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HOW PUBLIC PENSION PLANS HAVE SHAPED PRIVATE EQUITY

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Private equity is one of the most important asset classes in the global investment marketplace. The rise of private equity over the past two decades has been fueled in significant part by public pension plans. Historically, these institutions avoided alternative investments, but today public pension plans are collectively the largest investors in private equity funds.

In this Article, I identify several ways in which public pension plans have shaped the modern private equity industry, using the SEC's three-part mission as an analytical framework. First, public pension plans have complicated the orderliness and efficiency of private equity contracting by introducing several distinctive non-market incentives and requirements to the industry. Second, large-scale investment in private equity by public plans has also increased the number of ordinary people who are impacted by private equity fund performance. Over the years, the SEC has repeatedly pointed to public pension plans—which manage the retirement assets of teachers, firefighters, and other public servants—as an investor protection-based justification for its expanded regulatory presence in private equity. Third, the massive flow of public pension capital to private equity over the years has also had important implications for capital formation dynamics and the distribution of bargaining power in the private equity industry.

For all these reasons, private equity is far more public than is commonly understood. Even though private equity funds are considered "private funds" under the federal securities laws, public pension plans have left a deep imprint on how the industry operates, and the industry's operations have enormous consequences for the fiscal health of states and localities across the country.

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INTRODUCTION

Private equity's biggest backers are public pension plans. Sometimes held up as an elite private contracting setting,[1] the $4.5 trillion private equity industry[2] is actually funded in significant part by capital that comes from public retirement funds. Historically, public pension plans invested nearly all their capital in traditional stocks and bonds,[3] but they have collectively become the largest investors in the modern private equity fund industry.[4] Public plans' pace of investment in private equity has only accelerated since the onset of the COVID-19 pandemic.[5]

This Article identifies several ways in which public pension plan investment has shaped the modern private equity industry. For an analytical framework, I use the Security and Exchange Commission ("SEC")'s three-part mission to (1) protect investors, (2) promote capital formation, (3) and maintain fair, orderly, and efficient capital markets.[6] I argue that even though private equity funds are considered "private funds" under the federal securities laws, the enormous presence of public pension plans has both

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1. *See, e.g.*, Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STUD. 59, 68 (2012) ("The generally accepted view of private equity is that it is a highly competitive market involving sophisticated players. Most observers deem it de facto efficient, such that the relationship between managers and investors requires no attention."); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298 (2009) ("Private-equity buyout firms provide a leading example of the use of partnership mechanisms in governing large firms.").

2. The size of the market is over $7 trillion if you count other private market asset classes including private debt, real estate, and infrastructure. *See* MCKINSEY & CO., A YEAR OF DISRUPTION IN THE PRIVATE MARKETS: 2021 MCKINSEY GLOBAL PRIVATE MARKETS REVIEW 11 (2021), https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2021/mckinsey-global-private-markets-review-2021-v3.pdf.

3. *See infra* Section II.A.

4. *See* PREQIN, 2020 PREQIN GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL REPORT 40 (2020) (showing that public pension plans are the largest investors in private equity funds, representing 35% of all capital in the asset class).

5. *See* Heather Gillers, *Retirement Funds Bet Bigger on Private Equity*, WALL ST. J. (Jan. 10, 2022, 5:30 AM), https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604 ("Government retirement funds are pumping record sums into private equity, defying concerns about risk and cost as they try to plug pension shortfalls. U.S. pension funds' private-equity investments swelled to an average 8.9% of holdings in 2021 after three years of straight growth . . . .").

6. *See The Role of the SEC*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/role-sec#:~:text=The%20U.%20S.%20Securities%20and%20Exchange,Facilitate%20capital%20formation (last visited Mar. 11, 2022) ('The U.S. Securities and Exchange Commission . . . has a three-part mission: Protect investors . . . [m]aintain fair, orderly and efficient markets . . . [and] [f]acilitate capital formation.").

shaped how this industry operates and also increased the public's interest in what happens in this market.[7] Thus, while one can argue about whether the past and proposed[8] SEC interventions in this market are well-conceived or within the agency's legal authority, the SEC's growing interest in private equity over the years is not particularly surprising.

I argue first that the massive presence of public pension plans in the industry has complicated the orderliness and efficiency of private equity contracting.[9] Public pension plans introduce several non-market requirements and incentives to the private equity contracting process. For example, as government entities, state and local pension plans are commonly subject to various standing prescriptive policies and regulatory requirements[10] mandating that they receive certain terms. This adds complexity and cost to the private equity negotiating process and reduces contracting flexibility and adaptability. Moreover, even setting aside formal policies and regulations that prescribe public pension bargaining behavior, the staff members and trustees at public pension plans are also likely to have elevated concerns about "headline risk" and other non-market factors that can affect their bargaining priorities. The state and local officials behind these plans also tend to be more insulated from market forces than other types of institutional investors. For these and other reasons, the private equity industry cannot simply be viewed as a pure private market setting where all participants are perfectly rational contracting parties.

Second, I argue that the rise of public pension investment in private equity has affected the investor protection calculus in the industry by increasing the number of ordinary people who are impacted by fund operations.[11] State and local pension plans invest the retirement savings of public servants across the nation, including teachers, firefighters, and policemen, and they are typically backed by the taxpayers in the relevant jurisdiction sponsoring the public plan.[12] Concerns for these underlying stakeholders have been amplified by a history of pension underfunding

7. While foreign public pension plans and sovereign wealth funds also play an important role in the private equity ecosystem, this Article's analysis focuses primarily on the effect of state and local pension plans located in the United States.

8. Gary Gensler's tenure as SEC Chair has marked a remarkable new chapter in the SEC's regulatory interest in private equity, as evidenced by recently proposed rules that would dramatically increase mandatory disclosure in the industry and introduce other regulatory interventions. *See infra* Section VI.A.1.

9. *See infra* Part III.

10. Moreover, plans are overseen by legislative bodies that can respond to market developments by passing mandatory laws and policies. *See infra* note 91 and accompanying text.

11. *See infra* Part IV.

12. *See* KATELIN P. ISAACS, CONG. RSCH. SERV., 98-810, FEDERAL EMPLOYEES' RETIREMENT SYSTEM: BENEFITS AND FINANCING 11 (2015).

problems in state and local governments[13] and academic studies documenting problematic investment management practices by public pension investment staffs.[14]

A review of the SEC's rhetoric over the years confirms that these concerns have in fact played a role in shaping the SEC's approach to private equity. In response to questions about why the SEC had dramatically expanded its private equity examination program and brought enforcement actions against private equity fund managers in the mid-2010s, the SEC repeatedly invoked the massive presence of public pension plans in the industry and the potential for negative effects on pension beneficiaries and taxpayers.[15] More recently, throughout his tenure Chair Gary Gensler has raised familiar concerns about industry practices and has similarly referenced public pension plans as justification for additional regulatory interventions.[16] In February 2022, this language turned to action when the SEC released a groundbreaking rulemaking proposal that, if adopted, would dramatically

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13. *See infra* Section IV.A.2.

