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REDUCE INCOME INEQUALITY: ALLOW RETAIL INVESTORS TO INVEST IN PRIVATE EQUITY

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INTRODUCTION

Throughout the 2020 election season, Republicans and Democrats both strongly emphasized economic issues in making their case for election. Republicans pointed to the strength of the economy: prior to COVID-19, unemployment had reached a fifty-year low,[1] while the stock market reached all-time highs.[2] After years of stagnation, wages finally started to rise.[3] Democrats generally did not dispute that the economy was

[1] Christopher Rugaber, *U.S. Companies Keep Adding Jobs, Easing Worries of Weakening Economy*, L.A. TIMES (Dec. 6, 2019), https://www.latimes.com/business/story/2019-12-06/november-jobs-report-unemployment.

[2] Fred Imbert, *Stocks Rise for a Fourth Straight Day, Hit Record Highs*, CONSUMER NEWS & BUS. CHANNEL (Dec. 16, 2019), https://www.cnbc.com/2019/12/16/us-futures-point-to-higher-open-on-wall-street.html.

[3] Ben Casselman, *Why Wages Are Finally Rising, 10 Years After the Recession*, N.Y. TIMES (May 2, 2019),

strong. Instead, they argued that the additional wealth generated was distributed amongst the already rich, with low-income and middle-class Americans foreclosed from opportunities to increase their wealth.[4]

These disagreements are not readily resolvable, in part because they implicate different values. An emphasis on economic equality may lead some to advocate for heavy regulations of corporate entities. Although doing so may impede economic growth, supporters would argue that such policies ensure adequate protection of American consumers.[5] In contrast, drastically reducing regulations may encourage economic activity, though at the possible expense of eliminating protections for individuals who previously relied on them.[6]

Which of the above paths is preferable will depend on one's values. Not all economic regulatory policy decisions, however, implicate the same tradeoffs between broad economic growth and consumer regulatory protections. This Article will focus on one such topic: opening the private equity markets to individual retail investors. Permitting retail investors to invest in private equity would allow investors to reduce the risks of their portfolio while retaining or even increasing their returns, which can make the middle-class investor better off. Additionally, the money that will flow into private equity will allow private equity firms to continue improving American businesses, which will allow American companies to grow and better compete in the international stage. Thus, allowing retail investors to invest in private equity can both help middle class Americans while bolstering overall economic growth.

Importantly, given the very narrow majority Democrats hold in the House and Senate, proposals that can obtain at least some bipartisan support are significantly more likely to make an impact. The proposals in this Article can appeal to both sides of the aisle, as will be explained in greater detail.

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https://www.nytimes.com/2019/05/02/business/economy/wage-growth-economy.html.

[4] *See BUILDING A STRONGER, FAIRER ECONOMY*, DEMOCRATIC NAT'L COMM., https://democrats.org/where-we-stand/party-platform/building-a-stronger-fairer-economy/ (last visited April 5, 2021).

[5] *Regulation & the Economy the Relationship & How to Improve It*, COMM. FOR ECON. DEV. OF THE CONF. BD. (Sept. 27, 2017), https://www.ced.org/reports/regulation-and-the-economy.

[6] *See Id.*

Part I of this Article will discuss the current regulatory framework that prohibits most individual investors from investing in private equity firms. This Part will explain why such polices—meant to help investors—serve to harm investors. Part II will discuss the steps that should be taken to allow investors to invest in private equity funds in their 401(k) retirement accounts. Finally, Part III will discuss the carried interest tax treatment that private equity managers benefit from. This Part will argue that the treatment should be reversed, which will raise revenue and allow for a political compromise to help encourage the passage of the proposals set out in Parts I and II.

I. RETAIL INVESTORS SHOULD NOT BE FORECLOSED FROM THE BENEFITS OF PRIVATE EQUITY INVESTMENT

A. The Regulatory Framework Governing Private Equity Investments

Pursuant to Section 5 of the Securities Act of 1933 ("Securities Act"), all sales of securities must be registered with the United States Securities and Exchange Commission ("SEC") unless they qualify for an available exemption.[7] SEC registration allows the issuer of the securities to sell the securities to the general public on public exchanges. However, the costs of such registration—in both time and money—are significant.

Accounting firm PricewaterhouseCoopers ("PwC"), for example, recommends that firms interested in entering into an Initial Public Offering ("IPO") first engage in an internal "readiness assessment."[8] PwC explains: "Because of the significant effort and time needed to develop the capabilities for being public, a thorough IPO readiness assessment can take twelve to eighteen months to complete. The assessment will help you determine where your company currently stands and then assess and

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[7] 15 U.S.C. § 77(a) et seq; s*ee Registration Under the Securities Act of 1933*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933 (last visited April 8, 2021).

[8] *Considering an IPO to Fuel Your Company's Future?*, PWC DEALS, https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html (last visited Dec. 21, 2019).

identify gaps in your company's preparedness."[9] An additional six to nine months is estimated before the IPO will be completed.[10]

In addition to the significant amount of time that it takes a company to go public, the financial costs of going public and staying public are significant. Eighty-three percent of chief financial officers estimated spending more than $1,000,000 to go public, exclusive of the large underwriting fees.[11]

Further, two-thirds of chief financial officers estimate spending between $1,000,000 and $1,900,000 every single year on costs associated with staying public.[12] These additional costs are attributed to additional amounts spent on auditing, financial reporting, regulatory compliance, and other requirements.[13]

Aside from the required financial outlays, public companies must publicly release information that they are not required to release while private. These disclosures have the potential of arming competitors with proprietary company information, which may leave a company going public at a competitive disadvantage.[14]

Given such costs of going public, many companies prefer to remain private. There are important exemptions from SEC registration available for companies who want to raise capital from investors but do not want to deal with the significant costs of going public. Such non-public offerings are referred to as "private placements" or "unregistered offerings."[15]

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[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Considering an IPO to Fuel Your Company's Future? Insight into the Costs of Going Public and Being Public*, PWC DEALS 14–16 (Nov. 2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf.

[14] *Disclosure Requirements for Public Companies: A Few Downsides*, DEAL CAP. PARTNERS, LLC, https://investmentbank.com/disclosure-requirements-for-public-companies/ (last visited Feb. 24, 2021).

[15] *Investor Bulletin: Private Placements Under Regulation D,* SEC. & EXCH. COMM'N (Sept. 24, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

Section 4(a)(2) of the Securities Act provides an exemption from registration with the SEC for "transactions by an issuer not involving any public offering."[16] The statute does not define this phrase; instead, caselaw and SEC guidance set the boundaries of this exemption.[17] To qualify for this exemption, the SEC explains that the securities must be sold only to those who are "shown to be able to fend for themselves and, accordingly, do not need the protection afforded by the Securities Act; and [h]ave access to the type of information normally provided in a prospectus for a registered securities offering."[18]

As the above requirements make clear, the factors governing eligibility for private placements are standards, not rules.[19] Issuers would thus face a large amount of regulatory uncertainty regarding whether their purchasers meet the qualifications required for their offering to constitute a private placement. Selling a security to one individual who does not qualify could render the entire offering violative of the Securities Act.[20]

To help alleviate such uncertainty, the SEC issued Rule 506(b) of Regulation D.[21] Rule 506(b) contains safe harbor rules, which means that if issuers follow the requirements of Rule 506(b), the sale of securities is guaranteed to be non-public and thus exempt from registration.[22] To qualify for the safe harbor, the following conditions must be met as explained by the SEC:

- "no general solicitation or advertising to market the securities" and
- "securities may not be sold to more than 35 non-accredited investors (all non-accredited investors, either alone or with a purchaser representative, must meet the

[16] *Concept Release on Harmonization of Securities Offering Exemptions*, 84 Fed. Reg. 30460, 30479 (June 26, 2019) (citing 15 U.S.C. § 77d(a)(2)), available at https://www.sec.gov/rules/concept/2019/33-10649.pdf (future page references relate to the electronic version); s*ee also Private Placements - Rule 506(b)*, SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings/rule506b (last visited Dec. 23, 2019).

[17] *Id.*

[18] *Id.* (citing SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953)).

[19] *See id.*

[20] *Id.*

[21] *See* 17 C.F.R. § 230.506(b) (2021).

