our assessment of how the agency should move forward under the new administration. We have determined that recent changes made to the retail investor definition were premature and potentially misguided. This memorandum will provide a background of private capital markets in the United States and present a selection of policy arguments and recommendations for and against expanding access to private equity investments. Then it will provide a critical analysis of the secondary market and the reliability of reported performance measures. Finally, it will critique the SEC's final rulemaking and present alternative regulatory frameworks.

Background

Current debates about investor access to private funds focus primarily on private equity funds, which invest in private companies.[6] Private equity fund investments are illiquid assets, typically requiring investors to commit their capital for 8-12 years.[7] An investor who chooses to exit a fund before the commitment period has expired requires approval from a fund manager to either transfer or sell the share on the secondary market.[8] In return for this commitment, private equity funds pay an illiquidity premium to their investors.[9] This premium is generated via operational and strategic changes implemented at the portfolio company and supervised by the fund.[10] According to some recent studies, private equity funds consistently outperform the public markets, but this conclusion is disputed.[11] Over the past two decades, private equity has reported higher returns with lower volatility than the public markets.[12] However, 2019 marked the first time that public market 10-year returns matched those of private equity funds.[13] It is important to note that the accuracy of these performance metrics is debated.

From 2015 through 2018, companies have raised almost twice as much capital through Private

[6] Committee on Capital Markets Regulation, *Expanding Opportunities for Investors and Retirees*, Nov. 2018, p. 27 https://www.capmktsreg.org/2018/10/30/expanding-opportunities-for-u-s-investors-and-retirees-private-equity/.

[7] Id at 12.

[8] Id.

[9] Id at 13.

[10] Id.

[11] Id at 16.

[12] Blackstone Asset Management Advisory Committee*, Expanding Retail Access to Private Markets*, Jan. 14, 2020, slide 6. https://www.sec.gov/files/Panel2-John-Finley-Blackstone.pdf.

[13] Bain & Company, *Global Private Equity Report 2020*, p. 5.

Regulation D Offerings as through public IPO's.[14] According to SEC estimates, in 2019 $2.7 trillion was raised on private markets, compared with $1.2 trillion on public markets.[15] Additionally, companies are exiting the public markets, leaving fewer opportunities available for retail investors to diversify their portfolios.[16] Commenters argue this is partially due to institutional investors' domination of public markets as well as loosened regulations over private market funding options.[17]

The legislative history of the 1933 Securities Act indicates that it was adopted primarily to ensure that investors were provided full and fair disclosures prior to purchasing securities.[18] The Small Business Investment Incentive Act, passed by Congress in 1980, added the term "accredited investor" to the Securities Act and delegated the SEC power to determine when a person has the financial sophistication, net worth, knowledge, financial experience, or sufficient net assets to qualify.[19] The expanded exemption was meant to give small businesses greater access to capital without onerous registration requirements.[20] Pursuant to its statutory mandate, the SEC adopted Regulation D in 1982, which established the $200,000 individual income and $1 million net worth thresholds, but the agency did not provide a policy rationale for the thresholds.[21]

In a 2011 amendment to the net worth standard[22], the SEC reiterated the 1980 policy behind the accredited investor rule, stating that the standard attempts to identify investors who can bear the economic risk of unregistered securities, including reduced liquidity and potential for complete loss of the investment.[23] More recently, in 2015, SEC staff reiterated that the accredited investor definition, as a central component of Regulation D, is intended to identify individuals who do not require the protection that registration affords due to financial sophistication, ability to absorb loss, and "ability to fend for themselves."[24]

In 2015, SEC staff proposed a series of revisions to the accredited investor definition. The report suggested revising the financial thresholds that were set in 1982 via various reforms. Since the thresholds were established, the percentage of qualifying households has increased from 2% to 10%, causing concern about whether current conditions conform to the original intent of the drafters.[25] Among the suggested approaches was leaving the thresholds unadjusted, but imposing investment limitations based on a percentage of the individual's net worth; adjusting the thresholds for inflation without applying additional

[14] Committee on Capital Markets Regulation, *U.S. Public Equity Markets are Stagnating*, April 2017, p. 8, https://www.capmktsreg.org/wp-content/uploads/2018/10/U.S.-Public-Equity-Markets-are-Stagnating.pdf.

[15] WALL STREET JOURNAL, *SEC Gives More Investors Access to Private Equity, Hedge Funds*, https://www.wsj.com/articles/sec-gives-more-investors-access-to-private-equity-hedge-funds-11598452858.

[16] Expanding Opportunities, supra note 1.

[17] Expanding Retail Access, supra note 7, slide 14.

[18] Id at 28.

[19] SMALL BUSINESS INCENTIVE ACT OF 1980, PUB. L. NO. 96-477, § 602, 94 Stat. 2275 (1980).

[20] Expanding Opportunities, supra note 1, pg. 32.

[21] Id.

[22] The amendment implements the Dodd Frank Act requirement that the accredited investor net worth requirement excludes the value of a person's primary residence.

[23] NET WORTH STANDARD FOR ACCREDITED INVESTORS, SEC, SECURITIES ACT RELEASE NO. 33-9287, 76 FED. REG. 81,793, Dec. 29, 2011, pg. 4.

[24] SEC, Report on the Review of the Definition of "Accredited Investor," Dec. 18, 2015, p. 4.

[25] Id.

investment limitations; and permitting spousal equivalents to pool their finances for the purposes of qualifying as accredited investors.[26] Commission staff also considered the option of allowing individuals to qualify as accredited investors based on financial sophistication, rather than income or net worth.[27] This could include individuals with certain professional credentials,[28] individuals with relevant investment experience, or knowledgeable employees of private funds.

In 2019, the SEC issued a concept release for harmonization of securities laws, which have evolved via piecemeal amendments since initial implementation of the 1933 Securities Act.[29] In August 2020 the SEC amended the accredited investor definition to allow individuals who have achieved "defined measures of professional knowledge, experience or certifications" and entities that meet an investment test to participate in private markets.[30] Additionally, the SEC agreed not to increase the wealth thresholds, set in 1982, for inflation.[31] Over the last three decades, an estimated increase of 550% of households now qualify for private capital investment opportunities because of inflation.[32] In the concept release, the SEC expressed an intent to more effectively identify individuals with sufficient knowledge and expertise to participate in investment vehicles without rigorous disclosure and procedural requirements as required by Securities Act registration.[33]

There are options to available to regulators who would like to expand access to private equity investments. One of the mechanisms available to the SEC is allowing for more direct investment under a liberalized accredited investor definition. Historically, the SEC has restricted participation in private capital market investment vehicles such as private equity, hedge funds, and venture capital funds to accredited investors.[34] Accredited investors, as defined by 17 CFR 230.501(a) ("Rule 501(a)") of Regulation D, are "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary."[35] Investors with more than $1 million in net assets, excluding a primary residence, or at least $200,000 in net income are considered accredited.[36] Additionally, the qualified purchaser standard prohibits investors with less than $5 million worth of investments from directly investing in private funds with over 100 investors.[37] The term "retail investors" refers to the 87% of U.S. households that do not meet the accredited investor standard and the 98% of U.S. households that do not meet the qualified purchaser standard.[38]

[26] Id at 94.

[27] Id.

[28] The staff included investors who have passed the Series 7, Series 65, or Series 82 examination as examples.

[29] ABA Business Law Section, Letter Re: Concept Release on Harmonization of Securities Offering Exemptions, p. 1.

[30] SEC, Press Release, SEC Modernizes the Accredited Investor Definition, https://www.sec.gov/news/press-release/2020-191.

[31] Commissioners Allison Herren Lee and Caroline Crenshaw, Joint Statement on the Failure to Modernize the Accredited Investor Definition, https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26.

[32] Id.

[33] Securities and Exchange Commission, 17 CFR PARTS 239 AND 240, p. 3/164.

[34] Securities and Exchange Commission, Concept Release on Harmonization of Securities Offering Exemptions, https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[35] Securities and Exchange Commission, Accredited Investor Definition, https://www.sec.gov/rules/final/2020/33-10824.pdf.

[36] WALL STREET JOURNAL, supra note 9.

[37] Expanding Opportunities, supra note 1.

[38] Expanding Opportunities, supra note 1.