14. *See infra* notes 120–126 and accompanying text.

15. *See, e.g.*, Andrew J. Bowden, Dir., Off. of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014) (transcript available at https://www.sec.gov/news/speech/2014--spch05062014ab.html) ("Why is [Office of Compliance Inspections & Examinations ("OCIE")] spending resources on private funds? . . . Why not devote more resources to helping 'mom and pop' investors? . . . To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S."); Andrew Ceresney, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Address at the Securities Enforcement Forum West: Private Equity Enforcement (May 12, 2016), (transcript available at https://www.sec.gov/news/speech/private-equity-enforcement.html) ("[W]hy is the SEC spending its limited resources on the private equity industry given the sophistication of most investors? Because it is important to understand that retail investors are significantly invested in private equity. For example, public pension plans frequently invest the retirement savings of their plan beneficiaries — which include teachers, police officers and firefighters — in private equity funds. . . . So, if an adviser defrauds a private equity fund, the underlying victims frequently include retail investors, who in many cases are not in a position to protect themselves.").

16. *See, e.g.*, Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Testimony Before the United States House of Representatives Committee on Financial Services (Oct. 5, 2021) (transcript available at https://www.sec.gov/news/testimony/gensler-2021-10-05) ("I believe we can enhance disclosures in this area, better enabling pensions and others investing in these private funds to get the information they need to make investment decisions. Ultimately, every pension fund investing in these private funds would benefit if there were greater transparency and competition in this space."); Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Prepared Remarks at the Institutional Limited Partners Association Summit (Nov. 10, 2021) (transcript available at https://www.sec.gov/news/speech/gensler-ilpa-20211110#_ftn12) [hereinafter Gensler, Remarks at ILPA Summit] ("[Increased transparency] could raise the returns for the pensions and endowments behind the limited partner investors. This ultimately could help workers preparing for retirement and families paying for their college educations.").

increase regulatory intervention in the market.[17] Following that release, all three SEC commissioners who supported the proposal issued statements that referenced public pension plans as a motivating force behind their support.[18] A reference to public plans also features prominently in the proposal itself.[19]

Finally, the rise of public pension investment in private equity has also contributed to enormous institutional demand for private equity fund products over the years.[20] As private equity managers have enjoyed extraordinary success in increasing assets under management over the past decade, institutional investors have frequently complained about an imbalance in bargaining power[21] that leads to manager-favorable governance terms in private equity funds.[22] Interestingly, a large body of research

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17. *See infra* Section VI.A.1.

18. Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Statement on Private Fund Advisers Proposal (Feb. 9, 2022) (transcript available at https://www.sec.gov/news/statement/gensler-statement-private-fund-advisers-proposal-020922) ("[T]hese funds matter because of what, or who, stands on either side of them. The funds pool the money of other people: the limited partners. And who are those limited partners? Sometimes, they're wealthy individuals. Often, though, they're retirement plans, like state government pension plans, or non-profit and university endowments. The people behind those funds and endowments often are teachers, firefighters, municipal workers, students, and professors."); Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Proposed Rules for Private Fund Advisers (Feb. 9, 2022) (transcript available at https://www.sec.gov/news/statement/lee-private-fund-20220209) ("In considering this proposal, it's critical to note the large and growing presence of retail investors, and particularly those with retirement assets, exposed to this market. For example, U.S. pension funds hold roughly $480 billion in private equity investments, representing an average of about 9% of their holdings."); Caroline A. Crenshaw, Comm'r, U.S. Sec. & Exch. Comm'n, Private Fund Advisers Proposal – Statement in Support of Accountability Enhancing Updates (Feb. 9, 2022) ("Private fund investors, including entities such as pension funds, charitable organizations, and college endowments, rely on the protections afforded by the Advisers Act and benefit from advisers' obligations to place their clients' interest first.").

19. U.S. Sec. & Exch. Comm'n, Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Feb. 9, 2022) (to be codified at 17 C.F.R. pt 275), https://www.sec.gov/rules/proposed/2022/ia-5955.pdf [hereinafter Feb. 2022 SEC Proposed Rule] ("Private funds and their advisers also play an increasingly important role in the lives of everyday Americans saving for retirement or college tuition. Some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals.").

20. *See infra* Part V.

21. *See, e.g.*, Letter from Steve Nelson, Chief Exec. Officer, Institutional Ltd. Partners Ass'n, to Brent Fields, Sec'y, U.S. Sec. & Exch. Comm'n, ILPA Follow-up Letter on Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18, at 3 (Nov. 21, 2018), https://ilpa.org/wp-content/uploads/2018/12/ILPA-Follow-Up-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-11.21.18.pdf (noting "the significant imbalance in bargaining power between investors and private equity advisers" in recent years).

22. *See, e.g.*, Letter from Steve Nelson, Chief Exec. Officer, Institutional Ltd. Partners Ass'n, to Brent Fields, Sec'y, U.S. Sec. & Exch. Comm'n, Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18, at 9 (Aug. 6, 2018), https://ilpa.org/wp-

suggests that state and local plans in the United States had perverse incentives to over-invest in private equity and other risky assets for many years.[23] Studies show that these non-market incentives did, in fact, lead to higher allocations by public pension plans to risky investments.[24]

For all these reasons, private equity is not the pure private market contracting setting that a surface-level view of the industry might suggest. To the contrary, even though private equity funds are considered "private funds" under the federal securities laws, public plans have played an enormous role in shaping how this industry works and have amplified the public's interest in the industry's outcomes.

Importantly, this fact should not be seen as providing the SEC with a blank check for intervening in the industry, and this Article does not purport to assess the extent of the agency's formal legal authority to enact regulations. As noted above, the SEC implemented an industry-wide examination program in the early-2010s that has remained quite active over the years, and in recent months the SEC released a sweeping proposed rule that would require managers to make a broad set of mandatory disclosures and prohibit certain controversial practices in the industry, among other requirements.[25] If SEC interventions are going to be effective, policymakers need to understand the problems that impair effective bargaining in private equity and tailor their interventions to respond to those problems. This Article provides insight into one important source of potential bargaining problems in private equity.

