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Private Wealth for Private Equity Markets

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Around half of total global assets under management are held by individual investors, yet less than a fifth of this capital is allocated to alternative assets.[1] Private equity managers are hoping to change that. We examine why managers are focused on raising more capital from individuals and retirement plans, and how they are navigating the regulatory and operational complexities that come with securing funding from these new investor pools.

Alternative assets have never been an obvious option for private investors and workplace retirement plans—but things are changing.

Historically, the illiquid fund structures and minimum check sizes in the alternative asset space have left limited scope for individuals to invest in alternative asset strategies. But according to Boston Consulting Group and iCapital research, high-net-worth-individual allocations to private equity, for example, are expected to reach US$1.2 trillion by 2025—2.4x greater than the levels recorded in 2022.[2]

This push to "democratize" private equity has come from individual investors as well as managers. For the latter, unlocking investment from the private wealth and retirement segments is seen as the next driver of growth for an asset class that has traditionally relied almost exclusively on institutional investment.

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>
> *—Bob Rivollier, Private Equity*

As the institutional market matures, however, investment from individuals will be crucial for sustaining the industry's upward trajectory. According to analysis from Bain & Company, individual wealth invested in alternative assets is expected to grow at a rate of 12% per annum until 2032, outpacing the 8% per annum rise forecast for institutional allocations, albeit from a smaller base.[3]

The world's largest alternative asset managers have already signaled their determination to tap into this private wealth opportunity. Bain & Company reports that Blackstone sees potential to more than double its retail capital base from US$200 billion to US$500 billion, while KKR expects between 30% and 50% of new capital raised in the coming years to come from the private wealth space. Smaller firms are also reappraising their fundraising strategies to take private wealth into account.[4]

Individual investors themselves, meanwhile, noting the returns investments in alternative assets have delivered over the last decade, have a strong appetite to build their exposure in this space. According to research by Hamilton Lane, private equity and private credit strategies outperformed global public equity and public credit markets in 19 of the 20 years between 2001 and 2021, while portfolios with higher private equity and real estate allocations have beaten traditional 60/40 portfolios (split between equities and bonds) by almost two percent per year.[5] Individual investors have missed out on this performance and are eager to gain access to alternative strategies.

"On the private equity side, there is a tremendous focus on fundraising from individual investors, particularly in current markets where fundraising from institutional investors has dropped off during the last year. When it is harder to raise funds from institutional investors, the retail investor base offers an additional pool of money that is obviously very, very appealing," says Ropes & Gray private equity transactions partner **Bob Rivollier**. "If you look at investment opportunities from the perspective of the individual investor, the number of public companies has roughly halved during the last 20 years, and there has been limited opportunity for individuals to diversify their portfolios and gain exposure to companies earlier in their growth cycles, before they may go public. There is genuine appetite from individual investors to change that."

Routes to market

In the U.S. and Europe, there are some pathways in place for managers to reach individual investors, although still within limited parameters.

In the U.S., public and private securities regulations were updated in the 1990s to allow individual investors with investments of US$5 million or more to gain qualified purchaser status and make allocations to alternative assets.

Michael Doherty, Ropes & Gray asset management partner and registered funds practice co-head, says that during the last decade "an ecosystem of feeder

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funds has emerged to pool together capital from these qualified purchasers and then make allocations to alternative asset funds via feeder vehicles."

"Feeder fund service providers can deal with hundreds of retail investors, but from the sponsor's perspective, the feeder is like a single limited partner. The technology has become more scalable and basically allows that pooling to be done on a more efficient basis," Doherty says.

Business development companies (BDCs) and interval funds provide other routes for U.S. investors into various alternative assets, including investors who are not "qualified purchasers."

BDCs are unregistered, closed-end investment companies conceived by the U.S. Congress in the 1980s. They are designed to allow retail investors to direct capital into private small- and medium-sized U.S. businesses. The underlying portfolios of BDCs are generally illiquid, but the BDCs themselves can be listed on stock exchanges or set up to offer quarterly repurchase offers, providing some liquidity for investors.

Interval funds, meanwhile, combine characteristics of open-end and closed-end funds. They are not publicly traded but do provide investors with liquidity through periodic repurchases, usually at either monthly or quarterly intervals.[6]

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In Europe, the eligibility criteria for individual investors to invest in alternative assets varies between jurisdictions, but a general principle is that individuals must demonstrate not just a certain level of wealth, but also sufficient investment expertise.