Additionally, the DOL has used defined contribution plans (401(k)s as a mechanism for expanded retail investor access to private equity investments. In June 2020 the DOL released an information letter allowing 401(k)'s to participate in private equity investments.[39] Under ERISA, 401(k) plan sponsors—including anyone who exercises discretionary authority over a plan—owe fiduciary duties to the plan's participants.[40] Selecting the investment options available to plan participants constitutes an exercise of discretion, liability for which extends to employers, plan trustees, and investment managers.[41] Due to this obligation, plan fiduciaries can be held liable for imprudently selecting investment options, which would include the decision to offer private equity investments to participants.[42] ERISA §404(c) provides safe harbor for plans that meet given criteria, but prior to the DOL's June announcement it was not clear whether offering exposure to private equity funds satisfied this criteria.[43] With the information letter, the DOL aims to provide plan sponsors some comfort that offering private equity investment options will not, on its own, constitute a violation of their fiduciary obligations. Although the DOL's information letter did not receive the notice and comment treatment of the SEC's rulemaking, opening 401(k) plans to private equity will likely be more consequential than opening direct access because of private equity's attitude toward lower net worth limited partners.

Another possible mechanism for expanded access is reconsidering the SEC rule that prohibits mutual funds from acquiring an illiquid investment if total illiquid investments would constitute more than 15% of net assets after the acquisition. The rule, finalized in 2016, also imposes a highly liquid investment minimum.[44] This rule was delayed in 2018,[45] but presents another possible avenue to private equity access that could be considered.

Policy Arguments in Support of Expanding Access to the Private Markets

A. The Accredited Investor Definition

Given the growth of the private capital market as well as its record of strong returns, there is significant support for expanding retail investors' access to private capital both inside and outside of the relevant regulatory agencies. Arguments in favor of expanding access to private funds attempt to assuage the fears that have dominated the last several decades of regulatory decision making. First, proponents of expanding investor access argue that regulators need not worry about adequate disclosure because most private equity funds voluntarily provide the same level of disclosure as a public fund, partially due to institutional investor demand.[46] Additionally, SEC regulations applicable to private equity funds prohibit fund managers from making materially false or misleading statements and requires most registered fund managers to file Form ADV which includes the fund's business practices, fees and compensation, material

[39] DOL, News Release, U.S. Department of Labor Issues Information letter on Private Equity Investments, https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0.

[40] 29 U.S.C. § 1002(a)(21).

[41] Expanding Opportunities, supra note 1, pg. 60.

[42] Id.

[43] Id at 63.

[44] Michael S. Barr, Howell E. Jackson, and Margaret Tahyar, Financial Regulation: Law and Policy, 2nd Ed., pg. 1069.

[45] Id at 1070.

[46] Expanding Opportunities, supra note 1, at 34.

risks of the investment strategy, and any conflicts of interest.[47]

Next, commenters argue that wealth-based restrictions act as a proxy for financial sophistication, but this same expertise can be gained via consultation with an investment adviser or broker acting as a fiduciary.[48] Additionally, it is not clear that a private equity strategy is any more complex a business model than that of a corporate conglomerate.[49] Finally, supporters argue that since private equity has a history of higher returns and less risk than public markets, investors should not be required to have any greater ability to bear losses.[50] In fact, opening access to private equity funds could reduce risk for investors by allowing greater diversification.[51] Other proponents argue that it is inappropriate for the SEC to evaluate the risk of securities and should instead focus on ensuring adequate disclosures.[52]

B. Defined Contribution Plans

Supporters of expanded access to private capital via a 401(k) plan believe that a plan sponsor can offer exposure to private equity investments without violating fiduciary duties. Supporters argue that private equity is less volatile than the public markets and the investments allow for further diversification. Regarding the information letter mentioned above, then Secretary of Labor Eugene Scalia celebrated that it would allow retail investors to “gain access to alternative investments that often provide strong returns.”[53] Supporters of expanded retirement plan access see the potential for higher returns over the long term, due to investment in growth companies that have elected to stay private longer.[54] Some believe that expanded investment opportunities can offer advantages in the form of superior long-term returns, net of fees.[55] Further, private equity investments potentially provide less downside during periods of market distress, another reason support for expanding 401(k) access, when retirement assets are most at risk.[56]

This exposure can be accomplished in various ways. If an investment option holds sufficient liquid assets, there is less liquidity risk from participants switching options on a daily basis.[57] Studies cited by supporters of expanded access show that retirement plan participants rarely switch investment options, mitigating the risk of an inadequate liquidity buffer.[58] Private equity funds do not provide daily valuations, but, supporters argue, a retirement plan that invests in private equity can rely on the most recent valuation information available for the fund.[59] The secondary market can provide investors with the option to

[47] Id at 35.

[48] Id.

[49] Id at 37.

[50] Id at 38.

[51] Id.

[52] Id.

[53] Investopedia, supra note 40.

[54] Id.

[55] FT, supra note 53.

[56] Charlie Nelson, Marketwatch, *Private Equity in your 401(k)—is this a good idea?,* Aug. 17, 2020, https://www.marketwatch.com/story/private-equity-in-your-401k-is-this-a-good-idea-2020-08-17.

[57] Expanding Opportunities, supra note 1, at 66.

[58] Id.

[59] Id.

purchase shares in a private equity investment outside of the fund's commitment period.[60]

Furthermore, supporters urge the DOL to provide plan sponsors safe harbor from fiduciary liability related to the private equity option. Proponents also recommend that the DOL apply additional requirements for a 401(k) plan to qualify for safe harbor, recommendations intended to provide an additional safety net for participants. This includes applying threshold scale and experience requirements as well as material institutional investment in the fund. It also includes guidance addressing carried interest fee disclosures.[61]

Policy Arguments in Support of Limiting Access to the Private Markets

A. The Accredited Investor Definition

Dissenting from the August 2020 vote to modernize the definition of an accredited investor, Commissioners Allison Herren Lee and Caroline Crenshaw excoriated the Commission for failing to update the wealth thresholds to account for inflation.[62] The dissenting commissioners noted widespread support by groups including the Small Business Capital Formation Advisory Committee, industry groups, state regulators, and academics for indexing the thresholds to inflation.[63] Rebutting the argument that indexing the thresholds will reduce potential capital supply, the dissenters note that private capital is not in short supply and that the Commission failed to conduct a basic economic analysis when making the decision.[64] Lee and Crenshaw also note the risks of private equity's illiquidity, the increased potential for fraud, and the "naturally opaque… private markets where issuers are not required to provide… robust disclosures" characteristic of public offerings.[65] A coalition of state attorneys provided several rebuttals to the SEC's reasoning and criticized the agency for "assuming and intuiting" what happens in private equity rather than conducting further investigation and collecting additional data.[66]

B. Defined Contribution Plans

In response to the DOL's June information letter, allowing retirement plan sponsors to prudently offer private equity funds as an investment option, nineteen investor advocacy groups drafted a response urging the letter's repeal. The investor advocates argue that the DOL did not adequately probe private equity representatives' claims about investment performance and complexity.[67] They state that private equity fund performance cannot be reliably measured in the absence of standardized ratios and that the median private equity buyout fund has actually matched the performance of public markets.[68] Further, critics argue that allowing 401(k) investment in private equity funds will lock retirement savers into

[60] Id.

[61] Id.

[62] Lee and Crenshaw, supra note 22.

[63] Id.

[64] Id.

[65] Id.

[66] Attorney General of California Xavier Becerra, Comment Letter, https://www.sec.gov/comments/s7-25-19/s72519-6960384-212775.pdf.

[67] Group Sign on Letter, p. 1, https://consumerfed.org/wp-content/uploads/2020/06/Group-Sign-on-Ltr-Urging-Withdrawal-of-DOL-PE-Guidance.pdf.

[68] Id.

"unnecessarily complex investments that underperform publicly available alternatives."[69] These complex structures also tend to embed expensive fees.[70]

Worker advocates argue that, although retirement savers have longer investment horizons, they do not necessarily hold their retirement plan investments over the long term. A Bureau of Labor Statistics study found workers held almost 12 different jobs between the ages of 18 and 48—each of which may result in changing retirement plan investments.[71] Additionally, critics are concerned about the potential for illiquidity resulting from a collective investment trust (CIT), held within an employer-sponsored retirement plan, investing in private equity.[72] They demand that more attention be given to potential liquidity challenges posed by this arrangement.

Further concern is related to the characteristics of target date funds. These funds are disproportionately relied on by unsophisticated investors who are financially vulnerable.[73] As target date funds are often the default 401(k) option, retirement savers could be defaulted into these investments without their informed consent.[74] There are additional concerns about the fiduciary duties of plan sponsors and their ability to evaluate complex private equity valuations. Critics push back against the argument that plan sponsors have the financial literacy required to make prudent decisions about investment options[75] and may even turn to financial professionals with significant conflicts of interest who do not owe plan participants any fiduciary duty.[76] Some note the current frequency of lawsuits against plan sponsors for breaching fiduciary duties, arguing that these will only increase given access to the increased risk of private equity investment.[77]

Concerns have also been voiced about the potential impact on the private equity industry of allowing retirement plans to access private capital markets. Arguably, the trillions of dollars now available from target-date fund advisers will "completely disrupt the PE [private equity] markets."[78] It is unclear how the deluge of funding will alter the risks inherent to private equity investments.