[22] *Concept Release on Harmonization of Securities Offering Exemptions, supra* note 16, at 30480.

> legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment)."[23]

While the safe harbor allows for issuers to sell securities to a small number of non-accredited investors, in practice, non-accredited investors are effectively barred from these offerings. SEC data shows that just six percent of offerings made pursuant to Rule 506(b) reported any sales to non-accredited investors during the years from 2015 through 2018.[24]

Thus, the "accredited investor" limitation of Rule 506(b) is central to an issuer's ability to raise money via a private placement. Non-accredited investors are generally unable to invest in private equity.[25] The SEC explains that an accredited investor is an investor that meets one of the following criteria:

- [A] bank, savings and loan association, insurance company, registered investment company, business development company, or small business investment company or rural business investment company[;]
- an SEC-registered broker-dealer, SEC- or state-registered investment adviser, or exempt reporting adviser[;]

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[23] *Id.*; *see also Private Placements - Rule 506(b), supra* note 15.

[24] *Comments on Concept Release: Harmonization of Securities Offering Exemptions*, *supra* note 16, at 22 n. 47 (of the online version). There are additional regulatory requirements that must be complied with if an offering is made available to non-accredited investors. *Id.* at 66–70. Thus, many issuers may not be interested in non-accredited investors, since the number of non-accredited investors that can participate in any offering is limited, each non-accredited investor likely has only a small amount of money to invest, and there are additional regulatory costs involved in offering private placements to non-accredited investors. *Id.*

[25] *Id.* at 32 ("Accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in many private issuers and offerings by hedge funds, private equity funds, and venture capital funds"); see also *Amending the "Accredited Investor" Definition*, 85 Fed. Reg. 2522 (Dec. 18, 2019), available at www.sec.gov/rules/proposed/2019/33-10734.pdf.

- a plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5 million[;]
- an employee benefit plan (within the meaning of the Employee Retirement Income Security Act) if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million[;]
- a tax exempt charitable organization, corporation, limited liability corporation, or partnership with assets in excess of $5 million[;]
- a director, executive officer, or general partner of the company selling the securities, or any director, executive officer, or general partner of a general partner of that company[;]
- an enterprise in which all the equity owners are accredited investors[;]
- an individual with a net worth or joint net worth with a spouse or spousal equivalent of at least $1 million, not including the value of his or her primary residence[;]
- an individual with income exceeding $200,000 in each of the two most recent calendar years or joint income with a spouse or spousal equivalent exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year[;] or
- a trust with assets exceeding $5 million, not formed only to acquire the securities offered, and whose purchases are directed by a person who meets the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment[;]
- an entity of a type not otherwise qualifying as accredited that own investments in excess of $5 million[;]
- an individual holding in good standing any of the general securities representative license (Series 7), the investment adviser representative license (Series 65), or the private securities offerings representative license (Series 82)[;]

- a knowledgeable employee, as defined in rule 3c-5(a)(4) under the Investment Company Act, of the issuer of securities where that issuer is a 3(c)(1) or 3(c)(7) private fund[;] or
- a family office and its family clients if the family office has assets under management in excess of $5 million and whose prospective investments are directed by a person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment.26

Only thirteen percent of all households have sufficient income or a sufficient net worth to meet the accredited investor standard.[27]

Issuers must submit Form D to the SEC in connection with their Regulation D offering.[28] Unlike the filings required for an IPO, Form D only requires general information about the company and its offering.[29] Importantly, federal law preempts state law with respect to securities sold under Rule 506, so that states are unable to enact substantive regulations that govern Rule 506 offerings.[30]

In addition to Rule 506(b) discussed above, there are other rules which allow private firms to raise capital. For example, Rule 506(c) under Regulation D allows firms to raise capital without the same solicitation

[26] *Frequently Asked Questions About Exempt Offerings*, SEC. & EXCH. COMM., https://www.sec.gov/smallbusiness/exemptofferings/faq (last modified March 15, 2021). For the full regulatory text of the accredited investor definition, *see* 17 C.F.R. § 230.501.

[27] *Concept Release on Harmonization of Securities Offering Exemptions*, *supra* note *16*, at 36. *See Amendments to Accredited Investor Definition*, *infra* note 86, and accompanying text (regarding the small number of additional individuals who will qualify as accredited investors based on very recent additions to the accredited investor definition).

[28] *See Form D: Everything You Need to Know*, UPCOUNSEL, https://www.upcounsel.com/form-d (last visited Dec. 24, 2019).

[29] *Id.*

[30] *Frequently Asked Questions About Exempt Offerings*, *supra* note 26; see *also* Brenda Hamilton, *Do State Blue Sky Laws Apply To Regulation D Offerings?*, SECS. LAW. 101, https://www.securitieslawyer101.com/2016/do-state-blue-sky-laws-apply-to-regulation-d-offerings/ (last visited Dec. 24, 2019).

restrictions that apply to Rule 506(b).[31] Still, Rule 506(b) is discussed here because of its significance for private firms who need capital. In 2018, a plurality of all money raised in exempt offerings—$1.5 trillion—was raised pursuant to Rule 506(b).[32]

B. Problems with the Accredited Investor Standard

The SEC's accredited investor definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."[33] Put another way, non-accredited investors are prohibited from investing in private placements because the SEC deems them to be too financially unsophisticated to fend for themselves, and unable to sustain the risk of investment loss associated with private placements.

While preventing retail investors from investing in private placements protects the retail investor from private placement losses, it also forbids the retail investor from participating in the significant upside such investment opportunities present. Thus, the SEC's accredited investor standard robs the retail investor of the ability to decide for him or herself whether to invest in private placements, locking the investor out of these investments to protect investors from themselves. Investors should instead be able to make their own investment decisions when it comes to investing their own hard-earned money in private placements. The SEC should allow them to do so.

The scope of the accredited investor limitation becomes apparent when considering recent trends in company financing. In 2018, more than twice as much money was raised in exempt offerings ($2.9 trillion) as was raised in registered offerings ($1.4 trillion).[34] While the difference between exempt and registered offerings varies year-to-year, between 2009 and 2018 "exempt offerings have accounted for significantly larger amounts of new capital compared to registered offerings."[35] By drastically limiting (or eliminating) the ability of non-accredited investors to

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[31] *General Solicitation—Rule 506(c)*, SEC. & EXCH. COMM., https://www.sec.gov/smallbusiness/exemptofferings/rule506c (last visited Dec. 25, 2019).

[32] *Concept Release on Harmonization of Securities Offering Exemptions*, *supra* note *16*, at 19, 78 (of the online version).

[33] *Id.* at 32 (of the online version).

[34] *Id.* at 16 (of the online version).

[35] *Id.* at 17 (of the online version).

participate in exempt offerings, the SEC is closing off approximately two-thirds of the capital markets to non-accredited investors, all in the name of protecting them.

The SEC's accredited investor definition creates arbitrary winners and losers, with some able to invest in private equity and enjoy the associated returns and others forbidden from investing in private equity and closed off from such investment gains. Public sector pension funds who invest on behalf of public sector workers, for example, can invest in private equity, benefitting the public sector worker as detailed below. Private sector workers, in contrast, do not generally have pensions, and are restricted from investing in private equity themselves if they do not meet the accredited investor definition.

This disparity unfairly harms private sector workers, as demonstrated by the private equity returns that the public sector enjoys. The American Investment Council, which advocates for private equity, issues a report each year detailing the returns pension funds earned on their private equity investments.[36] A recent report found that for each of the prior seven years, private equity was the highest-performing asset class for public pensions.[37] The vast majority—ninety-one percent—of public pension funds were exposed to private equity investments.[38] The report found a 10-year annualized return of 10.2% for private equity, higher than the 8.5% return that accrued to public equity.[39]

Thus, the public-school teacher who has an employer-provided pension reaps the benefits of having her retirement money invested in private equity. Ben Meng, the Chief Investment Officer of the California Public Employees' Retirement System, said "We need private equity, we need more of it, and we need it now."[40] Meng's view is likely informed by the high returns attributed to private equity: "Private equity has been the

[36] *Private Equity Powers Public Pension Portfolios*, CHIEF INV. OFFICER (Aug. 28, 2019), https://www.ai-cio.com/news/private-equity-powers-public-pension-portfolios/. *See generally*, AM. INV. COUNCIL, https://www.investmentcouncil.org/ (last visited April 15, 2021).