"Thresholds will vary from country to country in Europe, but generally you have to be of a certain wealth and of a certain sophistication in order to be playing at the moment," says **Tom Alabaster**, Ropes & Gray asset management partner and head of the firm's EMEA funds practice. "There is a certification regime in Europe to classify yourself as an eligible investor. You must be able to evidence that you have some experience in private equity, for example, or have worked in the industry for a certain period. You can't just decide that you're going to go and invest in a private equity fund."

For eligible European investors, the main routes to market have been via independent financial advisers and private banks, which offer access to alternative assets either through products structured by large managers, or via third-party providers that specialize in tapping into retail and private wealth via feeder fund structures.

"One of the issues with the European regime is that there isn't an EU-wide marketing passport for retail investors investing in mainstream private funds," says **Eve Ellis**, Ropes & Gray asset management partner specializing in financial services regulation. "As such, managers need to look at things on a country-by-country basis. This may change with the updates to the European Long Term Investment Fund regime, which

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does provide more flexibility for marketing to retail investors," says Ellis.

"The growth in the number of third-party providers is a significant development. They have taken the burden of accessing retail investors off the managers themselves. They are specialists that know what they're doing and have the relationships with the private banks and other distributors," Alabaster says. "The space is constantly evolving, and we have seen some feeder funds structured as semi-liquid funds that offer redemptions on an annual or semi-annual basis. We see constant experimentation with the types of products that work for individual investors. Everyone is exploring how to realize capital faster than in the traditional institutional fund area."

Unlocking retirement capital

In addition to sourcing capital directly from individuals, managers are also exploring ways to tap into defined contribution pension fund capital. Some progress has been made in this area.

In 2020, the U.S. Department of Labor (DOL) published an Information Letter advising that 401(k) defined contribution retirement plan fiduciaries should be able to offer an alternative assets allocation component to individuals, although it issued a subsequent statement cautioning fiduciaries not to interpret its initial letter as endorsement of these strategies.[7]

In the UK, meanwhile, *Pitchbook* reports that defined contribution pension plans allocate less than 1% of their assets to unlisted businesses. Looking ahead, it is hoped that a deal between the UK government and the country's largest defined contribution pension schemes will see plans invest up to 5% of default funds (investments that individuals do not select themselves) in unlisted equities by 2030.[8]

These developments are promising, but sponsors and defined contribution retirement plans are still testing the waters. There is a long way to go before managers will be able to raise capital from defined contribution pension schemes at scale.

A delicate balancing act

Although various frameworks already provide sponsors with pathways into the retail and private wealth markets, accessing these new pools of individual capital presents significant operational and regulatory challenges.

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Managing large numbers of individual investors with certain liquidity expectations requires a very different skill set and approach to investor relations when compared to working with smaller cohorts of sophisticated institutional investors with longer-term investment horizons. Managers and advisers must also navigate material litigation risk when seeking capital from retirement plans and retail investors.

Joshua Lichtenstein, Ropes & Gray ERISA and benefits partner and head of the firm's ERISA fiduciary practice, says litigation has proven a major deterrent for 401(k) fiduciaries when considering offering members allocations to alternative assets.

"There aren't really any regulatory hurdles to a plan sponsor of a 401(k) plan offering access to private equity. There is actually a clear playbook for how it can be done, but we're not seeing it in any large numbers," Lichtenstein says. "The main reason for that, more than anything, is that there is an incredibly active plaintiffs' bar that brings class action lawsuits against plan sponsors and plan fiduciaries based on a number of things, including claims that an investment product offered to plan participants charged excessive fees. When it comes to private equity markets, there is just no getting around that the fee load is going to be higher than for a passive exchange traded fund."

"Raising funds through a feeder or third-party distributor can give rise to a host of potential practices that may become the focus of scrutiny by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)," says **Eva Carman**, managing partner of Ropes & Gray's New York office and co-head of the firm's global securities and futures enforcement practice. "Those areas include those associated with marketing and sales practices. In this context, managers and broker-dealers that sell the managers' products are well served assessing these potential risk areas early to address them through policies, procedures and trainings so that when the SEC or FINRA inevitably does come in for an exam or investigation, they will be ready," Carman says.