Financial Policy Transition Team's Response to the 2020 Rulemaking and Guidance

The Clayton SEC argued that the final rule, expanding access to investors holding enumerated certifications and leaving thresholds unadjusted, maintains necessary safeguards while recognizing that

[69] Id.

[70] Investopedia, *401(k) Plans Can Now Invest in Private Equity Funds*, https://www.investopedia.com/401-k-plans-can-now-invest-in-private-equity-funds-4846917#citation-5.

[71] Group Letter, supra note 44, at 2.

[72] Id.

[73] Id at 3.

[74] Id. *See also* Rita Raagas De Ramos, Oct. 22, 2020, FINANCIAL TIMES, *401 Retirement Advisers, Hopes of greater diversity as DoL allows private equity in 401(k) plans* ("If employees do not understand the risk and have losses, they will have attorneys seeking recoveries from fiduciaries, which could likely be the advisers themselves."), https://www.ft.com/content/2158b9f2-8622-4e76-99f6-0d9e332e7490.

[75] Francesca Federico, co-founder at Twelve Points Wealth Management, warns that advisers who do not have a deep understanding of private equity should not recommend the investments to plan sponsors. She says, "If the adviser does not work with private equity in their wealth management business, they likely should not do so in the retirement space." FT 401 Retirement Advisers, supra note 53.

[76] Group Sign on Letter at 3.

[77] Investopedia, supra note 47.

[78] Id.

wealth is not a perfect indicator of an investor's ability to evaluate an investment vehicle—including analyzing risks, allocating investments in a way that mitigates loss, gaining access to relevant information.[79] It is true that an investor's wealth is not indicative of that investor's ability to assemble a responsible investment portfolio. Undeniably, investors with sophisticated financial training are in a better position to understand the risks associated with private equity investment than accredited investors without any financial training. However, with opaque private equity investments, the risk is not with investor knowledge and ability. Rather, the opacity and informational asymmetry characteristic of private equity funds makes it nearly impossible for investors to make an informed decision. Instead, an investor's bargaining position and ability to withstand loss are more important considerations.

Further, the Clayton SEC declined to use modernization as an opportunity to update investor thresholds for inflation or tie them to inflation moving forward. This effectively opens private equity investments to more investors every year that inflation increases. In response to numerous commenters supporting an adjustment for inflation, the SEC determined that "changes over the years in availability of information and advances in technologies" negates the effects of inflation on less-wealthy investors.[80] Of course, whether technological advancement can reasonably be compared to the effects of dollar value inflation and an investor's ability to withstand loss or make an informed decision about the economics of an investment is a debatable proposition.

The Clayton SEC provided two other arguments against tagging the thresholds to inflation. The first is the unfairness and cost of removing investors who have already participated in private equity from the pool.[81] This unfairness can be avoided, at least in part, with the addition of a grandfather clause allowing participants before a given date to retain their investments without regard to the new definition. Next, the Commission was concerned about higher costs of capital, due to a smaller pool of accredited investors available for investment, disrupting markets for small business.[82] This concern is beside the purpose of the definition and lacks support. Private equity markets have a considerable amount of capital to deploy and the reduction of qualifying households from 13% to 4.2% does not reflect the number of households that actually choose to invest in private equity.[83]

The Commission also argued that it is not clear what factors were considered when determining the initial threshold. The SEC is empowered to perform an updated analysis taking into consideration, among other things, the current cost of living, levels of retirement and emergency savings, bargaining power of private equity firms in relation to individual investors, need for small business investment, and risks inherent to the industry. This could reveal a more accurate and efficient definition that could be pinned to inflation in the future.

Finally, the Commission argued that in 1982 the calculation of net worth included the value of a primary residence, which was amended in 2011 to exclude a primary residence.[84] In 2011, the Commission, updating the definition to comply with the Dodd-Frank Act, explained that the purpose of the accredited investor concept is to identify investors who can hold less-liquid, unregistered securities for an indefinite

[79] Securities and Exchange Commission, 17 CFR PARTS 239 AND 240, p. 5,6.

[80] 17 CFR, supra note 82, p. 72.

[81] Id.

[82] Id.

[83] Id.

[84] Id at 73.

period and afford a complete loss of that investment.[85] Updating the definition reflected the concern that investors would have to sell primary residences to absorb the loss of investment. It is possible that this exclusion requires a smaller adjustment to the 1982 thresholds but does not excuse the Commission from investigating a more reasonable threshold. In fact, since the 1980s, home price to income ratios have increased, indicating that a home is now a more significant portion of a person's net worth than it was when the thresholds were determined.[86]

Taken together, the SEC and DOL updates seem to provide contradictory bases for expansion. The argument for investors with certain professional certifications to be allowed to invest is based on the belief that these investors can understand the risks associated with the investment class and make an informed decision for themselves. In the case of a 401(k), the investments in the individual portfolio would be chosen by an expert but the investors who own the 401(k) are not required to have any knowledge of the asset class. Unlike allowing a retail investor with expertise to invest in private equity, the DOL guidance directly and necessarily relates to retirement savings. If workers consider a 401(k) a reliable and safe source of retirement income, losing up to 15% of the account's value to a risky investment or paying higher fees for average returns will directly impact investors' ability to save for retirement.

Secondary Market and Valuation Challenges

The secondary market is a potential source of liquidity for private equity investors. However, the expanded liquidity has been accompanied by increasing complexity. This could be positive for retail investors as there is a robust market developing to provide them with liquidity without a significant discount to Net Asset Value (NAV). On the other hand, it could be harmful as their counterparties and competition will be sophisticated investors with carefully tailored portfolios and investment strategies. The reliability of the secondary market requires further investigation.

The secondary market has been considered a source of liquidity for distressed investors who need to sell shares because of systemic market disruptions, such as a banking crisis or recession, or idiosyncratic disruptions, such as unexpected individual liquidity needs or rebalancing portfolio allocations due to public market price declines. A concern with the secondary market, however, is the discount to NAV that investors will have to accept when they exit. Past data indicates that sales made because of systematic distress incur a 50% discount while sales made because of an idiosyncratic shock incur a 20% discount.[87] Returns that are reported in private equity databases are based on those that would be earned by a limited partner (known as an "LP" and typically the way in which outside investors participate in private equity funds) who commits capital at fund inception and never sells on the secondary market.[88] The secondary market NAV depends on various factors, and under the right circumstances can be close to 100%, but is not a perfect replacement for public equity's liquidity. According to an Ohio State research paper, the returns realized by LPs who experience disruptions resulting in secondary sales are 1-2% of IRR/year less than the held-to-maturity fund returns as published in private equity databases.[89]

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[85] Securities and Exchange Commission, 17 CFR PARTS 230, 239, 270, AND 275, p. 4.

[86] See Joint Center for Housing Studies at Harvard University, Price-to-income ratios are nearing historic highs, https://www.jchs.harvard.edu/blog/price-to-income-ratios-are-nearing-historic-highs.

[87] Nicholas P.B. Bollen and Berk A. Sensoy, *How much for a haircut? Illiquidity, secondary markets, and the value of private equity*, p. 9.

[88] Id at 27

[89] Id at 6

Fortunately, the recent increase in private equity trading has resulted in a robust secondary marketplace. A 2019 analysis found that, over a six-month period, investors were paying full value for another investor's interest.[90] This has not been an unalloyed victory, however. The market is bifurcated between higher and lower quality assets and has experienced periods of wide bid/ask spreads. In 2014, intensified competition for high quality asset portfolios and the entrance of non-traditional buyers grew secondary market pricing to a post-crisis high of 93% of NAV.[91] However, market volatility in 2016 led to another pricing gap, which closed by the end of the year when valuations in underlying portfolios began to stabilize.[92] As the market has increased in popularity, the gap between the valuation of popular funds and the rest of the market has widened.[93] Historically, par and premium prices were paid for large-cap funds with well-diversified portfolios and regular distributions.[94]

Recent uncertainty caused by the economic contraction related to the coronavirus pandemic provided new data about the secondary market's reaction to systemic disruption. During Q2 2020 shares of quality, diversified private equity funds were selling at double-digit discounts to 2019 year-end valuations.[95] At the beginning of the pandemic, the secondary market experienced a lull as investors waited to learn the financial impact on fund holdings.[96] These losses would not be disclosed until 6/30 reporting.[97] Some experts predicted at the time, however, that GPs would smooth losses over two quarters.[98] In response to the uncertainty, an adviser recommended that clients use a 10% value at risk metric to estimate the potential loss to a portfolio.[99] Another adviser forecasted 20-40% discounts to pre-pandemic pricing.[100] In the case of a systemic shock, the delayed disclosure results in wide bid-ask spreads as the entire industry reacts at the same time.[101] In comparison to the public markets, this effect is more severe due to the relative complexity, opacity, and liquidity concerns of private equity.