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] Heather Gillers, *Calpers Wants to Double Down on Private Equity*, WALL ST. J. (Mar. 17, 2019), https://www.wsj.com/articles/calpers-wants-to-double-down-on-private-equity-11552834800.

California pension fund's best-performing asset class over the past decade."[41] In sharp contrast, the private school teacher is restricted from investing in private equity and unable to bear the risk or enjoy the returns of private equity investments.

The above example demonstrates the horizontal inequity resulting from the accredited investor standard. Similarly situated individuals are treated very differently, with public pensioners benefiting from private equity investments, while individuals with similar amounts of wealth in the private sector are unable to benefit. The accredited investor standard also results in vertical inequities, allowing the already rich to invest their money in private equity and earn the superior returns discussed above. Middle-class investors, by contrast, are shut out of the private equity market and forced to accept the often-lower returns the public markets offer. The SEC's accredited investor standard unfairly punishes middle-class retail investors.

In addition to the horizontal and vertical inequities, the accredited investor standard also fails to accomplish its intended goals. As previously mentioned, the SEC set the standard to ensure that only investors who are able "to sustain the risk of loss of investment"[42] are permitted to invest in private placements. The accredited investor definition does a poor job of ensuring investors can sustain the risk of loss.[43] For an individual to be accredited, they generally must meet one of the following two criteria:[44]

- [N]et worth or joint net worth with a spouse or spousal equivalent of at least $1 million, not including the value of his or her primary residence.
- income exceeding $200,000 in each of the two most recent calendar years or joint income with a spouse or spousal equivalent exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.45

[41] *Id.*

[42] *Concept Release on Harmonization of Securities Offering Exemptions, supra* note 16, at 32 (of the online version).

[43] *Id.*

[44] While the SEC recently added two additional categories under which individuals may qualify as accredited investors, these two new categories will only apply to a very small number of individuals. *See infra* section II(C).

[45] *Frequently Asked Questions About Exempt Offerings*, SEC. EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings/faq (last visited Apr. 12, 2021); *see also Updated Investor Bulletin: Accredited Investors,*

Such criteria amount to all-or-nothing rules which do little to ensure that investors can sustain the risk of their investments. To illustrate, an individual with a net worth of $950,000 does not meet criterion number one, so would be prohibited from investing even $100 in a private equity fund. The accredited investor standard presumes this individual cannot sustain the risk of loss of $100. In contrast, an individual with a net worth of exactly $1,000,000 would be able to invest her entire net worth in a single private equity fund. The accredited investor standard presumes that this individual can sustain the loss of her entire $1,000,000 fortune.

Likewise, someone earning $195,000 does not meet criterion number two above, and so would be prohibited from investing anything in private equity and deemed unable to sustain the risk of loss of investment. An individual earning $205,000 can invest in private equity without limitation.

In addition to ensuring that the investor can sustain the risk of loss, the accredited investor standard's purpose is to ensure that only those with "financial sophistication" are able to invest in private placements. However, criteria one and two above likewise do a poor job of ensuring that investors have the requisite financial sophistication to invest.

For example, an MBA graduate with many years of work experience in the financial sector would be prohibited from investing any savings in private equity funds, assuming his net worth is below $1,000,000 and salary below $200,000. Likewise, a lawyer who represents private equity clients would be prohibited from investing any of her own money in private equity if she earns $150,000 a year and has a net worth below $1,000,000. Even a professor of finance earning $180,000 a year teaching at a public college would not be able to invest in private placements.

In contrast, someone with a net worth above $1,000,000 due to an inheritance or even a lottery winning is permitted to invest in private equity without limit, as the accredited investor standard presumes that they

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INVESTOR.GOV (Jan. 31, 2019), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-3.

are amply sophisticated to understand the risks of private equity investing. Wealth is simply a poor indicator of financial sophistication.

Criterion number one also arbitrarily excludes the value of one's home from the net worth calculation for determining accredited investor status. Given that many Americans hold a very large percentage of their wealth in their homes,[46] this exclusion serves to significantly limit the number of investors who qualify. It also produces an odd inequity between investors who are equally well-off and equally able to sustain losses: if you choose to purchase a home as your primary residence, the amount of equity in your home is excluded from your net worth for the purposes of the accredited investor standard.

If, instead of purchasing the house, you rent the house from its current owners and invest the excess cash savings in the stock market, such stock holdings would count towards your net worth. The primary residence exclusion thus serves to arbitrarily punish homeowners while rewarding renters, even if both groups are equally sophisticated and are equally wealthy.

This treatment is especially odd given general U.S. policy towards homeownership. The home mortgage interest tax deduction, for example, exists to encourage and reward homeownership.[47] Additionally, up to $250,000 of capital gains attributed to the sale of one's primary home—and $500,000 for couples—is exempt from taxes, further rewarding those who purchase homes.[48] These policies are justified by home ownership's central place in the American dream.[49] When it comes to building wealth via investing in private placements, however, U.S. policy is completely flipped. Homeownership is discouraged and penalized via the accredited investor definition's exclusion of home value from net worth calculations, preventing homeowners from allocating their investments in line with their wishes.

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[46] *See, e.g.*, Jann Swanson, *Homeownership is the Top Contributor to Household Wealth*, MORTG. NEWS DAILY (Aug. 28, 2019), www.mortgagenewsdaily.com/08282019_homeownership.asp.

[47] Eric Toder et al., *Reforming the Mortgage Interest Deduction*, URBAN INST. (Apr. 1, 2010), webarchive.urban.org/publications/412099.html.

[48] *Topic No. 701 Sale of Your Home*, INTERNAL REVENUE SERV., https://www.irs.gov/taxtopics/tc701 (last accessed Dec. 27, 2019).

[49] *Homeownership: The American Dream*, OFF. OF POL'Y DEV. & RSCH., https://www.huduser.gov/portal/pdredge/pdr-edge-frm-asst-sec-081318.html (last accessed Dec. 26, 2019).

These limitations should be relaxed to allow more individuals to invest in private equity. To be sure, all investments have risk, and private equity investments are no exception. However, the current regulatory landscape treats private equity and other private placements in a logically inconsistent manner relative to other investment opportunities. Investing in the stock market, of course, comes with significant risks. In 2008, amid the financial crisis, the S&P 500 lost 37% of its value.[50] Individual stocks are even riskier. Despite the stock market reaching all-time highs in 2019, many individual stocks suffered horrible performances. Macy's department store company lost about 45% of its value in 2019, and Pacific Gas and Electric Company ("PG&E") lost about 54% of its value in 2019.[51] Yet, the retail investor would have been permitted to invest all his wealth in Macy's or PG&E, but none of his wealth in private equity.

Indeed, with the help of a margin account, retail investors are able to take on even more risk by investing borrowed money in a single publicly traded stock.[52] Thus, current rules allow investors to invest money they don't have, making them responsible for interest charges on the borrowed money, and leaving investors with the additional risk the investment platform will forcibly liquidate their margin stock if the stock goes down too low.[53] Still, private equity is off-limits for such investors.[54]

Retail investors can engage in additional risky transactions in the public markets.[55] Investors can short stocks if they believe the stocks will drop in value. Unlike long positions on stocks, where the initial investment limits the potential loss, the amount of potential loss on a short position is theoretically limitless.[56] One trader reportedly took a $37,000 short

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[50] *S&P 500 Total Returns*, SLICKCHARTS, https://www.slickcharts.com/sp500/returns (last visited Dec. 27, 2019).

[51] Donna Fuscaldo, *10 Worst-Performing Stocks of 2019*, NASDAQ (Dec. 23, 2019), https://www.nasdaq.com/articles/10-worst-performing-stocks-of-2019-2019-12-23

[52] *Increase Your Buying Power with Margin Trading*, TD AMERITRADE (last accessed Dec. 27, 2019), https://www.tdameritrade.com/investment-products/margin-trading.page.

[53] *Id.*

[54] *See supra* Section II(A).

[55] *Id.*

[56] *Short Selling Explained: Risks and Rewards*, ALLY (Mar. 1, 2017), https://www.ally.com/do-it-right/investing/short-selling-explained-risks-and-rewards/.

position on a pharmaceutical stock, only to have the stock increase around 800% the next day.[57] He quickly racked up a reported debt of $106,445.56 on this trade.[58] Still, despite the risks inherent in shorting stocks, these positions are readily available to the retail investor.