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"Both the SEC and FINRA are laser-focused on sales by broker-dealers in the retail channel," says **Brynn Rail**, Ropes & Gray asset management partner and leader of the firm's broker-dealer team. "Broker-dealers that sell alternative products to retail investors should consider carefully whether they are making recommendations and thereby triggering the SEC's Regulation Best Interest (Reg BI), which requires a broker-dealer to act in the best interest of its retail customers. These broker-dealers should also be familiar with state standards of care requirements, as more states seek to enforce their own unique standards of care, which differ from, and can be more onerous than, the SEC's best interest standard," Rail says.

Finding solutions

Managers remain in the very early stages of coming to grips with these obstacles and testing which structures present the best routes to market, address the liquidity requirements of retail and retirement investors, and reduce downside litigation and regulatory risk.

Lichtenstein adds that, on the retirement side, new guidance and legal developments have also helped to smooth the way.

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"The 2019 SECURE Act created what is known as a pooled employment plan ("PEP"). These are plans that allow a 401(k) plan sponsor to hire a vendor to handle everything related to the plan, including the investment menu design, which can offer alternative asset exposure," Lichtenstein says. "If you choose a PEP that provides alternative assets access, there are multiple levels of independent professional fiduciaries between the decision to include that product and the plan sponsor, so that can help to limit the liability risk."

Lichtenstein adds that the "ESG rule," introduced by the DOL at the end of 2022, could also help to reduce litigation risk associated with 401(k) private capital allocations.

"The rule basically outlines that fiduciaries can invest in anything so long as they go through an appropriate process and determine that the investment option offered is in the best financial interests of the plan's participants," Lichtenstein says. "It also says that when plan participants express a desire to have access to certain asset classes, plan participant wishes can form part of the decision-making process. That is coming within the context of the ESG rule, but it doesn't solely relate to ESG and could also apply to alternatives or any other asset classes."

Alternative asset managers still have a long way to go to deliver on the vast potential that retail, private wealth, and defined contribution retirement plans hold for the industry. But momentum is building, and these pools of capital will become increasingly important for the industry's long-term growth.

"The retirement side is definitely an area that private equity firms are actively pursuing. Sometimes it's been more off and on, but in the last few years I'd say that it's been more sustained. When these products really, truly get cracked and we start seeing them more frequently, my expectation is that this goes from a novel product to include in a 401(k) plan into something that's commonplace," Lichtenstein says.

Rivollier concludes: "There is no denying that there are regulatory and practical hurdles to work around, but there's a huge pool of capital out there that is untapped and that private equity firms can access if the stars align. We're at the beginning stages of what is a tremendous opportunity."

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Private equity managers are exploring ways to raise capital from individual investors and defined contribution pension plans with more intensity and focus than ever before.

It is easy to see why. As institutional investor alternative asset programs mature, managers will have to find new pools of investors to sustain the industry's growth trajectory. Private wealth and workplace retirement plans present the next frontier for private equity markets expansion.

Managers, however, have yet to fully capitalize on these untapped pools of capital. Minimum check sizes and a reluctance to grapple with the costs and complexities of marshalling large cohorts of individual investors—as well as finding ways to offer individuals some form of liquidity—have deterred many managers in the past.

Managers also continue to face regulatory and litigation risk when distributing products through private banks and feeder funds. Moreover, workplace pension plan fiduciaries have been wary about the risk of lawsuits when adding alternative asset strategies to their allocation offerings.

However, the industry is determined to find a way forward. Managers are exploring all options and testing the waters for the best structures to raise funds from individuals and workplace pension plans.

Even with complexities and obstacles to deal with, the opportunity is now simply too big and too important to ignore.

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ENDNOTES

[1] https://www.bain.com/insights/why-private-equity-is-targeting-individual-investors-global-private-equity-report-2023/. See par 2.

[2] https://www.businesswire.com/news/home/20220301005877/en/BCG-and-iCapital%C2%AE-Report-Finds-HNWI-Investment-in-Private-Equity-Will-Rise-to-US1.2-Trillion-by-2025

[3] https://www.bain.com/insights/why-private-equity-is-targeting-individual-investors-global-private-equity-report-2023/. See fig. 2.

[4] https://www.bain.com/insights/why-private-equity-is-targeting-individual-investors-global-private-equity-report-2023/. See par 8.

[5] https://www.hamiltonlane.com/en-US/Insight/7ae66cad-f78a-4d8e-ba37-8ea60c09a522/Beyond-60-40-Allocating-to-Private-Markets

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[7] https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020-supplemental-statement

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