The secondary market is becoming increasingly complex in a way that parallels the increasing complexity of the underlying private equity funds. This could represent an opportunity for retail investors to access a greater pool of liquidity, but with sophisticated institutional and GP sellers also competing in the market, retail investors will have to compete with increasingly broad asset portfolios and increasingly complex strategies. Additionally, in the case of 401(k) participation, investors will have to rely on their fiduciaries to navigate the secondary market and will not have the same flexibility as individuals making direct investment in private equity. The secondary market offers a viable opportunity for LPs to access enhanced liquidity, but it is not a perfect solution.

Two additional mechanisms for retail investor access to private equity investment are private

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[90] Julie Segal, Institutional Investor, *Investors Now Pay Full Price for Second-Hand Private Equity*, https://www.institutionalinvestor.com/article/b1hmpkm1ykm8y5/Investors-Now-Pay-Full-Price-for-Second-Hand-Private-Equity.

[91] A Primer, supra note 94, p. 4.

[92] Id at 4.

[93] Id.

[94] A Primer, supra note 94, p. 5.

[95] Private Equity Secondaries: Four things to know now, p. 1.

[96] Trading, supra note 109, p. 1.

[97] Id at 2.

[98] Alicia McElhaney, Private Equity Investments Are Going to Lose Value, p. 2.

[99] Id.

[100] Id.

[101] Trading, supra note 109, p. 2.

equity exchange-traded-funds (ETFs) and interval funds. ETFs are publicly traded securities that pool investments in a diverse array of private equity funds. This allows retail investors to access private equity returns while also maintaining diversification and liquidity. A private-equity ETF does not eliminate the underlying valuation risk of the fund-level portfolios and it may still take several years to realize returns, but the funds do allow investors to commit smaller amounts of capital and to exit the investment at any time. They also resolve some of the secondary market valuation challenges as the price is publicly available and changes throughout the day as shares are bought and sold. Interval funds offer another source of private equity investment without all the risks of direct investment. Similar to a private equity fund, interval funds are closed-ended, but, unlike private equity funds, they offer liquidity at regular, disclosed intervals.[102] At these intervals, shareholders may sell their shares at a price that is based on the fund's net asset value.[103] Like ETF's, interval funds allow for diversification across fund strategies, but they do not have a price that is determined by trading on the market. Investors are still exposed to the subjectivity of the underlying fund valuations, but interval funds mitigate some of the risks of private equity by offering diversification and liquidity.

Measuring Returns and the Impact of COVID-19

The debate regarding retail investor access to private capital is largely dependent on the performance of private equity funds and their risk profile, especially in the event of an economic crisis. Underlying secondary market NAVs are the portfolio company-level valuations that contribute to the overall risk of private equity investment. On a quarterly basis, throughout the life of a private equity fund, the GP reports the NAV of the fund's portfolio companies to LPs, with provisions for carried interest.[104] Although valuation guidelines require GPs to mark their investments to market, the methodology used to do this is largely at the discretion of the fund managers.[105] Portfolio companies are, primarily, Level III investments, which means that the price, unobservable on a readily available market, is determined by a subjective valuation process determined by the private equity fund's managers. The choice of valuation method is entirely up to the fund manager's discretion. Available valuation procedures include: recent transaction price (usually within one year); discounted cash flow models; comparable company analysis; and the First Chicago method. Private equity companies have a variety of valuation processes available to them and may use different processes for each portfolio company. Further complications arise from a lack of readily comparable companies of similar size and complex capital structures funding the companies. A lack of formal valuation rules allows for a level of manipulation by fund managers.

A 2018 investor survey found that 60% of respondents are skeptical of private equity valuations and the same proportion have trouble comparing performance between fund managers.[106] As expressed in a response letter to Secretary Scalia, consumer advocates are concerned about the manipulability of performance comparisons in the absence of standardized performance calculations.[107] In 2019 Warren Buffet remarked, "We have seen a number of proposals from private equity funds where the returns are

[102] FS Investments, *What is an Interval Fund?*, https://fsinvestments.com/education/interval-fund/.

[103] Id.

[104] Tim Jenkinson, *How Fair are the Valuations of Private Equity Funds*, p. 7.

[105] Id.

[106] David M. Freedman, Financial Poise, *How Reliable are Private Equity Valuations?*, p. 1.

[107] Group Letter, supra note 44, p. 1.

really not calculated in a way that I would call honest."[108] As an investment company offering shares to a limited number of accredited investors, private equity funds do not have to comply with certain SEC reporting rules under the Investment Company Act of 1940.[109] A fund is responsible for valuing its investments and may choose from a number of valuation methods to price their portfolio, which means that although all funds report a comparable NAV, the calculations underlying this reported value are not all comparable and, given a lack of transparency, investors do not have an opportunity to reconcile these differences.[110] This subjectivity has been curbed to a certain extent by Accounting Standard Codification 820, which offered guidance for fair value accounting, but a significant level of subjectivity remains.[111] Interestingly, the effect of GP discretion in valuations is evident in the valuation of club deals—regularly, funds invested in the same club deal will assign different valuations to the same portfolio company.[112]

Other industry standards have also been developed to promote consistency, but none are mandatory.[113] Although this removes a level of subjectivity from the valuation process, the experts are paid by the private equity fund and the fund ultimately makes the final decision on the price. Regulators continue to consider valuations an area of increased concern and it is important that enhances regulatory efforts continue if more investors are given access. The riskiness of private equity valuations is an element of the higher expected return, and it is not realistic to expect valuations to be accurate all the time, but it is important that the SEC seeks to reduce the subjectivity and ensure that disclosures are appropriate before liberalizing access to more vulnerable investors.

Symptomatic of fund managers' discretion, private equity valuations evidently experience less volatility than public equity as GP's can smooth earnings.[114] The effect is evident at the end of the year, when NAVs typically increase after valuations are audited by independent accounting firms.[115] Therefore, the subjectivity in valuations is in favor of conservatism. Although this might seem to be desirable, especially from the perspective of regulators, when considering the possibility of secondary market sales as an element of the regulatory environment, smoothed earnings during the year could penalize investors who redeem shares on the secondary market mid-year. Absent strong regulatory protections, a retail investor who needs liquidity mid-year or re-allocates a 401(k)-investment strategy in response to a changing risk profile will not have the option of waiting several months until the NAV is fairly reported. This again puts sophisticated institutional buyers at an advantage.

Further, an analysis by an Oxford University economist indicates that private equity returns since 2006 have not actually outperformed public markets.[116] In a controversial paper published in 2020, Ludovic Phalippou, an outspoken private equity critic, argues that publicly available data does not support the claim

[108] Sanjay Arya, Morningstar, *As Private Equity Goes Mainstream, Investors Need Help*, https://www.morningstar.com/articles/1005143/as-private equity-goes-mainstream-investors-need-help.

[109] Freedman, supra note 126, p. 1.

[110] Id at 2.

[111] Id at 2.

[112] Jenkinson, supra note 124, p. 7

[113] Id at 2.

[114] Id at 11.

[115] Id.

[116] Julie Segal, Institutional Investor, *The Inconvenient Fact Behind Private Equity Outperformance*, https://www.institutionalinvestor.com/article/b1lxv2czrsv9y7/The-Inconvenient-Fact-Behind-Private-Equity-Outperformance.

that private equity outperforms public markets.[117] Several private equity funds responded to his papers, critiquing the data and the valuation methodologies that he employed. Although it is important to question the integrity of Phalippou's methods, the debate reveals the difficulty of verifying private equity funds' performance claims—even those made by the largest funds about headline transactions. He further criticized the fact that private equity returns are often compared to underperforming public indexes and joins those who argue that PMS is preferable to IRR as a performance measure.[118]

A 2020 private equity report prepared by Bain & Company analyzes the financial condition of private equity prior to the economic fallout of the pandemic. In 2019, for the first time ever, 10-year returns in the public markets matched those or private equity.[119] In a survey conducted prior to the pandemic, 70% of private equity general partners responded that their number one source of anxiety was overheated asset valuations.[120] Fortunately, in response to these concerns, fund managers had begun assessing recession risk as an element of their portfolio strategy.[121] Still, competition for private debt has resulted in covenant-lite loans and far more deals with debt multiples higher than 6x EBITDA as compared to the years following the 2008 global financial crisis.[122] Portfolio companies are stretched to the breaking point generating returns large enough to overcome management fees of over $100 billion in the average 4.5 year holding period.[123] Already, a record amount of capital is invested in a limited number of high-quality assets.[124] It is to be seen how a mature private equity industry, injected with potentially trillions of new dollars because of 401(k) eligibility, will continue to generate returns that justify the opacity and fee structure of the investment.