Furthermore, looking beyond the SEC, the many interdependencies between private equity and public pension plans also raise questions about

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content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf ("[A]s the market has rebounded [from the Great Recession], the legal terms have becom[e] immensely more challenging. This has been exacerbated by the current fundraising environment, which is characterized by unprecedented fund raising levels and speed, where GPs have significant leverage in negotiations, and many LPs, particularly public pensions, are forced to deploy capital under disadvantaged terms in order to achieve certain performance thresholds designed to allow them to meet their pension and other disbursement requirements. LPs, including even the nation's largest public pensions, with correspondingly reduced leverage in negotiations, have continued to face a market where they are forced to accept these reductions in the applicability of basic duties of fairness, loyalty and good faith owed to them by the investment advisers they invest with. This is extremely harmful to LPs and their beneficiaries . . . . As many of these investors need to deploy their capital to meet their obligations to their beneficiaries, they are unable to walk away from these investment terms while still meeting their funding obligations." (footnote omitted)).

23. *See infra* Sections V.B. and V.C.

24. *See infra* note 175 and accompanying text.

25. *See infra* Section VI.A.1.

whether private equity has become too public to fail.[26] The public's substantial investment in private equity raises legitimate questions about moral hazard concerns in the industry.

This Article proceeds as follows. Part I identifies what makes a private equity fund "private" from a legal perspective and discusses the regulatory implications of that status. Part II discusses how public pension plans went from risk avoiders that rarely invested in private markets to the biggest private equity investors in the market. Part III shows how the large-scale participation of public pension plans in private equity complicates the orderliness and efficiency of the private equity fund market. Part IV discusses investor protection implications of large-scale public pension investment in private equity. Part V identifies capital formation effects resulting from the flow of public pension assets to private equity funds and discusses the literature showing that public pension plans had perverse incentives to over-invest in private equity funds for many years. Part VI considers various policy implications. The Article then concludes.

I. PRIVATE EQUITY FUNDS AS "PRIVATE FUNDS"

The term "private equity" refers to the investment strategy of acquiring controlling positions in private companies, making financial or operational improvements to those companies, and then selling them at a profit. A private equity investor can obtain a controlling position either by buying a controlling equity stake in a company that is already private, or by buying a controlling equity stake in a public company and "taking it private" by cashing out the minority shareholders. The "private" in the term "private equity" thus refers to the fact that the equity held by the investor is in a private, and not a publicly-traded, portfolio company.

Private equity is also private in another way. Private equity managers typically raise money by pooling the capital of their various investors into a single vehicle called a fund. In order to structure this vehicle as a conventional private equity fund and avoid costly regulatory restrictions and requirements, a fund must be raised in a manner that satisfies exemptions to the SEC registration requirements under the various federal securities laws.[27]

26. As discussed below, the COVID-19 pandemic provided an imperfect test case for this question, as reports suggest that the private equity industry largely came out of the pandemic unscathed, with returns largely unaffected. *See* Hugh MacArthur et al., *The Private Equity Market in 2020: Escape from the Abyss*, *in* GLOBAL PRIVATE EQUITY REPORT 2021, at 3, 4, 21 (Bain & Co. 2021), https://www.bain.com/globalassets/noindex/2021/bain_report_2021-global-private-equity-report.pdf ("It was a year of massive disruption—and private equity emerged unscathed. . . . By all indications, private equity weathered 2020's perfect storm without taking a hit to returns.").

27. Registration imposes obligations on managers that are typically viewed as costly and incompatible with the management of a typical private equity fund. *See* PRIVATE EQUITY FUNDS:

Thus, a private equity fund is also a "private fund"[28] in the sense that it avoids registration with the SEC under most of the federal securities statutes, unlike mutual funds and other "public funds" that are registered with the SEC.

To avoid registration under the Securities Act of 1933, all of a fund's investors typically must be "accredited investors" that meet certain net worth thresholds ($5 million for most entities and $1 million for individuals).[29] Registration under the Investment Company Act of 1940 (the "Investment Company Act") can be avoided if a fund's investors are all "qualified purchasers" that satisfy a higher set of net worth thresholds (generally $25 million for entities and $5 million for individuals).[30] Furthermore, if a fund's general partner wants to charge investors carried interest,[31] all fund investors must also meet the "qualified client" standard set forth in Rule 205-3 of the Advisers Act, which currently requires entities and natural persons to have a net worth of at least $2.2 million or an investment with the manager of at least $1.1 million.[32]

Given the significant requirements that investors must satisfy before they can enter the industry, one might expect private funds to be a model environment for private ordering. Basic law and economics theory supports the idea that sophisticated private parties will engage in optimal bargaining under the right conditions.[33] Moreover, if the investors participating in

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BUSINESS STRUCTURE AND OPERATIONS § 8.03, LexisNexis (database updated Aug. 2021) ("[T]he substantive requirements imposed on registered investment companies are not compatible with the business plan and management structure of a typical private equity fund.").

28. *See* Investment Advisers Act of 1940, 15 U.S.C. § 202(a)(29) (defining "private fund" as an issuer that would be a registered investment company under the Investment Company Act of 1940 but for certain exemptions set forth in that statute).

29. See 17 C.F.R. § 230.501(a) for the formal definition of "accredited investor."

30. *See* Investment Company Act, 15 U.S.C. § 80a-3(c)(7) (allowing a fund to raise an unlimited amount of money from an unlimited number of investors if they are all "qualified purchasers"). Various other exemptions to the Investment Company Act exist, but Section 3(c)(7) is the most commonly used. Another less common exemption is Section 3(c)(1), which imposes no sophistication requirements as long as the fund has fewer than 100 investors. *Id.* at § 80a-3(c)(1).

31. In practice, investors are charged carried interest in virtually every private equity fund. Carried interest is an incentive-based fee paid to the fund's general partner entity, which is an affiliate of the fund manager. *See* STEPHANIE BRESLOW & PHYLLIS SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 1.01 (2d ed. 2016 & Supp. 2022) (noting that profits generated by a fund are ordinarily "divided according to a formula which provides the General Partner with a share (typically 20%) of the profits (the 'Carried Interest') attributable to the Limited Partners' Capital Contributions").

32. 17 C.F.R. § 275.205-3; Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, 86 Fed. Reg. 32,993 (June 23, 2021).

33. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 547 (2003) (arguing for formalist interpretation of contracts between sophisticated economic actors); Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and*

private funds can satisfy such significant net worth standards, it seems logical to conclude that those investors will be able to sustain the risk of potential losses, making it unnecessary to impose restrictions on leverage, incentive compensation, investment concentration, and other factors that lead to increased investment risk.

