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COMMENTARY & ANALYSIS | RETAIL WHOLESALE , MONTHLY MAGAZINE , TOP NEWS NORTH AMEI

Will Regulatory Rule Dash Private Equity's Retail Dreams?

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By

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Updated Oct. 2, 2017 2:19 p.m. ET

Private equity has had many false starts trying to get its retail-investing strategy right, but the industry finally looks up to speed. A new rule, however, may add a dose of friction.

Firms have spent years trying to perfect the formula for reaching retail investors, aiming to unlock the huge amount of capital held by individuals wealthy enough to back alternative assets. After plenty of fiddling to find the best distribution model, however, private-equity firms—or at least the largest ones—are soaking up a huge amount of retail capital.

Blackstone Group LP, for instance, now gets about 15% of its inflow from retail investors, while KKR & Co. gets 10% to 15%, executives of the firms said on recent earnings calls. Carlyle Group LP's proportion is even higher, with about 22% of its inflow coming from retail investors as of June 30, more than from sovereign-wealth funds and endowments combined.

Estimates of private equity's overall retail fundraising can be hard to come by due to the fragmentation of the market, but a survey of retail-distribution intermediaries by the Money Management Institute and Dover Financial Research found that private-equity assets at wirehouses more than doubled from 2013 to 2016, to $46 billion, with 50% growth last year.

Even as private equity's retail-distribution strategies start to bear fruit, the fiduciary rule, a Labor Department regulation that went into effect in June, is forcing firms to step carefully. The rule expands the liability of organizations that market and advise on retirement investments, making it potentially dangerous to sell risky investments such as private-equity funds.

There is confusion about how, and whether, the rule will be applied—it isn't yet being enforced, and further delays and exemptions are likely—but when it kicks in, anybody who offers advice on investing retirement assets will have the responsibilities of a fiduciary. Private equity doesn't take 401(k) money, but it does accept money from individual retirement accounts of wealthy retail investors, which could expose firms—and advisers that funnel money to them—to litigation risk, lawyers said.

The rule ultimately "could affect the amount of money that comes in" to private equity, said Josh Lichtenstein, an attorney at Ropes & Gray LLP. Marketing a fund to a retail investor with an IRA "could cause you to be viewed as acting as a fiduciary," he said. "And if the fund doesn't do well, then you could be viewed as breaching your fiduciary duty." Private-equity firms that accept IRA cash could be sued by individual investors who lose money, said Mr. Lichtenstein, or a government agency could determine they've made a prohibited transaction and take action.

It isn't known exactly how much IRA money is in private equity, but experts agree it is growing and that the fiduciary rule could crimp it.

Tom Anderson, president of the Retirement Industry Trust Association, a trade group representing custodians of self-directed IRA assets, said his group's members have a combined $90 billion under custody, of which about 10% is invested in private equity. The amount in private equity rose by 11% in 2016 from the year before, he added.

Firms are working around the fiduciary rule in different ways, while waiting to see how the DOL will ultimately decide to enforce it. Firms need to be cautious about dealing directly with IRA investors and instead try to deal with retail investors only through an independent fiduciary, such as an adviser or a private bank, lawyers said.

However, some advisers and banks are reluctant to take on the litigation risk of being an independent fiduciary, or may want to increase the fees they charge to compensate for it, said Bruce Simonetti, a partner at law firm Akin Gump Strauss Hauer & Feld LLP. Ultimately, the greater litigation risk may make it too expensive for some retail investors to tap into private equity.

Some custodians are trying to push the Labor Department to modify the rule to give a carve-out so that wealthy investors can put IRA cash into alternatives, said Curtis Glovier, chairman and chief executive of Pensco Trust Co. Private equity makes up 68% of Pensco's $16 billion in assets under custody, up from 51% at the end of 2013.

The rule was established to ensure brokers and advisers don't give conflicting retirement advice, Mr. Glovier said. Stifling IRA investment in private-equity funds is an unintended consequence of the rule he thinks should be changed.

"Most people don't think it was set up to limit a PE fund's ability to go to sophisticated retirement investors and market [its] fund," he said.