Alternative Regulatory Frameworks

France has also recently opened private company investment to retail investors. Rather than increasing the population that is granted access, the state-backed investment bank, Banque Publique d'Investissement (BPI) created a special purpose vehicle (SPV) invested in select private equity funds.[125] The SPV owns 5% of a BPI portfolio consisting of 145 French private equity funds invested in from 2005-2016.[126] In the aggregate, these fund own more than 1,500 small and medium private business and start-ups based in France.[127] The funds were specifically selected from 2005-2016 because funds typically incur losses in their early years.[128] This solution could be replicated in the United States without the involvement of an investment bank. Rather than determining certain populations that can be considered accredited investors—a solution that some criticize for exacerbating existing inequalities by allowing access to people with certain levels of education and jobs that offer 401(k)s—regulators can determine certain funds that

[117] Id at 5.

[118] Id.

[119] Bain & Company, supra note 8, at 1.

[120] Id at 3.

[121] Id.

[122] Id at 6.

[123] Segal, supra note 87.

[124] Bain & Company, supra note 8, at 64.

[125] Chris Flood, FINANCIAL TIMES, Oct. 25, 2020, *France broadens retail investor access to private equity*.

[126] Id.

[127] Id.

[128] Id.

meet heightened requirements or that opt into increased regulatory oversight. The availability of trillions of dollars of unaccredited investor capital provides an incentive for fund managers to differentiate themselves by operating funds prudently and accepting higher costs of compliance or reduced fees.

In the case of individual investors who want to invest in private equity without using their 401(k), this option would reduce the current investment barriers. Generally, private equity funds require a minimum commitment of $200,000, an amount that is prohibitive for most retail investors.[129] Allowing the public to access a sliver of the highest quality funds for a significantly reduced commitment will allow for greater democratization than the current regulatory scheme.

[129] James Garrett Baldwin, INVESTOPEDIA, *Understanding Private Equity Fund Structure*, https://www.investopedia.com/articles/investing/093015/understanding-private-equity-funds-structure.

Appendix B

U.S. Securities and Exchange Commission

Asset Management Advisory Committee

Final Report and Recommendations for Private Investments

September 27th 2021

(excerpted)

1. Introduction

The Asset Management Advisory Committee ("AMAC") established a subcommittee to review retail investors' access to private investments (the "PI Subcommittee"). The AMAC offers the U.S. Securities and Exchange Commission ("SEC") this Final Report and Recommendations on increasing retail investor access to private investments[130] ("the Report"). Our observations, conclusions and recommendations are based on the information and input provided to the AMAC and PI Subcommittee by several industry and academic experts and on our independent research.

We structured the Report as follows:

1. Consideration of the macroeconomic supply and demand factors impacting the asset management industry and retail investors[131]. We discuss whether these factors warrant consideration of wider access to private investments by such investors.
2. Consideration of investment returns from three classes of private investments for which there were comparable public market investments. We believe that in the absence of sufficient evidence of equal or better returns from private investments, the risks of private investments may outweigh the benefits. We analyzed the returns from private equity, private debt and private real estate and compared them to the returns of similar public market investments.
3. Consideration of the main legal and regulatory requirements that apply to both retail and

[130] Private investments are investments that are not generally available to ordinary retail investors usually because they require investors to have certain income, asset, educational or professional qualifications. Private investments are investments that (1) typically have cash flows unlike those public equity, and when distributions occur, these cashflows cannot be re-invested in the original project; (2) are often made in stages, with capital calls occurring over multiple years; and (3) do not trade in a secondary market, and thus have no market price associated with them (instead, they are usually valued by fund management on a quarterly basis). See: Interim Report of Subcommittee on Private Investments, SEC Asset Management Advisory Committee, Jul. 7, 2021, at pg. 7-8.

[131] By retail investors we are generally referring to individual investors who do not meet investor qualifications thresholds such as Accredited Investors, Qualified Purchasers or Qualified Clients.

non-retail investors accessing private investments to round out our understanding of the current regime.

4. We offer some key principles-based guidelines to the SEC that we believe could balance wider access with investor protection - our “Design Principles.” We believe these Design Principles could guide any wider access by retail investors to private investments.
5. Specific recommendations of how wider access to private investments may be achieved within our Design Principles. In particular, we focused on using the registered investment company (“RIC”) framework with certain modifications.

2. Summary of Observations and Conclusions

Following our analysis and review of information provided to the AMAC and the PI Subcommittee, our main observations are:

1. There are several macroeconomic and structural factors that are resulting, and will likely continue to result, in:
   a. higher demand for investments and investment choices from retail investors; and
   b. a more concentrated supply of public market equity investment choices.
2. Currently, most retail investors are precluded from accessing many private investments due to restrictions relating to investor qualifications and the immaterial amount of private investments held by traditional retail investment vehicles.
3. Returns from the private investment asset classes we reviewed exhibit similar or higher returns than their public market equivalents. Private investments are less liquid than public market investments and there is evidence of a higher dispersion of returns between private fund managers compared to public funds in some of the asset classes we reviewed.
4. In relation to the specific asset classes, we reviewed we observe:

   Private Equity -

   a. While the returns of private equity (“PE”) investments are not easily comparable to public equity markets, historically we find support for PE returns being at least slightly better to somewhat better than those for public equity markets but we have some concern that some performance measures used by PE managers (e.g., internal rate of return (“IRR”) are not fully understood by retail investors; and
   b. There is some evidence of a trend of declining additional PE returns as compared to public equity due to a lower illiquidity premium being required by investors and/or a lower interest rate environment.

As a result of the observations above our main conclusions are:

1. The SEC should consider permitting retail investors access to a wider range of private

investments;

2. Wider access could initially be considered within a set of “Design Principles” that balance the potential benefits to retail investors from wider access to private investments with sufficient investor protection; and
3. The current RIC framework could serve as the basis on which to achieve the balance sought by the Design Principles outlined.

While not the focus of this Report, we have also outlined some specific recommendations that are focused on the main legal and regulatory areas that the SEC would need to consider allowing wider access to private investments under the RIC regime in Section 7 of this Report.

3. Macroeconomic and Structural Factors Impacting the Supply and Demand for Investments

Our first area of work was to understand the size and growth of the asset management industry, particularly with reference to retail investors on both the supply and demand side for investments.

3.1 Demand Side

The AMAC found clear data that the demand side for investments in the U.S. is growing more quickly than the general economy due to combined economic, demographic, and structural factors.

The size of the U.S. asset management industry has grown from around $18Tn of assets under management (“AUM”) in 2002 to around $45Tn in 2019,[132] a compounded growth rate of around 5.5% compared to inflation over the same period averaging around 2.2% per annum[133] and GDP growth averaging around 2% per annum.[134] Retail investors and IRA accounts make up around 50% of the total AUM.[135]

AUM within the retirement market was around $34.9Tn in 2020. Employer-sponsored defined contribution plans[136] have remained relatively static in the last 15 years in terms of their overall share of this segment at around 8% to 9% albeit more than doubling in dollar terms consistent with the overall growth of retirement assets in that period. IRA and 401(k) accounts (which are self-directed) have increased from around 40% to 54% of total retirement assets and from $5.8Tn to $18.9Tn over the last

[132] *Issues Facing the US Money Management Industry* – Presentation to the SEC Asset Management Advisory Committee by Michael L Goldstein of FMMI Inc – Slide 3.

[133] Calculated from annual data from USA FACTS.

[134] *U.S. GDP Growth Rate 1961-2021*, MACROTRENDS.

[135] *Issues Facing the US Money Management Industry*, supra note 3 at Slide 5.

[136] When referring to employer-sponsored defined contribution plans we are referring to plans that are managed by the employer (or an appointed investment manager) rather than self-directed plans such at 401(k) and ROTH 401(k) plans.

15 years. In contrast, defined benefit plans have decreased from around 42% of total retirement assets to 30% even while notional assets have risen from $6Tn to $10.5Tn.[137]

AMAC believes that an aging U.S. population combined with forecasted GDP growth rates of around 2% per annum[138] should result in the notional size of the asset management industry continuing to increase over the next few decades. We expect the relative share of investment assets attributable to retail investors and self-directed retirement accounts (including 401(k) plans) to continue to grow more quickly than the general economy and the asset management industry. Retail investors and self-directed retirement investors are generally limited to public market investments.