Historically, policymakers approached private equity with this perspective in mind. Private equity funds could generally opt out of the registration requirements for each of the federal securities statutes, and they operated almost entirely off the SEC's radar. Similarly, scholars held out private equity funds as a leading example of private ordering by contract in the academic literature, touting the ability of private equity investors and managers to contract for efficient terms.[34]

The first significant deviation from this policy approach happened in 2010, when Congress eliminated the exemption that most private equity managers had been relying on to avoid registration under the Advisers Act.[35] These changes did not dramatically modify the substantive regulatory requirements imposed on private equity managers, as the Advisers Act is largely a disclosure-based statute that imposes few affirmative obligations on managers beyond disclosing their conflicts of interest[36] and making

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Their Breach, 9 J.L. ECON. & ORG. 230, 233 (1993) ("[I]f the private parties are sophisticated and are symmetrically informed at the time of contracting, then there is no benefit to the courts' mandating the terms of private contracts." (emphasis omitted)); Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. LEGAL STUD. 131, 131 (2008) (finding that "when enough consumers are sophisticated and the naive have a relatively low willingness to pay for their preferred contract, exploitative contracts decline in frequency and may actually vanish"); MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 120 (1993) ("To the extent that there is a margin of informed, sophisticated, and aggressive consumers in any given market, who understand the terms of the standard form contracts on offer and who either negotiate over those terms or switch their business readily to competing suppliers offering more favourable terms, they may in effect discipline the entire market, so that inframarginal (less well informed, sophisticated, or mobile) consumers can effectively free-ride on the discipline brought to the market by the marginal consumers . . . .").

34. *See supra* note 1 and accompanying text.

35. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (June 22, 2011), https://www.sec.gov/news/press/2011/2011-133.htm (noting that because Title IV of the Dodd-Frank Act eliminated the "private adviser exemption . . . many previously unregistered advisers, particularly those to hedge funds and private equity funds, w[ould] have to register with the Commission and be subject to its regulatory oversight, rules and examination").

36. *See* Ceresney, *supra* note 15 (indicating that managers must "disclose sufficiently specific facts such that the client is able to understand the [manager's] conflicts of interest and business practices, and can give informed consent to such conflicts or practices"). As a result, if a manager has disclosed certain risks and investors have not negotiated for contractual protections against those risks, the investors generally will be exposed to those risks without any protection from federal fiduciary duties. Interpretive guidance issued by the SEC in 2019 on the fiduciary duties of investment advisers did little to change the agency's fundamental approach to regulating managers of private funds. *See* Memorandum from Simpson Thacher & Bartlett LLP, SEC Rulemakings and

themselves available for regular SEC examinations.[37] However, by granting examination authority to the SEC, this update gave the SEC its first direct view into the industry's operations, and the results of those early examinations were troubling to many industry observers. The SEC articulated serious concerns about fee and expense practices, transparency problems, and issues relating to conflicts of interest in the industry,[38] and the agency brought several enforcement actions against private equity managers.[39]

In the years following that initial wave of activity, the SEC's examination program continued unabated.[40] Notwithstanding the considerable attention that this program brought to issues of transparency and conflicts of interest in private equity funds over the years, the industry did not respond in a manner that was satisfying to the SEC.[41] Under Chair Gary Gensler, the SEC recently proposed a broad set of rules that would

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Interpretations Addressing Investment Adviser and Broker-Dealer Standards of Conduct and Disclosure Obligations (June 20, 2019), http://www.stblaw.com/docs/default-source/memos/firmmemo_06_20_19.pdf ("For investment management firms that only advise private investment funds and other institutional clients, the SEC Releases should have a limited effect on their businesses.").

37. Other obligations of registered managers included filing an annual, publicly available report that sets out certain basic information about the manager's operations and conflicts of interest. *See* OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, OMB CONTROL NO. 3235-0049, FORM ADV (U.S. Sec. & Exch. Comm'n 2021), https://omb.report/icr/202108-3235-017/doc/original/114223400.pdf. Registered managers were also required to file a confidential annual report on Form PF with basic information about asset holdings to support systemic risk management. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Approves Confidential Private Fund Risk Reporting (Oct. 26, 2011), https://www.sec.gov/news/press/2011/2011-226.htm.

38. *See, e.g.*, Bowden, *supra* note 15; Marc Wyatt, Acting Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

39. *See, e.g.*, *In re* Apollo Mgmt. V, L.P., Advisers Act Release No. 4493, 2016 WL 11467649 (Aug. 23, 2016); *In re* TPG Cap. Advisors, LLC, Advisers Act Release No. 4830, 2017 WL 6554183 (Dec. 21, 2017); *In re* Blackstone Mgmt. Partners, L.L.C., Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

40. *See Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds*, SEC. & EXCH. COMM'N OFF. OF COMPLIANCE INSPECTIONS AND EXAMINATIONS 1 (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf [hereinafter *Risk Alert* 2020] (noting that "OCIE examines hundreds of private fund advisers each year"); *Risk Alert Observations from Examinations of Private Fund Advisers*, SEC. & EXCH. COMM'N DIV. OF EXAMINATIONS (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

41. *See* Feb. 2022 SEC Proposed Rule, *supra* note 19, at 9 ("The [SEC] has pursued enforcement actions against private fund advisers for practices that have caused private funds to pay more in fees and expenses than they should have . . . or resulted in investors not being informed of relevant conflicts of interest . . . . Despite our examination and enforcement efforts, these activities persist.").

dramatically increase its intervention in the industry, driven by unresolved concerns about how the industry operates.[42]

Why does private equity matter to the SEC? Should it? In this Article, I argue that public pension plans are an important part of the answer to these questions.

II. HOW PUBLIC PENSIONS BECAME THE BIGGEST INVESTORS IN PRIVATE EQUITY FUNDS

Public pension plans are the single most important source of capital for private equity funds.[43] Ranging from some of the smallest investors in the industry to some of the largest and most influential, the total volume of money that is collectively invested by public plans in private equity today is staggering.

So even though private equity funds themselves have historically been largely exempted from direct regulation under the federal securities laws, the largest investors in these funds are government-sponsored entities subject to their own sets of internal regulations.[44] This kind of large-scale investment in private equity funds is a relatively recent development for state and local plans in the United States.

A. When Public Pensions Started to Embrace Risk

For much of their history, state and local pension plans were legally prohibited from holding risky assets.[45] For most plans, this meant that they could only invest the pension fund's assets in bonds issued by federal, state, or local governments. When public plans were allowed to invest in the securities of private businesses, they were typically limited to a "legal list" containing only the safest, blue chip corporate investments.[46] In 1942, state pensions invested 90% of their portfolios in public bonds issued by federal,

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42. *See infra* Section VI.A.1.