Outside of the securities markets, ordinary individuals can engage in a wide variety of risky—even foolish—financial behavior. Students are able to take out large debt loads courtesy of the federal government to attend college, even if they are majoring in fields of study that make it unrealistic that they will repay their loans.[59] Elisha Bokman, for example, owed approximately $500,000 in student loans eight years after graduating with a "doctorate degree in naturopathic medicine and master's in acupuncture from Bastyr University."[60] Additionally, recent data shows that six percent of borrowers owe six figures on their student loan debt.[61] The borrowing available for attending graduate school is "nearly unlimited"[62] and is not generally restricted based on expected earnings or estimated returns on investment.[63]

Individual investors are also able to take other large risks outside of the securities markets. One who wishes to invest in real estate, for example, can simply invest all his savings in property, but non-accredited investors cannot invest any money in private equity.[64] Similarly, investors who wish to invest their life savings in Bitcoin and other cryptocurrencies

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[57] Philip van Doorn, *Opinion: Why You Should Never Short-Sell Stocks*, MKT. WATCH (Nov. 27, 2015), https://www.marketwatch.com/story/why-you-should-never-short-sell-stocks-2015-11-19.

[58] Shawn Langlois, *Help! My Short Position Got Crushed, and Now I owe E-Trade $106,445.56*, MKT. WATCH (Nov. 20, 2015), https://www.marketwatch.com/story/help-my-short-position-got-crushed-and-now-i-owe-e-trade-10644556-2015-11-19.

[59] Annie Nova, *More Student Loan Borrowers Carry Six-Figure Balances*, CONSUMER NEWS & BUS. CHANNEL (July 12, 2019), https://www.cnbc.com/2019/07/12/she-owes-500000-in-student-loans-giant-balances-are-on-the-rise.html.

[60] *Id.*

[61] *Id.*

[62] Jeffrey J. Selingo, *Where Student Loan Debt Is a Real Problem*, WASH. POST (Jan. 5, 2018), https://www.washingtonpost.com/news/grade-point/wp/2018/01/05/where-student-loan-debt-is-a-real-problem/.

[63] *Id.*

[64] *See supra* Section II(A) (discussing restrictions on non-accredited investors).

can easily do so, despite the extreme volatility and high risk that are inherent in these investments.[65]

The fact that these risky or foolish opportunities exist does not mean that other foolish investment options should go without regulation. However, it does demonstrate an illogical double standard between how private equity investments are treated as compared to other, riskier strategies, some of which allow for ordinary investors to invest money they do not even have.[66]

Ultimately, the question of private equity regulation can be summed up as follows: Should the SEC forbid all retail investors from investing any money in private equity, solely because some investors will lose money on their investments if they are permitted to invest? The answer is no. The fact that some investments will not work out should not foreclose individual investors from enjoying the returns and diversification benefits that private equity offers.[67] All investments contain risks. The investor, not the SEC, should be the one to decide their own risk tolerance and make decisions accordingly.[68] Responsible options for investing in private equity exist, and responsible individuals should not be foreclosed from doing so only because some other individuals may make unwise decisions with this freedom.[69]

Importantly, the SEC's accredited investor limitations may increase the risks that retail investors must bear, undercutting the SEC's

[65] *See, e.g.,* Paul Vigna, *Bitcoin: What to Know Before Investing*, WALL ST. J. (Feb. 16, 2021), https://www.wsj.com/articles/bitcoin-what-to-know-before-investing-11613498045 (referring to Bitcoin as a "highly volatile, almost completely speculative investment"); s*ee also* Paul Vigna, *Crypto Investing Comes with a Big Risk: The Exchanges*, WALL ST. J. (Mar. 3, 2018), https://www.wsj.com/articles/crypto-investing-comes-with-a-big-risk-the-exchanges-1520078400.

[66] *See Increase Your Buying Power with Margin Trading*, *supra* note 52 (discussing the ability of retail investors to borrow money to purchase securities). Note that some money which might otherwise have been invested in private equity may be redirected to riskier investment options as a result of the SEC's accredited investor restrictions.

[67] *See supra* Section II(B) at 8–10 (discussing the importance of individual investor autonomy).

[68] *See id.*

[69] *See id.* (arguing the current state of regulation improperly limits the freedom of responsible investors).

argument that the accredited investor standard ensures that investors do not take on more risk than they can handle. Diversification is one of the most important tools of risk reduction available to the investor.[70] While any given security may be subject to very high volatility, holding a diversified portfolio of different types of securities in different sectors reduces portfolio risk.[71] This is because securities in a diversified portfolio will generally not all move in the same direction or experience the same amount of price change, allowing losses on some securities to be balanced by gains on other securities.[72]

Investors can easily and quickly diversify within the stock and bond markets, sometimes with buying just a single fund.[73] Vanguard Target Retirement 2040 Fund, for example, invests in the total U.S. stock market, total U.S. bond market, total international stock market, and total international bond market.[74] Funds like this provide quick and easy diversification for the retail investor at a very low cost.[75]

However, these funds reflect the retail investors' general limitations—namely their inability to invest in private placements.[76] Wealthy accredited investors can further diversify their investments by holding private equity investments and other private placements, but retail investors are prohibited from doing so.[77] While the extent to which private

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[70] *See, e.g.*, *The Guide to Diversification*, FIDELITY (July 30, 2019), https://www.fidelity.com/viewpoints/investing-ideas/guide-to-diversification (discussing how diversification mitigates risk).

[71] Nick K. Lioudis, *The Importance of Diversification*, INVESTOPEDIA (updated Jan. 29, 2021), https://www.investopedia.com/investing/importance-diversification/.

[72] *Id. See also The Guide to Diversification*, *supra* note 70.

[73] *Vanguard Target Retirement 2040 Fund*, VANGUARD (last accessed Dec. 28, 2019), https://investor.vanguard.com/mutual-funds/profile/VFORX.

[74] *Id.*

[75] *Id.* The Vanguard Target Retirement 2040 Fund has an expense ratio of 0.14%, meaning investors pay $1.40 annually for every $1,000 they have invested in the fund. *Id.*

[76] Bob Pisani, *Regular Investors Are Cut Out of a Major Financial Market and the Sec Chief Wants to Change that*, CNBC (Sep. 10, 2019), https://www.cnbc.com/2019/09/10/sec-chief-jay-clayton-wants-regular-investors-access-to-private-markets.html ("the Main Street investor for the most part does not have access to private markets.")

[77] *See supra* Section II(A) (discussing regulatory limitations on non-accredited retail investors).

equity provides diversification benefits has been disputed,[78] academic findings demonstrate that private equity can help diversify portfolios and improve the risk-return profiles of such investments.[79]

Further, the fact that many extremely sophisticated investors embrace private equity investments suggests that private equity can be a smart addition to one's portfolio. As mentioned earlier, 91% of public pension funds have exposure to private equity.[80] BlackRock surveyed "230 institutional clients, representing over $7 trillion in investible assets" in November and December 2018.[81] It found that 51% of institutional investors planned on reducing their exposure to equities in 2019.[82] Still, 47% of the institutional clients planned on increasing their exposure to private equity.[83]

Non-accredited investors who wish to make similar moves are forbidden from doing so by the SEC's rules.[84] Ultimately, the SEC's accredited investor definition should be relaxed to limit the inequities the current regulatory regime perpetuates. Wealthy individuals and those who have pension funds investing on their behalf take advantage of the returns and potential diversification benefits of private equity. Retail investors do

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[78] Kyle Welch, *Private Equity's Diversification Illusion: Economic Comovement and Fair Value Reporting* (Jan. 14, 2014), https://www.stern.nyu.edu/sites/default/files/assets/documents/con_045805.pdf.

[79] Francis Milner & Ed Vos, *Private Equity: A Portfolio Approach*, 5 J. OF ALT. INVS. 51 (Mar. 2003), https://www.researchgate.net/publication/229053200_Private_equity_A_portfolio_approach; *see also* Sean Duffin, *Diversification Challenges*, CAMBRIDGE ASSOCS. (Sept. 2019), https://www.cambridgeassociates.com/research/diversification-challenges/.