3.2 Supply Side

As retail investors and self-directed retirement accounts (including 401(k) plans) become a higher percentage of the overall asset management AUM we believe that they will place a higher demand on the industry for investment choices and products. Given this expected growing demand, AMAC next looked at whether the supply of investment products and choice for these investors is expected to keep pace. We focused primarily on the U.S. public equity market as this market makes up the majority of investments open to retail investors.

U.S. public equity markets have grown from a total capitalization of around $17Tn in 2005[139] to close to $50Tn at the end of March 2021[140]. There has also been significant growth in asset choice and low-cost products such as ETFs. The number of ETFs and their market capitalization have grown explosively: increasing from around 200 funds and $0.3Tn in assets in 2005, to around 2,200 funds and $5.4Tn in assets in 2020 but still remain at a little more than 20% of the AUM in mutual funds. Mutual funds have remained relatively static in terms of numbers (around 8,400 in 2005 and around 9,000 in 2020) even as their assets grew from around $8.8Tn to $24Tn over the same period.[141] Around 57% of the underlying investments in mutual funds and ETFs are in U.S. domestic equities (43%) and global equities (14%).[142]

Against this apparent growth in the supply side of investments, there has been a sharp decrease in the number of listed companies. From the peak in 1996 of just over 8,000, the number has decreased approximately 45% companies to around 4,400 in 2018.[143] In addition, the concentration of the largest companies has increased. Four companies, all in the technology sector, now each has over a $1Tn market capitalization. Further, the top 10 companies of the S&P500 index now account for around one third of

[137] 2021 INVESTMENT COMPANY FACT BOOK – *A Review of Trends and Activities in the Investment Company Industry*, Pg. 177.

[138] FOMC Economic Projections, March 16-17, 2021, Meeting – Table 1.

[139] World Bank Data,: *Market capitalization of listed domestic companies .*

[140] *Total Market Value of U.S. Stock Market*, Siblis Research.

[141] 2021 INVESTMENT COMPANY FACT BOOK, supra note 8 at Pg. 40, 41, 98.

[142] Id. Pg. 42, Fig 2.3.

[143] World Bank Data*, Listed domestic companies.*

the value of the total index.[144] Being a market capitalization weighted index, the S&P500 is heavily tilted to these large technology companies.

We observe that, notwithstanding the close to 300% increase in the market capitalization of U.S. listed companies over the last 15 years and the even more explosive growth of low-cost investment alternatives such as ETFs, public equity markets have become much more concentrated with fewer listed companies and a high concentration of the stock market capitalization in the top handful of companies. As such, we view the supply side for retail investors as being less diversified than 15 years ago.

3.3 Conclusions on the Supply and Demand for Investments

Given the growing demand by retail investors for investment product and choice and the more concentrated supply of the main component of most retail investments (public equities) we conclude that it is worthy to consider access to a wider range of investments for retail investors in order to better fulfill the growing demand for investment products and choice In particular, we believe that the SEC ought to consider wider access to private investments subject to:

1. Such investments providing similar to better returns than comparable public market investments; and
2. Sufficient investor protection.

4. Measuring Returns from Certain Asset Classes

Our next area of work was to consider the returns from certain private asset classes. We considered returns from:

1. Private Equity;
2. Private Debt; and
3. Private Real Estate.[145]

These asset classes were analyzed as they are most comparable to certain public market investments and AMAC believes that private investments ought to provide similar or better returns than current (primarily public) investment choices that retail investors have in order for wider access to be initially considered.

4.1 Private Equity

4.1.1 What is Private Equity?

[144] AMAC meeting, Sept 16, 2020, Slide 11, *Private Investment Sub-Committee Update* (sec.gov).

[145] [EDITOR NOTE: For purposes of the case study, discussion of private debt and private real estate has been omitted.]

Private Equity ("PE") refers to the equity of non-public firms whose shares are not traded on registered stock exchanges. It is a diverse asset class, encompassing venture capital, buyouts, growth, and distressed investments. While estimates vary, the size of the private equity market is approximately $4.5 trillion.[146] S&P Global reports transactions volume of $536 billion for venture capital and private equity deals globally in 2020.[147]

Similar to public equity, investors in private equity often gain their exposure through pooled investment vehicles. However, whereas the returns of pooled public equity vehicles can be readily compared to one another, or to standard benchmarks such as the S&P 500 Index, such straightforward comparisons are not possible with PE pools. A primary reason for this is that an investment in private equity is often made in stages, with capital calls and distributions occurring over multiple years. This is distinct from public equity, where a single investment is all that is required to gain exposure to a given issuer's equity. The result is that customary holding period measures of return that are used for public equity pools are unworkable for typical PE investments.

4.1.1 Measuring Private Equity Returns

Alternative measurements of PE returns are used by investors and managers. The traditional method of computing PE returns is the internal rate of return ("IRR").[148] Using IRR to measure returns has a number of drawbacks including assumptions about the reinvestment of proceeds and the large effect on measured IRR from cash flows that occur early in the life of the pool. Although IRR remains one of the industry-standard means of reporting returns at present, these and other drawbacks make IRR difficult as a singular return measure especially for retail investors who: 1. likely may not understand the limitations of the IRR metric and; 2. the differences between IRR and return metrics used for public equity or registered investment funds.

Several other measures have been developed that attempt to compensate for the shortcomings of IRR. Multiple of Money ("MoM") is the sum of the net asset value of the investment plus all the distributions received divided by the total amount paid in. MoM ignores the time value of money as well as the scale of the investment, but it is free from certain distortions of IRR. It also has the virtue of being simple to understand in that it is the ratio of value received divided by money invested.

The second common return measure is the Public Market Equivalent ("PME") and its variants.[149] It is formed by applying the cash flows of the PE investment to a public market index, such as the S&P 500. For example, when the PE investment has a capital call of $50M, the PME requires a $50M investment in the S&P 500 index. The PME has the advantage of allowing a comparison of the PE investment to public market investments that are feasible for retail investors to understand. However, it suffers from the same

[146] SEC Asset Management Advisory Committee –Private Investments Sub-Committee Update, Dec. 1, 2020, *Access to Alternative Investments*, John Suydam , Slide 3.

[147] S&P Global Market Intelligence, *2021 Global Private Equity Outlook*.

[148] For an illustration of IRR: SEC Asset Management Advisory Committee –Private Investments Sub- Committee Update, Sept. 16, 2020, Slide 24.

[149] Id, Slide 25 and 26 for a brief explanation of the various types of PME measures.

drawbacks as IRR in that it ignores the scale of the project and can be problematic if cash flows are extreme.[150]

4.1.2 Private Equity Returns Data

Turning to the question of realized PE returns, while there is some disagreement between practitioners and academics about the precise magnitude of returns, some general results are summarized here.

Hamilton Lane ("HL"), a firm that, among other things, collects data on the performance of the PE industry, reported that as an asset class, a 10-year trailing average of PE industry IRRs outperformed broad domestic and global equity market indices' PMEs in most years between 2001 and 2019.[151] However, there was some underperformance by PE relative to broad market returns over the last few years. Similarly, using IRRs and PMEs, Cambridge Associates ("CA"), another industry data provider, found that as of the end of 2019, PE outperformed broad market indices over a range of investment horizons ranging from three to 30 years.[152]

Josh Lerner, an economist and academic[153] comes to slightly different conclusions using data from Prequin.[154] He finds that over vintage years from 2000 to 2017, PE only slightly outperformed public markets, with PMEs for most vintage years being close to 1.0. Using a slightly different measure of returns, Lerner finds that returns have been steadily declining over time, with a peak TVPI[155] (a return measure similar to PME) of 2.37 in 2010 steadily declining to a TVPI of .99 in 2017.

Both HL and CA note in their presentations that there are meaningful sources of variation in their respective reported returns. HL documents considerable cross-sectional dispersion of IRRs across PE managers by sub-strategy. For example, over an almost 40-year period, the dispersion of net returns across Growth Equity managers is approximately 15% per year. The dispersion falls to about 11% for large-firm buyout funds. The firm also documents different levels of dispersion by geography of the fund, range from 15% for the "World ex-Asia" category to about 10% for Global Funds. CA documents dispersion in other dimensions as well. When returns are partitioned by the AUM of the fund, a pronounced relationship between return dispersion and fund size is revealed. Funds greater than $10B have TVPI ranging from 1.1 to 1.9, whereas for funds less than $200M AUM, the range of TVPI is from approximately .6 to 3.4.

Unconditionally, CA provides evidence that the range of outcomes for PE funds is much larger than for funds of publicly traded equity. For the period from 2005-2019, they find that the average dispersion from

[150] For a good comparison of PE return measures, see *Measuring Private Equity Fund Performance*, Background Note, INSEAD, 02/2019-6472, 2019.