43. *See supra* note 4 and accompanying text.

44. *See infra* Section III.A.

45. *See* PEW CHARITABLE TRS. & LAURA & JOHN ARNOLD FOUND., STATE PUBLIC PENSION INVESTMENTS SHIFT OVER PAST 30 YEARS, PEW CHARITABLE TRUSTS ISSUE BRIEF 2 (2014), https://www.pewtrusts.org/~/media/assets/2014/06/state_public_pension_investments_shift_over_past_30_years.pdf [hereinafter PEW BRIEF 2014] ("Before the early 1980s, many public retirement plans were bound by strict regulations limiting their investment options.").

46. *See* ROBERT L. CLARK, LEE A. CRAIG & JOHN SABELHAUS, *State and Local Pension Plans During the Great Depression*, *in* STATE AND LOCAL RETIREMENT PLANS IN THE UNITED STATES 36, 40 (2011) ("Admission to the legal list was based on a compilation of corporate assets, earnings, dividends, prior default history, and so forth. The objective was to provide a list that consisted of the bluest of blue chip corporate securities.").

state, and local governments, and just 10% of their funds in stocks, corporate bonds, mortgages, and other private assets.[47]

Nearly all states and cities that maintained pension plans invested a large percentage of their investment portfolios in their own securities. These were secure investments, and by purchasing its own debt a state or locality could avoid the transaction costs associated with both selling its own debt in the market and buying other investments for its pension funds. In effect, a city or state was simply borrowing money from one state account—the pension fund—to pay for another, like a school construction fund, for example.[48] While some have argued that this approach was both safe and sufficiently high-yielding,[49] it did suffer from an important flaw. Because municipal bonds are exempt from state and federal income taxes, they offer lower yields than similarly risky corporate bonds.[50] When income tax rates jumped during World War II, public pension managers were forced to decide between continuing to invest in municipal bonds and shifting into higher-yielding private securities.[51] By 1972, state pensions were investing 96% of their funds in the securities of private-sector companies.[52]

After moving to private-sector investments, state and local plans initially focused primarily on investments in fixed-income corporate securities. While these investments were riskier than bonds issued by governmental entities, they were still relatively low-risk investments. As recently as the early 1980s, public pension plans were still investing nearly 80% of their portfolios in fixed income securities and cash.[53]

In recent decades, however, public pension plans have come to fully embrace the riskiest sectors of the market. By 2016, the average public pension plan invested over 70% of its portfolio in corporate stocks, private equity funds, hedge funds, and others.[54] The "risk premium" of the average

47. *See* Michael R. Glass & Sean H. Vanatta, *The Next COVID-19 Victim? Public Pension Funds.*, WASH. POST (Apr. 17, 2020), https://www.washingtonpost.com/outlook/2020/04/17/next-covid-19-victim-public-pension-funds/.

48. *See* ROBERT CLARK, LEE A. CRAIG & JACK W. WILSON, *Early Pension Plans for State and Local Workers*, *in* A HISTORY OF PUBLIC SECTOR PENSIONS IN THE UNITED STATES 167, 212 (2003).

49. *See id.* Some commentators have proposed returning to this practice of "fiscal mutualism." *See* Glass & Vanatta, *supra* note 47 (recommending a return to the early 1900s practice that preferred "public investment over maximum returns").

50. Unlike individual investors, states and cities do not benefit from the tax-exempt nature of state and local bonds because they do not pay taxes.

51. *See* Glass & Vanatta, *supra* note 47 ("By 1945, tax-exempt municipal bonds yielded less than half of taxable corporate bonds.").

52. *Id.*

53. *See* PEW BRIEF 2014, *supra* note 45, at 3.

54. *State Public Pension Funds' Investment Practices and Performance: 2016 Data Update* PEW CHARITABLE TRS. 2 (Sept. 2018), https://www.pewtrusts.org/-

public pension plan's investment portfolio—that portion of the plan's expected return attributable to higher risk exposure—dramatically rose during this period.[55] One study's measures show that the investment risk of public pension portfolios more than tripled between 2000 and the late 2010s.[56] Notably, studies show that in the years leading up to COVID-19, state and local pension plans took on risk more aggressively than both private U.S. pension plans and public pension plans in other parts of the world.[57]

Private investment funds have become an integral part of the investment portfolios held by most state and local public pension plans. Whereas "alternative" assets only made up 11% of public pension assets in 2006, by 2016 this number had jumped to 26%.[58] A majority of these alternative investments are investments in private investment funds, including private equity funds and hedge funds.[59]

In the process, public pension plans have collectively become the largest investors in the private equity industry. A far cry from their conservative early days, public pension plans now supply over 35% of the capital in the private equity industry.[60] This has created an unusual dynamic. Private equity funds and hedge funds go to great lengths to avoid public scrutiny and

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/media/assets/2018/09/statepublicpensionfundsinvestmentpracticesandperformance-2016dataupdate_chartbook.pdf [hereinafter *Pew Brief Sept. 2018*].

55. This increase can be attributed both to increased exposure to risky investments and to a global decline in debt security interest rates during this period. *See id.*https://www.pewtrusts.org/-/media/assets/2018/09/statepublicpensionfundsinvestmentpracticesandperformance-2016dataupdate_chartbook.pdf

56. *See* Greg Mennis, Susan Banta & David Draine, *Assessing the Risk of Fiscal Distress for Public Pensions: State Stress Test Analysis* 52 (Harv. Kennedy Sch. Mossavar-Rahmani Ctr. for Bus. & Gov't, Working Paper No. 92, 2018), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/AWP_92_final.pdf (observing that since 2000, "measures of investment risk for pension portfolios have more than tripled, as has the use of higher-cost alternative investments, including real estate, private equity, and hedge funds").

57. *See* DONALD J. BOYD & YIMENG YIN, SUNY ROCKEFELLER INST. OF GOV'T, HOW PUBLIC PENSION PLAN INVESTMENT RISK AFFECTS FUNDING AND CONTRIBUTION RISK 1–2 (2017), https://www.albany.edu/slgf/Reports_and_Briefs/2017-01-10-Pension_Investment_Risks.pdf (showing that risky assets made up just 53% of the investment portfolios of private U.S. pension plans in 2016 as compared with approximately 70% of state and local plans); Aleksander Andonov, Rob M.M.J. Bauer & K.J. Martijn Cremers, *Pension Fund Asset Allocation and Liability Discount Rates*, 30 REV. FIN. STUD. 2555, 2592 (2017) ("Our results suggest that, over time, U.S. public pension funds have become the biggest risk-takers among pension funds internationally.").