[80] *Private Equity Powers Public Pension Portfolios*, *supra* note 36.

[81] *Global Institutional Investors Shifting Risks from Public to Private Markets -- BlackRock Study*, BUS. WIRE (Jan. 7, 2019), https://www.businesswire.com/news/home/20190107005341/en (citing *2019 Global Institutional Rebalancing*, BLACKROCK (Jan. 2019), https://images.marketing.blackrock.com/Web/BlackRock/%7Be3477f9f-d476-40a5-9762-7756af59e97c%7D_Rebalancing_2019_Global_Summaryv_STAMPED.pdf?cid=emc:rebalancingsurveythankyou_US:122718:dm-6853&elq_mid=27484&elq_cid=1858221&elq_cmp=).

[82] *Id.*

[83] *Id.*

[84] *See supra* Section II(B).

not have such opportunities. This leaves the retail investor at a significant disadvantage, unable to partake in about two-thirds of the capital markets. While meant to help retail investors, the SEC's accredited investor limitation does more harm than good. Proposed policy changes will be discussed below.

C. *Proposed Changes to the Accredited Investor Standard*

On December 18, 2019, the SEC proposed modest adjustments to the accredited investor standard.[85] These adjustments were adopted on August 26, 2020 and became effective on December 8, 2020.[86] While the adjustments represent a small step in the right direction, they will not significantly affect most retail investors.[87] The adjustments therefore do not go far enough in relaxing the accredited investor standard.

Specifically, the adjustments allow two additional sets of individuals to qualify as accredited investors: (1) those who are licensed under Series 7, 65, and 82;[88] and (2) "knowledgeable employees of private funds."[89] The Series 7, 65, and 82 licenses "are required in order to represent or advise others in connection with securities market transactions."[90]

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[85] *Accredited Investor Definition*, 85 Fed. Reg. 64234 (Oct. 9, 2020) (codified as 17 C.F.R. 230, 17 C.F.R. 240).

[86] *Amendments to Accredited Investor Definition,* SEC. & EXCH. COMM'N, https://www.sec.gov/corpfin/amendments-accredited-investor-definition-secg (last modified Dec. 8, 2020).

[87] *Accredited Investor Definition*, *supra* note 85, at 64262. The SEC itself explained that its recent, modest changes to the accredited investor standard will not result in a significant increase in the number of accredited investors. *See id.* The SEC estimates that its change, *at the maximum*, will increase the number of accredited investors by 4.3% relative to the number of accredited investors that existed prior to the change. *Id.* This increase represents (at the maximum) only an additional 0.2% of the general population who can now qualify as accredited investors due to the change. *Id.* The actual number of newly qualified accredited investors will be lower (perhaps significantly lower) than this maximum, since many who meet the new accredited investor criteria were already accredited investors prior to the change due to their accumulated wealth or income. *See id.* Therefore, the SEC's recent changes will have a very limited impact on the pool of accredited investors. *See id.*

[88] Accredited Investor Definition, *supra* note 85, at 64237.

[89] *Id.* at 64243.

[90] *Id.* at 64242.

While those who are in categories (1) and (2) above should qualify as accredited investors, adopting only these two proposals will not significantly increase the number of retail investors who can invest in private equity.[91] Listed below are several changes to the accredited investor standard this Article recommends, all of which will relax the current threshold and allow more retail investors to participate in private equity. Many of these recommendations can be adopted together, but the recommendations can also be adopted individually if the SEC is disinclined to adopt a large relaxation of the accredited investor standard.

In its 2017 report, the Department of Treasury recommended that the accredited investor definition include those investors who received advice from a fiduciary regarding the merits of investing in a Regulation D offering.[92] The SEC should adopt this proposal. Fiduciaries are legally required to have the investor's best interest in mind for the advice they give.[93] Meeting with a fiduciary financial advisor will significantly increase the likelihood that the investor will understand the risks and rewards of the proposed investment. This proposal would expand the number of individuals with access to potentially lucrative investments in the private market, while simultaneously helping to ensure that eligible investors understand the cost-benefit analysis that applies to their investments of choice.

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[91] *Id.*; *See* Taylor Tepper, *SEC Rule Change Gives More People Access to Riskier Investments*, FORBES (Aug. 27, 2020), https://www.forbes.com/sites/advisor/2020/08/27/sec-definition-change-accredited-investor/?sh=10e1d4b21543.

[92] Steven T. Mnuchin & Craig S. Phillips, *A Financial System That Creates Economic Opportunities*, U.S. DEPT. OF THE TREASURY (Oct. 2017), https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf; *see Concept Release on Harmonization of Securities Offering Exemptions,* Release No. 5256 (June 18, 2019).

[93] *See, e.g.*, Ron Lieber, *Fiduciary Rule Is Now in Question. What's Next for Investors.*, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/your-money/estate-planning/fiduciary-rule-is-now-in-question-whats-next-for-investors.html; Aaron Back, *Eliminating Obama's Fiduciary Rule Easier Said than Done*, WALL STREET J. (Dec. 5, 2016), https://www.wsj.com/articles/eliminating-obamas-fiduciary-rule-easier-said-than-done-1480976385.

Additionally, many companies already offer their employees the benefit of access to a subsidized financial advisor.[94] If adopted, this proposal would encourage such employees to take advantage of the available financial advisors, which would have the added benefit of informing individuals as to their overall financial picture.

Current rules exclude the value of one's primary residence from the net-worth calculation used to determine eligibility for the accredited investor standard.[95] This exclusion should be eliminated as it unfairly punishes homeowners and there is little justification for excluding home value from the calculation of an individual's net worth.

Those whose educational backgrounds indicate that they are financially sophisticated should be included in the definition of the accredited investor. For example, those with MBAs or graduate-level degrees in finance, economics or related fields should be able to invest in private placements, even if they do not meet the income or net-worth thresholds currently in existence. These individuals likely have the knowledge to understand the risks and rewards of investing in private placements, regardless of income or net worth.

Finally, those who do not meet any of the above criteria and are thus not accredited investors should still be permitted to invest a limited amount of money in private placements. As an example, non-accredited investors could be limited to investing up to 10% of their income annually in private placements.[96] This would allow some investors to achieve the

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[94] *See, e.g.*, *Financial Wellbeing – An Employer Point of View*, AON GLOBAL BENEFITS 14 (July 2018), https://www.aon.com/getmedia/0ea709bd-182f-45df-9a5c-d6860f0daff5/Financial-Wellbeing-Study-Results-Events-July-2018-FINAL-DECK.aspx.

[95] 17 C.F.R. § 230.501(a)(5)(i)(A); *see also Accredited Investor Definition*, *supra* note 85, at 64273 ("[S]ince 2011, the net worth standard excludes the value of the investor's primary residence.").

[96] The SEC rejected a proposal to limit the amount of money accredited investors can invest in private placements. *Amending the "Accredited Investor" Definition*, *supra* note 25 ("Limiting investment amounts for individuals who qualify as accredited investors based solely on the current income or net worth thresholds could provide protections for those individuals who are less able to bear financial losses. For example, the Commission could consider limiting investments for individuals who qualify as accredited investors solely based on the current thresholds to a percentage of their income or net worth (*e.g.*, 10% of prior year income or 10% of net worth, as applicable, per issuer, in any 12-month period). This alternative, however, would result in a smaller pool of accredited investors, reduce capital formation, and likely increase the implementation costs

diversification benefits of holding private equity investments while still limiting the potential losses these investors are exposed to. It would also eliminate the current all-or-nothing treatment, where those just below the accredited investor requirements cannot invest any money in private equity and those just above the requirements can invest an unlimited amount of money.

Adopting some or all of the above proposals would allow many more retail investors to invest in private equity, reducing the unfair disparity between the opportunities available to the already-rich and public sector workers on the one hand and non-rich, private-sector workers on the other hand. These proposals would also allow capital to be more efficiently allocated to companies in need of funding by reducing the arbitrary limitations imposed by the current accredited investor definition.