[151] *Presentation to SEC Asset Management Advisory Committee*, Hamilton Lane, Sept. 2020.

[152] *Presentation to SEC Asset Management Advisory Committee* Private Investments, Cambridge Associates, Sept. 16, 2020.

[153] Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, see: Josh Lerner, HBS profile.

[154] *Remarks to the SEC Asset Management Advisory Committee Private Investments Subcommittee,* Josh Lerner, Sept. 16, 2020.

[155] TVPI (total value to paid-in capital) provides prospective clients or investors with a multiple that indicates how many times more the investment is worth compared with the original investment without taking into account the time value of money. See: GIPS STANDARDS HANDBOOK FOR FIRMS, Nov. 2020, Provision 5.A.4.

the fifth percentile to the median fund return is about 21% for PE pools, while for the primary strategies typical of publicly traded equity pools the same measure of dispersion is 3% or less.

Another aspect of PE funds that warrants mention is their fees. Lerner points out that relative to traditional mutual funds, PE fund fees are high. While management fee ranges vary from 1.2% to 2%, investors in smaller funds often pay a “2 and 20” fee, consisting of a 2% fee on the capital invested coupled with a fee of 20% of the profits earned by the fund. When structured for retail investors, Lerner states that these funds may have an additional layer of fees consisting of management fees, up-front sales loads, and/or redemption fees. Lerner states that the various layers of fund fees may sum to a level that negates the remaining alpha of the fund. CA, using a different measure of cost, finds that the spread between gross and net (to LP investors) IRR averages over 600 bp over a 28-year period (largely driven by the 20% profit share), and observes that general partners of PE funds extract a lot of value from the pool.

In addition to potentially higher returns, PE funds offer a benefit to traditional equity investors in the form of enhanced diversification. Lerner, citing a paper by Ang, et. al (2018), states that PE funds of different strategies have different cyclicality to them.[156] An investor who holds a portfolio of diverse PE funds can enjoy considerable diversification within the PE domain alone. CA computes a correlation matrix of broad market-based indices with different styles of PE. They find than correlation coefficients are always below .65, and that the correlation coefficient becomes meaningfully lower as the market cap of the PE firms decline.

Finally, academic and economist Ludovic Phalippou[157] offers some notes of caution when it comes to retail investing in PE funds.[158] He cites one fund that states in its marketing materials that it had a gross IRR of almost 50% over nearly 20 years of investing in the software industry. He notes that if this IRR were to be interpreted as an annual rate of return in the sense of a traditional mutual fund, the dollar returns earned would be so large as to be unrealistic. He uses this as an illustration of the difficulties of marketing track records using IRR, and how such reporting has the potential to confuse retail investors. His analysis highlights the need for serious thought about how PE returns can be presented in a way that is readily understandable to retail investors who lack the sophistication of institutional investors that are the typical consumers of PE fund marketing materials.

After reviewing the data summarized above AMAC believes that PE funds offer potential benefits to retail investors compared to public equity investments due to their higher average returns and their diversification potential. However, the difficulty in measuring and reporting returns on a comparable basis, coupled with the potentially high fees associated with retail PE pools, requires that the SEC play a central role in designing an appropriate disclosure and regulatory regime for these products should they be offered to the retail investing public.

5. Current Access to Private Investments by Retail and Non-Retail Investors

[156] Ang, Andrew, Bingxu Chen, William N. Goetzmann, and Ludovic Phalippou, *Estimating Private Equity Returns from Limited Partner Cash Flows*, THE JOURNAL OF FINANCE, 73, no.4, (2018): 1751-1783.

[157] Ludovic Phalippou, Professor of Financial Economics, Saïd Business School, University of Oxford, see: Ludovic Phalippou, SBS, Oxford profile.

[158] Presentation to SEC Asset Management Advisory Committee, *Track Record Marketing in Private Equity*, Ludovic Phalippou, Sept. 16, 2020.

The AMAC also felt it necessary to consider what access retail investors currently have to private investments and what the main legal and regulatory requirements are currently for access to a wider range of private investments by non-retail investors in order to be able to make specific recommendations regarding potential changes to current requirements.

Our analysis focused on:

1. What access to private investments do retail investors currently have via retail investment vehicles; and
2. What are the key investor qualification requirements non-retail investors must meet for access to a wider range of private investments.

5.1 Current Access to Private Investment by Retail Investors

Currently retail investors can access private investments mainly through:

1. Open-end funds, such as mutual funds, which are allowed to hold up to 15% of their assets in illiquid investments;[159]
2. Closed-end funds (including tender offer and interval funds[160]) that hold no more than 15% of their assets in private funds;[161] and
3. Exempt securities offered by issuers primarily under certain small offering exemptions (Regulation A) and crowdfunding exemptions.[162]

5.1.1 Open-end Funds

While open-end funds may hold up to 15% of their assets in illiquid securities, we understand that most open-end funds limit themselves to a much lower percentage given the need to provide daily liquidity to investors. Overall, we believe that an open-end fund holding 5% - 10% of its assets in illiquid investments does not allow a retail investor to easily understand and track the performance of the fund's private investments as compared public investments as open-end funds do not provide separate performance related information between various assets in the fund.

5.1.1 Closed-end Funds

[159] 17 CFR § 270.22E-4 (LIQUIDITY RISK MANAGEMENT PROGRAMS). RULE 22E-4 UNDER THE INVESTMENT COMPANY ACT OF 1940 (THE "INVESTMENT COMPANY ACT") defines an illiquid investment as any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, as determined pursuant to the provisions of the rule relating to the fund's classification of portfolio investments.

[160] [EDITOR NOTE: For purposes of the case study, discussion of tender offer funds, interval funds, and exempt securities has been omitted.]

[161] Although SEC rules do not expressly limit the percentage of illiquid assets that a closed-end fund may hold, the SEC staff has taken the position that a closed-end fund that holds more than 15% of its assets in private funds should only be offered to accredited investors. See: Speech by Dalia Blass to PLI Investment Management Institute (July 28, 2020), text accompanying footnote 29.

[162] For a fuller discussion of the various exemptions, please refer to *SEC Concept Release on Harmonization of Securities Offering Exemptions*, Pg, 10 and 11.

Closed-end funds are a relatively small portion of the overall investment company market. There are around 500 closed-end funds with around $279 billion of assets.[163] The wider mutual fund industry is estimated to manage around $24 trillion of assets and comprises over 7,500 funds.[164] Closed-end funds have declined in size and number over the last decade or so as funds were liquidated, merged or converted into open-end mutual funds or ETFs.[165] Closed-end funds are predominantly bond funds, and an analysis of their asset holdings reveal they mainly hold liquid assets.

Closed-end funds (including tender offer and interval funds) may also require investors be qualified in the following situations, without limitation:

1. If the fund charges incentive fees investors will need to be Qualified Clients; and
2. Funds that invest more than 15% of their assets into private funds require all investors to be Accredited Investors.

5.1.2 Conclusions

We conclude that while there are some methods for retail investors to gain access to private investments, these are either in the form of diluted exposure in open end mutual funds or in closed-end funds which have remained a very small minority of the retail investment landscape representing less than 2% of all mutual funds' AUM. Closed-end funds may also require investors to be Accredited Investors and/or Qualified Clients which limits many retail investors from participating in such funds.

As such, the vast majority of private investments are currently not available to retail investors via existing retail investment vehicles.

5.2 Current Access to Private Investments by Non-retail Investors

We now turn to consider the current regulatory requirements for access to private investments by non-retail investors.[166] Investors must generally meet qualification thresholds in order to access a wider range of private investments.[167] The two key thresholds are the:

1. Accredited Investor threshold; and
2. Qualified Purchaser threshold.

In addition, in order for investment advisers to be able to charge performance fees to clients (which is a common feature of many private investments), investors must generally be Qualified Clients.[168]

[163] 2021 INVESTMENT COMPANY FACT BOOK, ici.org, supra note 8 at Pg. 119.

[164] Id. Pg. 66 (Fig 3.1) and Pg. 210

[165] Id. Pg. 119

[166] Non-retail investors are investors that meet investor qualification requirements and can therefore invest in a wider range of private investments not available to retail investors. The subcommittee also discussed this at the SEC AMAC meeting on Sept. 16, 2020, *Private Investment Subcommittee Update*, (sec.gov), see Slides 15- 19

[167] SEC Concept Release on *Harmonization of Securities Offering Exemptions*, supra note 37, at Pg. 177 – 183 provides a fuller discussion.

[168] [EDITOR NOTE: For purposes of the case study, discussion of non-retail investor requirements has been omitted to avoid repetition. Refer to the

5.2.1 Conclusions on Investor Qualification

Under the current regulatory landscape, particularly the financial thresholds for Accredited Investors, Qualified Clients, and Qualified Purchasers, most retail investors are precluded from investing in the majority of private investments.