58. *See Pew Brief Sept. 2018*, *supra* note 54, at 3.

59. *See* Jean-Pierre Aubry, Anqi Chen & Alicia H. Munnell, *A First Look at Alternative Investments and Public Pensions*, CTR. FOR RET. RSCH. AT BOS. COLL. 4 (July 2017), http://crr.bc.edu/wp-content/uploads/2017/06/slp_55.pdf (showing that over 66% of public pension investments in "alternative" investments in 2015 were directed to private equity and hedge funds).

60. *See supra* note 4 and accompanying text.

SEC registration under the federal securities laws,[61] yet their most important investors are themselves public entities that are managed on behalf of public servants and funded by taxpayers. These private vehicles thus have an impact that is remarkably broad and public in scope, notwithstanding the fact that much of their activity is kept private and their investors are typically subject to strict confidentiality restrictions.[62]

B. Scholarly Response – Is This Good for Public Plans?

Many scholars have been critical of this elevated risk-taking by state and local pension plans, noting that it has made public pension systems vulnerable to market downturns.[63] While investments in riskier assets may increase the mean expected return distribution for public plans, they also dramatically increase the variation of expected returns.[64] Notable economists have argued that this approach to risk by public plans creates "a small

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61. *See supra* Part I.

62. *See* Madison Marriage & Chris Newlands, *Pension Funds Forced to Sign Non-Disclosure Agreements*, FIN. TIMES (Oct. 26, 2014), https://www.ft.com/content/94524a60-5b96-11e4-81ac-00144feab7de ("Anger has erupted over the practice of asset managers coercing pension funds into signing non-disclosure agreements."); Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014), https://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html ("[I]n exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds' investments.").

63. *See, e.g.*, Mennis et al., *supra* note 56, at 1 ("These factors indicate that public pension systems may be more vulnerable to an economic downturn than they have ever been."); *Pew Brief Sept. 2018*, *supra* note 54, at 12 ("Public retirement systems continued to move assets from lower-risk fixed-income investments to higher-risk alternative and equity investments in 2016, resulting in greater vulnerability to market volatility and higher fees."); DONALD J. BOYD & YIMENG YIN, SUNY ROCKEFELLER INST. OF GOV'T, APPROPRIATENESS OF RISK-TAKING BY PUBLIC PENSION PLANS 21 (2017), https://www.albany.edu/slgf/Reports_and_Briefs/2017-02-01-Risk_Taking_Appropriateness.pdf ("The potential consequence of investment shortfalls, relative to state and local government tax revenue, is now more than three times as large as it was in 1995, and about ten times as large as in 1985.").

64. *See* James Farrell & Daniel Shoag, *Risky Choices: Simulating Public Pension Funding Stress with Realistic Shocks*E**rror! Hyperlink reference not valid.** 43 (Harv. Kennedy Sch., Working Paper No. RWP16-053, 2016), https://www.hks.harvard.edu/publications/risky-choices-simulating-public-pension-funding-stress-realistic-shocks ("[T]he movement towards riskier asset classes that has occurred has had a predictable effect on the distribution of outcomes. While higher risk, higher return allocation improves funding outcomes and reduces total costs at the median, it also greatly increases costs at the tail of the distribution."); Donald J. Boyd & Yimeng Yin, *Investment Risk-Taking by Public Pension Plans: Potential Consequences for Pension Funds, State and Local Governments, and Stakeholders in Government*, BROOKINGS INST. SIXTH ANN. MUN. FIN. CONF. 5 (July 17, 2017), https://www.brookings.edu/wp-content/uploads/2017/04/boyd.pdf (showing model results finding a high risk of severe underfunding in cases where public plans invest in high-risk portfolios).

probability of an extremely good outcome and a large probability of poor outcomes."[65]

Scholars have noted that concerns about this exposure to risk are amplified because low returns to risky investments are highly correlated with the state of the economy. This means that public pension plans are likely to need higher contributions due to low investment returns at precisely the times when tax revenues are reduced due to macroeconomic weakness.[66] Beyond the academic literature, various commentators,[67] judges,[68] and popular media sources[69] have characterized public pension risk-taking in recent years as gambling with the public's money.

There are mixed reviews on whether the increase in public pension exposure to private equity funds,[70] specifically, has been a positive development. On one hand, some proponents claim that private equity funds outperform other asset classes[71] and bring significant diversification benefits that cannot be achieved with investments in public securities alone. For example, the American Investment Council, the private equity industry's trade association headquartered in Washington D.C., claims that private equity has been the highest-performing asset class for public pension plans for most of the past decade.[72] Because private equity funds require that

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65. Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, J. ECON. PERSPS., Fall 2009, at 191, 192 ("Under current pension fund investment policy, there is a wide distribution of possible future funding outcomes. The outcomes are skewed in such a way that there is a small probability of an extremely good outcome and a large probability of poor outcomes.").

66. *See, e.g.*, Daniel Biggs, *The Public Pensions Quadrilemma: The Intersection of Investment Risk and Contribution Risk*, PROC. ANNUAL CONF. ON TAXATION & MINUTES ANNUAL MEETING NAT'L TAX ASS'N, 2014, at 27 ("Stock prices are correlated with the state of the economy, meaning that low returns and higher required contributions may occur at times when tax revenues are weak. . . . Additional dollars are needed when the marginal value of a dollar is highest, while surpluses occur when a marginal dollar is less valuable.").

67. Daniel Tenreiro, *As Shortfalls Grow, Public-Pension Funds Roll the Dice*, NAT'L REV. (June 17, 2020, 6:30 AM), https://www.nationalreview.com/2020/06/calpers-public-pension-funds-add-risk-to-meet-return-targets/.

68. *See infra* note 152 and accompanying text.

69. *See, e.g.*, Marcela Gaviria, Martin Smith & Nick Verbitsky, *The Pension Gamble*, PBS FRONTLINE (Oct. 23, 2018), https://www.pbs.org/wgbh/frontline/film/the-pension-gamble/.

70. *See supra* notes 58–59 and accompanying text.

71. *See, e.g.*, Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. FIN. 1851, 1852–53 (2014).