I. PROPOSED CHANGES TO THE REGULATIONS GOVERNING THE 401(K)

Until as recently as the 1980s, pensions were the most common retirement benefit employers offered.[97] Now, most private-sector workers are no longer offered this benefit.[98] Instead, private-sector workers are generally responsible for their retirements. Workers must choose whether to save for retirement and, if so, then also decide how much to invest and what to invest in. The investment options available to the private-sector worker are often very limited and do not generally include private equity. As then-SEC Chairman Jay Clayton pointed out in an interview at the U.S. Chamber of Commerce, there is an incongruity between the investment options available to public-sector workers and those of their private sector counterparts.[99] While public-sector pension funds can invest in private

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associated with verifying an investor's status as an accredited investor and her eligibility to participate in an offering."). While the SEC was right to reject this proposal, it should consider adopting a similar proposal that would allow even non-accredited investors to invest in private equity, so long as they invest only a limited percentage of their income.

[97] James McWhinney, *The Demise of the Defined-Benefit Plan*, INVESTOPEDIA (Nov. 16, 2020), https://www.investopedia.com/articles/retirement/06/demiseofdbplan.asp.

[98] *Id.*

[99] Mark Schoeff Jr., *Clayton Wants Retirement Investors to Have More Access to Private Funds*, INVESTMENT NEWS (Apr. 9, 2019),

equity for the benefit of the pensioners, private-sector workers are generally unable to invest their retirement funds in private equity.[100]

This incongruity should be changed. Private-sector employees should be able to allocate some portion of their retirement funds to private equity. Doing so would allow retail investors to diversify their retirement holdings and obtain the market returns available to private equity investors. Doing so would also ensure that private-sector workers are no longer disadvantaged relative to their public-sector counterparts. The regulatory framework that prevents private-sector workers from investing their retirement funds in private equity is discussed below.

Workers saving for retirement have two primary tax-advantaged options: the Individual Retirement Account ("IRA") and the 401(k).[101] The "traditional" 401(k) and IRA allow workers to contribute pre-tax dollars to the account, deferring the taxes that would otherwise apply until the money is withdrawn in retirement.[102] Such deferral is a significant benefit and allows workers to invest money that they would have otherwise been required to pay to the U.S. treasury. Similarly, the "Roth" 401(k) and IRA allow workers to contribute post-tax dollars to the accounts, with the benefit that all investment gains are completely exempt from income or capital gains taxes upon withdrawal.[103] These gains can be very significant, especially for younger workers who have a long time horizon before retirement.

401(k)s are provided by employers,[104] whereas individuals open IRAs through a brokerage such as Vanguard.[105] Given the significant tax

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https://www.investmentnews.com/article/20190409/FREE/190409922/clayton-wants-retirement-investors-to-have-more-access-to-private.

[100] *Id.*

[101] *401(k) vs. IRA? Use both if you can*, VANGUARD, https://investor.vanguard.com/ira/401k-vs-ira (last visited Dec. 30, 2019).

[102] *Traditional and Roth 401(K) Plans*, SEC. & EXCH. COMM'N OFFICE OF INV. EDUC. & ADVOC., https://www.investor.gov/introduction-investing/retirement-plans/employer-sponsored-plans/traditional-roth-401k-plans (last visited Dec. 30, 2019); *Self-Directed Plans - Individual Retirement Accounts* (IRAs), SEC. & EXCH. COMM'N OFFICE OF INV. EDUC. & ADVOC., https://www.investor.gov/introduction-investing/retirement-plans/self-directed-plans-individual-retirement-accounts-iras (last visited Dec. 30, 2019).

[103] *Traditional and Roth 401(K) Plans*, *supra* note 102.

[104] *Id.*

[105] *How to Open an IRA*, VANGUARD, https://investor.vanguard.com/ira/how-to-open-an-ira (last visited Dec. 30, 2019).

benefits of these accounts, there are dollar limitations on the amount that can be contributed to these tax-advantaged accounts in a given year. In 2020, individuals could contribute up to $19,500 into a 401(k)[106] and up to $6,000 into an IRA.[107]

The 401(k) is central to many Americans' retirement plans; 58% of respondents to a Charles Schwab survey said that the 401(k) "is their only or largest source of retirement savings."[108] It is thus especially important that ordinary workers can invest their 401(k) capital in investments that will provide them with adequate returns to afford retirement.

Although the employee invests his or her own money into a 401(k),[109] the plan sponsor—the employer—decides which investment options are available to 401(k) participants.[110] However, as Travis Plunkett pointed out before a Senate subcommittee, "investors generally have very limited options" in their 401(k) plans.[111]

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[106] *401(k) Plans - Deferrals and Matching When Compensation Exceeds the Annual Limit*, INTERNAL REVENUE SERV., https://www.irs.gov/retirement-plans/401k-plans-deferrals-and-matching-when-compensation-exceeds-the-annual-limit (last visited Dec. 30, 2019).

[107] *IRA FAQs - Contributions*, INTERNAL REVENUE SERV., https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-contributions (last visited Dec. 30, 2019). Older Americans have a slightly higher contribution limit. *Id.*

[108] *401(k) Participants' Investing Behavior May Leave Them Short*, CHARLES SCHWAB, https://www.aboutschwab.com/schwab-401k-participant-study-2019 (last visited Dec. 30, 2019).

[109] Note that many employers match employee contributions up to a limit, so some of the 401(k) balance may reflect employer contributions as well; *See, e.g.*, Melissa Phipps, *What Is a 401(k) Employer Match?*, THE BALANCE (May 1, 2019), https://www.thebalance.com/what-is-a-401-k-match-2894179.

[110] *Secrets of the 401(k) Industry: How Employers and Mutual Fund Advisers Prospered As Workers' Dreams of Retirement Security Evaporated*, BENCHMARK FIN. SERVS., INC., http://www.benchmarkalert.com/Secrets-of-the-401k-Industry.pdf ("Participants in a DC [(defined contribution)] plan must determine their level of contribution and direct the investment of their own and their employers' contributions, selecting from a menu of investment vehicles that have been chosen for them. Participants have no right to determine the investment options offered within the plan or the providers of services to the plan.").

[111] *Id.* ("Travis Plunkett, Legislative Director of the Consumer Federation of America in his testimony before the Senate Governmental Affairs

401(k) plans rarely include opportunities to invest in private equity, with employers generally unwilling to offer their employees private equity investment options.[112] Pantheon's Kevin Albert, who said his "dream [was] to figure out why no one ever put private equity" in worker retirement plans, concluded that employers are fearful of being sued if they provide private equity investment options in their 401(k) plans.[113]

Such employer fears are warranted given the current landscape of 401(k) litigation. In 2016–2017, more than 100 lawsuits were filed in connection with 401(k) plans.[114] The lawsuits can be very expensive; Lockheed Martin entered a $62 million settlement in connection with litigation regarding its retirement plan, and Boeing entered into a $57 million settlement.[115] 401(k) lawsuits broadly fall into the following three categories: "1) inappropriate investment options; 2) excessive fees; and 3) self-dealing."[116]

Recently, 401(k) lawsuits have focused on allegations of excessive fees charged for plan investment options.[117] To be sure, this has caused some positive changes to the offerings in retirement plans. For example, plans are trending away from actively managed mutual funds to cheaper passively managed index fund alternatives.[118] This aligns well with general industry trends even outside of the retirement context: over a recent twelve-month period, "U.S. equity index funds took in a net $238

Subcommittee on Financial Management, the Budget and International Security."). While Travis was focusing on the limited ability of 401(k) participants to select funds with low fees, the limited options also limit the ability of the participants to invest in the types of asset and investment categories they would like. *See id.*

[112] Frances Denmark, *Private Equity Tries to Break the 401(k) Barrier*, INSTITUTIONAL INV. (Apr. 19, 2017), https://www.institutionalinvestor.com/article/b1505q632mxb1s/private-equity-tries-to-break-the-401k-barrier.

[113] *Id.*

[114] George S. Mellman & Geoffrey T. Sanzenbacher, *401(k) Lawsuits: What Are The Causes And Consequences?*, CTR. FOR RET. RSCH. AT B.C. 1, 2 (May 2018), https://crr.bc.edu/wp-content/uploads/2018/04/IB_18-8.pdf.

[115] David McCann, *Passive Aggression*, CFO (June 22, 2016), https://www.cfo.com/retirement-plans/2016/06/passive-investment-aggression/.

[116] Mellman & Sanzenbacher, *supra* note 114, at 1.