Even in the case of registered funds (i.e., RICs), investors may need to meet the Accredited Investor threshold (e.g., a closed-end fund that invests more than 15% of their assets in private funds) and /or the Qualified Client threshold (if the fund charges incentive fees). The majority of retail investors will not meet these qualification criteria.

We believe that the SEC should consider how to amend the regulatory framework to provide wider access to private investments by retail investors while maintaining appropriate safeguards as set out in our Design Principles.

6. Design Principles

6.1 Why Design Principles Matter

The investor qualification requirements discussed in the previous section are based in part on concerns that retail investors lack the financial sophistication to properly consider the risks, expenses, and illiquidity of private investments, or lack the financial resources to absorb potential losses that may result from such investments.

Accordingly, AMAC believes that options to create wider access to private investments must balance investor choice with sufficient investor protection. We propose therefore that the SEC evaluate wider retail access to private investments first and foremost according to a set of design principles that recognize these concerns ("Design Principles"). This section of the Report discusses what we view as the key principles and refers to them as "Design Principles."

6.2 Design Principles

6.2.1 Liquidity of Investments

We believe that it is clear that an investment's liquidity is very important to retail investors. Yet liquidity is generally incompatible with private investments, since typically there are: (1) no secondary markets or redemption rights associated with most private investments; and (2) private securities may be subject to resale-related restrictions to avoid creating a public offering of securities.

Retail investors' behavior with respect to mutual fund investments confirms the importance they place on liquidity. Industry data show that, over the past 30 years, yearly redemption rates for long-term mutual

Background section of **Appendix A**.]

funds have ranged from 23.7% of the funds' average net assets to 39.9% of average net assets during periods of market turmoil, with an average yearly rate of 30.0%.[169]

AMAC believes any increased access to private investments will likely be subject to limited liquidity features. The SEC should consider favoring investment structures that offer at least limited redemption opportunities, or that can be traded on secondary markets without needing to liquidate an underlying private investment.

6.2.2 Chaperoned Access

We recommend the that the SEC limit retail access to private investments to those which have certain types of third-party participation. We refer to this Design Principle as "chaperoned access." We believe that chaperoned access will ensure that retail investors only invest in private investments that balance risk, returns, and appropriate fees.

One way to achieve chaperoned access would be to ensure that funds that invest in private investments and which retail investors would be allowed to invest in are managed by independent investment advisers who (and whose affiliates): (1) do not receive fees or other income from the underlying investments and who have an obligation to act in the best interest of investors (if broker-dealers); or (2) have a fiduciary obligation to the investors (if investment advisers). Compensating such independent advisers will add an additional layer of fees that institutional investors do not incur and an appropriate balance will need to be struck between the benefit of the chaperoned access and the cost.

Another way to achieve chaperoned access could be to require any private investment that retail investors have access to also have material participation in the fund or investment from more sophisticated institutional investors on substantially the same terms on the basis that such institutional investors would have carefully considered the risk and potential returns of the investment and the appropriateness of the fees being charged.

6.2.3 Disclosure of Fees, Risks, Terms and Returns

Based on our research and discussions with industry members, AMAC believes that another Design Principle is that any increased access to private investments must include standardized disclosure of important information about the private investment, particularly with respect to fees, risks, key terms, and returns.

6.2.4 Diversification

A typical private investment fund tends to be fairly concentrated both in terms of industry/asset theme as well as the number of investments it holds. There also tends to be a higher dispersion of returns from

[169] 2021 INVESTMENT COMPANY FACT BOOK, (ici.org), supra note 8 pg. 235, Table 26. These figures reflect both regular and exchange redemptions for a year as a percentage of average net assets at the beginning and end of each year between 1991 and 2020. Excluding exchange redemptions, redemption rates ranged from 16.5% to 30.1% of funds' average net assets, with an average yearly rate of 22.8%.

private fund managers compared to public managers.[170] To the extent feasible, AMAC believes retail access to private investments should be via holding a diverse portfolio of underlying private investments. There are two primary ways of ensuring diversification:

1. A portfolio of separate investments in different private funds; or
2. An investment in a fund that holds a reasonably diversified mix of private investments.

To date retail access to private investments has been mostly via mutual funds that may hold up to 15% of their assets in illiquid investments (such as private funds) but generally hold a much lower percentage. We believe that it would be better to diversify exposure to private investments via the methods outlined above, so that investors can better evaluate the performance of private investments particularly in relation to public market investments. As discussed earlier, this is not possible in a mutual fund which holds mainly liquid assets and relative performance information of the illiquid assets is not split out.

AMAC believes that the SEC should encourage retail investors to hold a diversified pool of private investments within their overall portfolio which should also comprise more liquid investments. We acknowledge that it may be beyond the SEC's ability to mandate overall portfolio diversification. There are situations, such as under Regulation Crowdfunding and Regulation A, where the SEC does mandate the maximum investment in a particular issuance based on a non-Accredited Investor's annual income or net worth.[171]

6.2.5 Use of the RIC framework

Chaperoned access via a RIC could fulfill many of the Design Principles. The SEC should consider whether the RIC framework is an appropriate method to balance investor protection with access to private investments. While the SEC may need to make some specific modifications to deal with the nature of private investments, some of the features of RICs that could be applied in this context include:

1. Use of a qualified independent registered investment adviser with a fiduciary duty to investors and/or a broker-dealer with an obligation to act in the best interest of a retail investor to access private investments; and

Required standardized disclosure of key items such as fees, risks, key terms, and returns.

7. Specific Recommendations

Lastly, in this section we provide some specific recommendations for the SEC to consider, some of which have been discussed in the body of this Report:

[170] *Presentation to SEC Asset Management Advisory Committee*, Hamilton Lane, Sept. 2020, (n23), Slide 9.

[171] See 17 CFR 230.251(D)(2)(I)(C) (Regulation A investment limits) and 17 CFR 227.100(A)(2) (Regulation Crowdfunding investment limits)

1. The SEC should consider whether its staff's current position that a closed-end fund that holds more than 15% of its assets in private funds should only be offered to Accredited Investors is appropriate. Investors in such funds already have the benefit of comprehensive investor protection under the RIC rules including having an investment adviser, independent directors and extensive disclosure and reporting requirements. In addition, this requirement is an impediment to closed-end funds listing and creating a secondary market (and thus liquidity) for investors' in closed-end funds.

2. Similarly, the Qualified Client requirement for closed-end funds that charge incentive fees should be reviewed for the same reasons as in the first recommendation.

3. The SEC should allow closed-end funds to list on a public market more easily. This may provide secondary market liquidity while allowing the closed-end fund itself to invest in illiquid assets. In turn this would likely require that investor qualifications such as being an Accredited Investor or Qualified Client would need to be removed. We note that substantial discounts between the trading price of a closed-end fund compared to its NAV may occur during times of market stress and could be problematic but similar issues arise in some types of ETFs and in listed REITs.

4. Chaperoned access will cause an additional layer of fees payable to the RIC investment adviser which may be mitigated by allowing large sponsors to also play the role of investment adviser to closed-end funds. Conflicts of interest would need to be disclosed and managed. The SEC should consider allowing large sponsors to play the role of investment adviser.

5. Chaperoned access may also be achieved by allowing closed-end funds to invest only in "approved" private funds with such approval status being based on size and diversification of investments as well as potentially at least a majority of capital commitments to the underlying private funds coming from Qualified Purchasers or other large institutional investors. The SEC should consider whether such "approved private" funds could be invested into directly by retail investors without the need for the additional layer of an investment adviser.

6. Interval funds and tender offer funds may also be suited to deal with the cashflow profile of investing in private funds,[172] however, the SEC should consider providing these funds with additional flexibility including:

    a. More flexibility on the initial investment period of an interval fund before the first repurchase and allowing flexible repurchase dates based on underlying liquidity instead of a fixed schedule; and
    b. allowing the more flexible repurchases of a tender offer fund to be undertaken in a

[172] Typical private equity funds for example have a drawdown profile as the fund goes through an initial investment phase and then periodically returns cashflows in later years as it exits investments.

similar manner to interval funds – i.e., aligning the Form N-23 (interval funds) with the Form TO requirements.

7. The SEC should consider standardized disclosure of fees, risks, key terms and returns as well as liquidity constraints of private investments that retail investors have access to.

8. The SEC should consider whether diversification requirements within a RIC should be required for RICs investing in private investment funds that retail investors can invest in. These may include:

    a. Minimum fund size and other qualifying criteria for each private fund that a RIC invests in; and
    b. RICs to have a defined maximum exposure to any particular private fund investment.

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