72. *See Public Pension Study*, AM. INV. COUNCIL 5 (July 2019), https://www.investmentcouncil.org/wp-content/uploads/2019-public-pension-study.pdf (claiming that private equity has been the highest-performing asset class in public pension portfolios for the past seven years).

investors lock up their capital for long periods of time, investors theoretically should be able to demand an "illiquidity premium" in those investments.[73]

Some academic research, however, casts doubt on these claims. Many studies show that the rate of returns from investing in public and private markets have been converging over time, with any excess returns from private equity investments largely absent today.[74] Diversification benefits from investing in private funds have also been called into question by recent research, which shows that the data on returns of private investments artificially understates volatility due to the infrequent nature of observation of returns and the use of appraised valuations to construct returns on illiquid assets.[75] Some scholars argue that, because of this, there are no well-accepted and reliable measures of the diversification benefits of private investment funds.[76]

As will be discussed in greater detail,[77] scholars have also criticized private equity funds for weak disclosure and governance practices,[78] and the

73. *See What Is the Illiquidity Premium?*, ECONOMIST (Nov. 9, 2019), https://www.economist.com/finance-and-economics/2019/11/07/what-is-the-illiquidity-premium. *But see* Erik Stafford, *Replicating Private Equity with Value Investing, Homemade Leverage, and Hold-to-Maturity Accounting* 27 (Harv. Bus. Sch., Working Paper No. 16-081, 2015), https://www.hbs.edu/faculty/Publication%20Files/ReplicatingPE_201512_3859877f-bd53-4d3e-99aa-6daec2a3a2d3.pdf (arguing that private equity investments do not earn an illiquidity premium because returns can be replicated (and exceeded) by investing in small value stocks with leverage).

74. *See, e.g.*, Robert S. Harris et al., *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14, 15 (2016); Ludovic Phalippou, *Performance of Buyout Funds Revisited?*, 18 REV. FIN. 189, 189 (2014); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1747 (2009); Berk A. Sensoy, Yingdi Wang & Michael S. Weisbach, *Limited Partner Performance and the Maturing of the Private Equity Industry*, 112 J. FIN. ECON. 320, 341–42 (2014); Ludovic Phalippou, *An Inconvenient Fact: Private Equity Returns and the Billionaire Factory* 3 (Univ. of Oxford, Said Bus. Sch., Working Paper, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623820 [hereinafter Phalippou, *An Inconvenient Fact*].

75. *See generally* Gregory W. Brown, Oleg R. Gredil & Steven N. Kaplan, *Do Private Equity Funds Manipulate Reported Returns?*, 132 J. FIN. ECON. 267 (2019); Arthur Korteweg, *Risk Adjustment in Private Equity Returns*, 11 ANN. REV. FIN. ECON. 131 (2019).

76. *See, e.g.*, Phalippou, *An Inconvenient Fact*, *supra* note 74, at 30–31 ("I do not know how to measure risk and diversification in [private equity], nor know any academic studies offering a well-accepted approach . . . . [R]eliable measures of these benefits are at best hard to come by.").

77. *See infra* Section III.B.

78. *See, e.g.*, David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership and Cash Flow Performance*, 26 REV. FIN. STUD. 2760, 2761 (2013) ("[T]he typical private equity contract allows GPs to earn excessive compensation and does too little to discipline GPs or to provide them with incentives to maximize LP returns."); Bowden, *supra* note 15 ("[M]ost limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. Of course, many managers voluntarily provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.").

high fee structure of private funds has been the subject of significant disapproval over the years.[79] Recent research also shows significant heterogeneity in returns experienced by public pension plans independent of plan size, reinforcing perceptions of the asset class's complexity.[80]

III. EFFECT #1: COMPLICATING THE ORDERLINESS AND EFFICIENCY OF PRIVATE EQUITY

It is difficult to overstate just how much this flow of public pension capital to private markets has affected the private equity industry. In the remainder of this Article, I examine the influence of public plans on private equity using the SEC's three-part mission as an analytical framework.[81] I start by discussing the effect of public pension plans on the orderliness and efficiency of the private equity fund market.

A. Less Free Contracting, More Regulatory Influence on Terms

If the private equity fund industry were an ideal private market setting where all parties were rational, self-interested parties who bargain for optimal outcomes on their own, then the best policy response would be to take a completely hands-off approach in regulating the industry. Doing so would lead to the most efficient outcomes and maximize returns for all parties in the market. Large-scale investment by public pension plans, however, introduces many non-market incentives and non-market actors that complicate this simple view.

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79. *See, e.g.*, EILEEN APPELBAUM & ROSEMARY BATT, CTR. FOR ECON. & POL'Y RSCH., FEES, FEES AND MORE FEES: HOW PRIVATE EQUITY ABUSES ITS LIMITED PARTNERS AND U.S. TAXPAYERS 12 (2016), https://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf; Lizzy Gurdus, *Hedge Funds' 'Obscene' Fees Make People Rich – Just Not Investors, Says Buffett*, CNBC: BUFFETT WATCH (Feb. 27, 2017, 10:01 AM), https://www.cnbc.com/2017/02/27/buffett-hedge-funds-fees-border-on-obscene.html ("[Hedge fund fees] make a lot of people rich, and it's going to make very few investors rich." "[It] borders on obscene."); DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 135 (2005) ("Some part of the failure of buyout managers to produce risk-adjusted returns stems from the inappropriate fee structure. . . . The large majority of buyout funds fail to add sufficient value to overcome a grossly unreasonable fee structure.").

80. *See* Juliane Begenau & Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions?* 4 (Harv. Bus. Sch. Working Paper No. 20-073, 2020), https://www.hbs.edu/ris/Publication%20Files/20-073rev11-17-21_c1ee53b8-fecf-41bc-ad1d-d58b8c1c4fe6.pdf.

81. *See The Role of the SEC*, SEC. EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/role-sec#:~:text=The%20U.%20S.%20Securities%20and%20Exchange,Facilitate%20capital%20formation (last visited Oct. 29, 2021).

In the conventional law and economics model, it is assumed that contracting parties will agree on optimal non-price contract terms.[82] Parties are generally assumed to be sophisticated actors who use their discretion to craft custom terms that will best accommodate the contracting relationship. Public pension plans deviate from this assumption in two ways.

First, more than most institutional investors, public plans are typically subject to various standing prescriptive policies and regulatory requirements mandating that they receive certain terms. Common provisions include information requirements relating to state FOIA obligations,[83] policies relating to political contributions and placement agents,[84] restrictions on the jurisdictions in which claims can be brought,[85] limitations on the investments

82. *See, e.g.*, Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933, 934, 938 (2006); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1073–74 (1977) ("Given . . . three assumptions, a firm will produce the same level of product quality regardless of whether the firm is a monopolist or a perfect competitor."); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 554 (2003) ("Bargaining power instead is exercised in the division of the surplus, which is determined by the price term. Parties jointly choose the contract terms so as to maximize the surplus, which the price [sic] may then divide unequally."); Alan Schwartz & Louis L. Wilde, *Product Quality and Imperfect Information*, 52 REV. ECON. STUD. 251, 251–52, 258 (1985) (arguing that where consumers are imperfectly informed about product prices and quality levels offered by the various sellers, and where there are low fixed costs to providing quality, a profit-maximizing seller will offer at least the optimal quality, but at a supracompetitive price).