[117] *Id.*

[118] *See id.* at 4–5.

billion in inflows" while "[a]ctive U.S. equity funds reported $210 billion in outflows."[119]

Active funds have been struggling to beat their passive counterparts: "Success rates [for actively managed funds] are well below 50% in most categories."[120] It thus makes sense that investors are refusing to pay the higher actively managed fees for returns that are below expectations.

However, as discussed earlier and below, investing in private equity often provides returns higher than those of the public equity markets. Sophisticated public pension managers see the benefits of private equity investments and invest retirement funds on behalf of pensioners in such funds. Private sector workers should likewise be able to do so.

The inability of private sector workers to invest their retirement funds in private equity adversely impacts their returns and makes it less likely that the average worker will be able to afford retirement. The Institute for Private Capital has found that: "Returns are consistently higher for portfolios that incorporate private equity funds;" and "[r]isk is consistently lower for portfolios that include buyout funds."[121] This holds true even after accounting for the additional fees that accrue to private equity.[122] While increasing the returns of a portfolio usually requires taking on additional risk,[123] adding private equity to an existing public equity portfolio may reduce risk while still increasing return.

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[119] Daren Fonda, *Stock Pickers Are Still Losing Money to Index Funds. Here's Why.*, BARRONS (Oct. 21, 2019), https://www.barrons.com/articles/outflows-inflows-active-passive-stock-funds-51571439212.

[120] *Id.*

[121] Gregory Brown et al., *Why Defined Contribution Plans Need Private Investments*, INST. FOR PRIV. CAP. (Oct. 2019), https://cdn.northerntrust.com/pws/nt/documents/asset-servicing/why-defined-contribution-plans-need-private-investments.pdf.

[122] *Id.* at 17 ("The results are provided in Table 6 and show that the diversified portfolio returns are dampened slightly by fees (as expected) but continue to outperform the all-public benchmark portfolio.").

[123] *Risk and Return*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/risk-and-return/ (last visited Dec. 31, 2019).

Additionally, investing in private equity in retirement accounts helps mitigate one of the possible downsides of private equity investments: lack of liquidity. The nature of the private equity cycle means that private equity investments are usually illiquid for a period of time.[124] Such illiquidity means investors may pay less money relative to a similar asset that is fully liquid.[125]

In the 401(k), such illiquidity should not present the same downside as would be present in other contexts. Individuals saving for retirement often have an extremely long time horizon for their investments. Many experts recommend starting to save for retirement during one's 20s.[126] For individuals with a 40-year time horizon, a relatively small period of illiquidity of a few years should not present too much of an issue.

In fact, the illiquidity of private equity may turn out to be a benefit in the context of the 401(k). A recent article on 401(k) investments defined cash-out leakage as "the voluntary, premature withdrawal of tax-qualified retirement savings following a job change, and prior to normal retirement age, which results in the payment of taxes and penalties."[127] Cash-out leakage was called a "silent crisis that unnecessarily robs millions of Americans of a comfortable, timely or secure retirement."[128] Up to six million people cash out their retirement accounts in a given year.[129] About two-thirds of such withdrawals are for non-emergencies and could have been avoided.[130]

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[124] *Private Equity Funds: The Cost of Cashing Out*, VOX (last visited Dec. 31, 2019), https://voxeu.org/content/private-equity-funds-cost-cashing-out.

[125] Aswath Damodaran, *Marketability and Value: Measuring the Illiquidity Discount,* STERN SCH. OF BUS. 33 (July 2005), available at http://people.stern.nyu.edu/adamodar/pdfiles/papers/liquidity.pdf.

[126] *See, e.g.*, *Ultimate Guide to Retirement*, CNN MONEY, https://money.cnn.com/retirement/guide/basics_basics.moneymag/index.htm (last visited Dec. 31, 2019); Steven Richmond *Why Save for Retirement in Your 20s?*, INVESTOPEDIA (Nov. 12, 2020), https://www.investopedia.com/articles/personal-finance/040315/why-save-retirement-your-20s.asp.

[127] Thomas Hawkins, *Why 401(k) 'Cashout Leakage' is a Crisis*, 401K SPECIALIST (July 9, 2019), https://401kspecialistmag.com/why-401k-cashout-leakage-is-a-crisis/.

[128] *Id.*

[129] *Id.*

[130] *Id.*

Having a portion of one's savings in illiquid private equity may discourage individuals from prematurely raiding their retirement accounts, mitigating some of the problems of early withdrawals. Additionally, to the extent that private equity investments trade at a discount due to their illiquidity, retirement savers will be able to benefit from the discounted offerings. The long time horizon of retirement savers means that the lockup period should not be too significant of a downside, while the liquidity discount will allow investors to invest for less.

Despite the benefits of investing retirement funds in private equity, the nature of the existing 401(k) regime means that employers have little incentive to offer private equity investment options in their retirement plans, and adequate reason to avoid doing so. The greater returns private equity has offered in recent years would benefit employees only, not employers, because it is the employees who invest their money via the 401(k) plans.[131] From the employer's perspective, adding private equity will simply expose the employer to litigation alleging that the fees charged by private equity firms are excessive. The cost-benefit analysis would too often lead the rational employer to refuse to add private equity options to their retirement plans, even if it leaves their employees worse off.

The retirement regulatory regime unnecessarily creates large amounts of uncertainty for employers who offer retirement accounts, leaving them guessing as to how to comply with the law. The Employee Retirement Income Security Act of 1974 ("ERISA") governs retirement accounts and is enforced by the Department of Labor ("DOL").[132] As the American Bar Association points out:

> Complying with ERISA is no easy task given the complexity of the statute and the continuing rapid development of the law due to a number of factors. Difficulty in meeting your fiduciary duties stems from fact-intensive circumstances and the law may vary depending on the particular area of the country (jurisdiction) within which a lawsuit is brought.[133]

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[131] Note that it is conceivable that employers may obtain some indirect benefit, for example, if employee satisfaction and retention move in a positive direction because of a better retirement plan.

[132] Mellman, *supra* note 114, at 2.

[133] José M. Jara, *ERISA: Thou Shall Not Pay Excessive Fees!*, AM. BAR ASS'N (Winter 2019),

While the DOL can help mitigate some uncertainty by issuing guidance to retirement plan administrators, it has chosen a different path: "[I]nstead of issuing specific guidance on how plan fiduciaries should act—such as providing concrete factors to consider in determining whether fees are reasonable—it has tended to 'regulate by enforcement' after the fact."[134] Thus, "[F]iduciaries are often left to guess what practices comply with ERISA and may only become aware of an alleged violation from a DOL investigation or a lawsuit."[135]

This approach should be reversed. The DOL should strive to create as much certainty as it can for employers without harming the worker-participants. Otherwise, employers are heavily disincentivized from providing new investment options in their retirement plans. DOL should be encouraging innovation that will help workers, instead of penalizing employers who provide their employees with diverse investment options. Much like the SEC's accredited investor standard, the DOL's actions—meant to help workers—instead harm workers by reducing the retirement options available to them.

DOL very recently published a letter stating that the offering of a private equity investment option in a retirement account *could* conceivably comport with a fiduciary's ERISA requirements.[136] Still, even with such DOL guidance, the state of ERISA with respect to private equity has been correctly characterized as "vague."[137] ERISA's vagueness results in significant uncertainty and discourages employers from offering private equity investment options to their workers.[138]

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https://www.americanbar.org/groups/real_property_trust_estate/publications/ereport/rpte-ereport-winter-2019/erisa--thou-shall-not-pay-excessive-fees-/.

[134] Mellman, *supra* note 114.

[135] *Id.*

[136] Department of Labor, *Information Letter*, DEP'T OF LAB. (June 3, 2020), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020

[137] "The novel nature of these funds, vague standards set out by caselaw and the DOL, and availability of low risk well performing alternatives will likely lead to less sophisticated employers avoiding PE for a long time to come. Most employers, especially in during the current business conditions, simply have more pressing things to address with their operations." Joe Schick, *Private Equity in Your 401(k): Analyzing Recent DOL Guidance*, U. Cin. L. Rev. (Oct. 29, 2020), https://uclawreview.org/2020/10/29/private-equity-in-your-401k-analyzing-recent-dol-guidance.

[138] Mellman and Sanzenbacher, *supra* at note 114.

There are many possible approaches the DOL can take to reduce ERISA's uncertainty. One approach is the creation of conditions that, when satisfied, results in a presumption that the employer has met its fiduciary duties. For example, if multiple extremely sophisticated investors have invested in a fund, it is reasonable to assume that the fees for such investments are not excessive. If Yale University's endowment and the California Public Employees' Retirement System both invested in a private equity fund, it is highly unlikely that the fees these entities paid are excessive, and a presumption can be created to that effect.

There have also been some innovative private equity funds introduced to encourage the adoption of private equity plans in retirement accounts. Pantheon, for example, introduced a private equity fund which eschews the typical management fee, and instead charges only a performance-based fee.[139] Further, the performance fees are not paid until the fund beats the S&P 500.[140] Additionally, Partners Group has introduced a private equity fund with liquidity – unusual for private equity funds.[141]

Private equity has a large incentive to create fund structures that allow it to appeal to retirement account holders, providing the industry with a new source of investment. The DOL should encourage innovative solutions that benefit workers instead of perpetuating a system of regulatory uncertainty and litigation threats that reduce the investment opportunities available to middle class workers.

II. THE CARRIED INTEREST TAX TREATMENT

In addition to the changes to the accredited investor standard and the retirement regulatory system discussed in Parts II and III, this Article recommends another change to the regulatory regime governing private equity firms: the repeal of the carried interest tax break. This repeal will raise revenue and allow for a political compromise to increase the

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[139] Frances Denmark, *Private Equity Tries to Break the 401(k) Barrier*, INSTITUTIONAL INV. (April 19, 2017), https://www.institutionalinvestor.com/article/b1505q632mxb1s/private-equity-tries-to-break-the-401(k)-barrier.

[140] *Id.*

[141] *Id.*

likelihood that this Article's recommendations in Parts II and III are adopted.

Broadly speaking, the tax code treats ordinary income and capital gains very differently. Ordinary income, such as salary, is taxed at a maximum marginal tax rate of 37%.[142] By contrast, long term capital gains, meaning "appreciation on [capital] assets held for more than one year," are taxed at a maximum rate of 23.8%.[143]

Many justifications have been offered for the lower capital gains rates. Some argue that taxing capital gains at lower rates encourages individuals to invest their money, resulting in job creation and greater economic growth.[144] Some of the gains received upon the sale of a capital asset represent asset appreciation due to inflation. Thus, it is argued that such gains do not represent gains in real terms and should not be taxed.[145] The lower tax rate helps account for such inflation gains.[146] Furthermore, because capital gains taxes are only imposed once the asset in question is sold, there is an incentive for individuals to hold onto their assets instead of selling them, thus deferring their tax burden.[147] The lower capital gains rates can help counteract such lock-in effects by reducing the amount of taxes owed upon the sale of a capital asset.[148]

Private equity firms generally receive management fees and performance fees.[149] Management fees are charged based on a percentage of assets under management—often amounting to 2% of assets.[150] Performance fees are charged based on the returns accruing to the private

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[142] Scott Eastman, *Is Increasing the Capital Gains Tax Rate the Right Way to Generate Revenue?*, TAX FOUND. (Mar. 14, 2019), https://taxfoundation.org/capital-gains-tax-rate-increase-generate-revenue/.

[143] *Id.*

[144] *Is It Fair to Tax Capital Gains at Lower Rates Than Earned Income?*, WALL STREET J. (Mar. 1, 2015), https://www.wsj.com/articles/how-should-capital-gains-be-taxed-1425271052

[145] *Id.*

[146] *Id.*

[147] *Id.*

[148] Michael Graetz, Deborah Schenk, & Anne Alstott, *Federal Income Taxation, Principles and Policies* 570 (8th ed. 2018).

[149] Matthew Johnston, *Carried Interest: A Loophole in America's Tax Code*, INVESTOPEDIA (Dec. 3, 2019), https://www.investopedia.com/articles/investing/102515/carried-interest-loophole-americas-tax-code.asp

[150] *Id.*

equity firm's investments.[151] Such performance fees—known as carried interest—often amount to 20% of the returns above a specified level of return.[152]

While the 2% management fees are taxed at the usual ordinary income rates, the 20% carried interest fees are taxed at lower capital gains rates.[153] Carried interest could instead be taxed at ordinary rates, not at the capital gains rates.

The usual justifications for the low capital gains tax rates do not seem to apply to carried interest.[154] Unlike the usual investor to whom capital gains rates apply, private equity managers are not primarily investing their own money into their funds.[155] Rather, it is the money of the outside, limited partner investors that is invested.[156] Unlike the investor who invests his own money in public company stock or in the purchase of a private company, private equity managers have limited downside risk because the money under management is not their own.[157]

Carried interest is like the bonus paid to law firm associates or investment bankers based on their performance during a given year.[158] Such bonuses are taxed at the ordinary tax rate.[159] Although performance-based, they in essence represent additional wages paid.[160]

Financial advisors who provide individuals with advice as to how to invest their money are likewise taxed at ordinary rates.[161] Private equity managers, who invest money on behalf of clients, could be taxed the same way.

Over the years, there have been bipartisan calls to eliminate the carried interest preferential treatment. President Biden supports

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[151] *Id.*
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id*.
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] 26 U.S.C. § 1 (2019)..

eliminating the carried interest tax break,[162] as did President Trump.[163] President Obama and Jeb Bush likewise support eliminating the tax break.[164] Bernie Sanders and Elizabeth Warren also agree that the tax break should be repealed.[165]

The Congressional Budget Office estimates that eliminating the carried interest tax break would raise $14 billion over ten years.[166] Still, the carried interest tax treatment lives on, in part due to the successful efforts of private equity lobbyists when the tax treatment was close to being repealed.[167]

III. CONCLUSION

This Article argues for three changes to the regulation of private equity: (1) the accredited investor standard should be relaxed to allow retail investors to invest in private equity; (2) the Department of Labor should issue clear guidance that will provide certainty to the retirement regulatory system, making it easier for employers to provide private equity investment options in 401(k) plans; and (3) the carried interest tax break that private equity enjoys should be repealed.

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[162] Joe Light, *One of the Most Hated Tax Breaks in America Just Won't Die*, BLOOMBERG (June 3, 2019), https://www.bloomberg.com/news/articles/2019-06-03/one-of-the-most-hated-tax-breaks-in-america-just-won-t-die

[163] Adam Lewis, *Donald Trump Pledges to Finally Roll Back Carried Interest Loophole*, PITCHBOOK (May 21, 2019), https://pitchbook.com/news/articles/donald-trump-pledges-to-finally-address-carried-interest-loophole.

[164] Katy Osborn, *This is the Tax Loophole Obama, Bush, and Trump All Want to Close*, MONEY (Sept. 16, 2015), https://money.com/tax-loophole-carried-interest/

[165] Light, *supra* note 162.

[166] Hazel Bradford, *Congress Revives Carried Interest Debate*, PENSIONS & INVS. (Mar. 14, 2019), https://www.pionline.com/article/20190314/ONLINE/190319916/congress-revives-carried-interest-debate.

[167] *See, e.g*, Alan Rappeport, *Trump Promised to Kill Carried Interest. Lobbyists Kept it Alive.*, N.Y. TIMES (Dec. 22, 2017), https://www.nytimes.com/2017/12/22/business/trump-carried-interest-lobbyists.html; Kevin Drawbaugh, *Obama, Edwards Hit Lobbyists on Private Equity Tax*, REUTERS (Oct. 9, 2007), https://www.reuters.com/article/us-privateequity-congress/obama-edwards-hit-lobbyists-on-private-equity-tax-idUSN0942219020071009.

Enacting these changes will help the retail investor prepare for retirement, increase the efficiency of our capital markets, and reduce the inequities in our tax system. Further, tackling these three issues together may provide for a political compromise, which will increase the likelihood of these changes occurring. Republicans, who generally oppose tax increases on businesses, will get the benefit of a less-regulated capital market system. Democrats, who often oppose deregulation, will get the benefit of a tax increase on the wealthy. Private equity, which has successfully fought off the repeal of the carried interest preferential treatment, may not strongly oppose such a repeal if it is coupled with other changes that will help the industry. At the same time, the retail investor—and, by extension, the economy as a whole—will be better off.