83. *See* BRESLOW & SCHWARTZ, *supra* note 31, § 4.19.3[F] ("Certain state pension plans and other governmental investors are subject to the Freedom of Information Act ("FOIA"). As a result, they may be required to publicly disclose the information they receive from portfolio funds in response to inquiries.").

84. *See* Mark C. Dempsey & Kristin M. Rylko, *Developing Side Letter Issues*, MAYER BROWN (2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2015/03/developing-side-letter-issues/files/developing_side_letter_issues/fileattachment/developing_side_letter_issues.pdf ("[A] growing number of governmental authorities have taken measures to restrict the use of placement agents and curb so-called 'pay-to-play' abuses. . . . A common manifestation of such regulations requires a Fund to represent and warrant to a Government Investor that it did not use a Placement Agent to obtain such Government Investor's investment and that no benefit was paid or promised to the Government Investor's employees, affiliates, or advisors to obtain its investment." (footnote omitted)).

85. *See* Thomas Smith, Margaret O'Neill & John Rife III, *Side Letters: Pitfalls and Perils for a Financing*, *in* FUND FINANCE LAWS AND REGULATIONS 2022 (2022), https://www.globallegalinsights.com/practice-areas/fund-finance-laws-and-regulations/12-side-letters-pitfalls-and-perils-for-a-financing ("Investors may seek to limit the jurisdictions in which a fund can pursue claims against them. . . . Investors that are most sensitive to the jurisdiction of proceedings tend to be sovereign investors, including U.S. state pension plans.").

that the fund can make,[86] sovereign immunity requirements,[87] and responsible contractor policies,[88] among various others. These kinds of requirements reinforce a commonly-criticized aspect of private equity fund contracting: the fact that in most fund launches, it is very common for investors and managers to spend a large amount of time negotiating "side letters" to the primary fund documents.[89] When each institutional investor has a different set of required terms that they are required to obtain, it becomes difficult to reflect those terms in the same document as a practical matter. This has contributed to a process that has been criticized as unnecessarily burdensome and costly.[90]

Second, unlike most institutional investors, public pension plans have law-making bodies standing behind them that can respond to specific market developments by passing statutory requirements, thereby taking certain terms off the negotiating table. Most famously, the State of California (and, to a lesser extent, certain other states) did this in 2016 when it passed detailed

86. *See, e.g.*, Eugene Kontorovich, *Illinois Passes Historic Anti-BDS Bill, as Congress Mulls Similar Moves*, WASH. POST: VOLOKH CONSPIRACY (May 18, 2015, 9:33 PM), https://www.washingtonpost.com/news/volokh-conspiracy/wp/2015/05/18/illinois-passes-historic-anti-bds-bill-as-congress-mulls-similar-moves/ (noting that a wave of legislation preventing public plans from investing in companies that boycott Israel had swept states throughout the nation); James Comtois, *Massachusetts Introduces Legislation Requiring MassPRIM to Divest from Gun Manufacturers*, PENSIONS & INVS. (Mar. 16, 2018, 1:00 AM), https://www.pionline.com/article/20180316/ONLINE/180319891/massachusetts-introduces-legislation-requiring-massprim-to-divest-from-gun-manufacturers; Heather Gillers, *CalPERS' Dilemma: Save the World or Make Money?*, WALL ST. J. (June 16, 2019, 4:22 PM), https://www.wsj.com/articles/calpers-dilemma-save-the-world-or-make-money-11560684601 (noting that in the aftermath of the Sept. 11, 2001 terrorist attacks, more than twenty states passed laws that could compel their pension funds to divest from Sudan, Iran, or other governments considered by the United States to be sponsors of terrorist activity).

87. *See* BRESLOW & SCHWARTZ, *supra* note 31, § 4.19.3[H] ("Government investors, such as state pension plans and sovereign wealth plans, often seek to include side letter provisions acknowledging their sovereign immunity.").

88. *See* David H. Webber, *Reforming Pensions While Retaining Shareholder Voice*, 99 B.U. L. REV. 1001, 1010 (2019).

89. In fact, in a 2020 survey of seventy institutional investors, institutional investors reported that more time was spent negotiating side letter terms than limited partnership agreement ("LPA") terms. *See* William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703, 753–54 (2022).

90. One prominent private funds attorney recently estimated that a law firm representing a manager in a substantial fundraise will typically spend about 7,000 hours negotiating contract terms with investors. Vicky Meek, *LPA Blues*, *in* PRIVATE EQUITY FINDINGS 24, 26 (Coller Cap., 2020), https://www.collercapital.com/sites/default/files/Private%20Equity%20Findings%20Issue%2016_0.pdf ("[A]cting for a general partner with a [10 billion euro]-plus fund, for example, [Jason Glover, managing partner of Simpson Thacher & Bartlett's London office] estimates that on average, his team spends 7,000 hours negotiating terms with limited partners and their legal counsel. 'That's a vast amount of time, but it's pretty typical.'"). *See also* PRIVATE EQUITY FUNDS, *supra* note 27, § 11.14 ("Side letters can be costly to negotiate and administratively burdensome, especially when a Fund grants voluminous side letters with overlapping provisions to multiple investors.").

legislation in response to revelations that private equity fund managers had been charging hidden fees that were not specifically disclosed to investors.[91] Various other states either followed California's lead or seriously considered doing so.[92] Ever since that law went into effect, California pension plans have been required to receive the same detailed set of fee disclosures. The New York City pension system made a similar move in 2016 when city officials passed a policy prohibiting the system from agreeing to any terms that required the system to indemnify its private equity fund managers.[93] As I have argued in a prior article,[94] this approach to regulating public pension investments in private equity faces distinct challenges.[95] These examples illustrate one of the more extreme ways in which non-market actors can play an outsize role in setting contract terms in the private equity space when public pension plans are present in the market.

Even setting aside formal policies and regulations that dictate public pension bargaining behavior, the staff members and trustees at public pension plans are also subject to informal pressures that can influence their bargaining activity. Because public pension plans are taxpayer-backed government entities, they are typically subject to greater public scrutiny than other types of institutional investors and private individuals. Thus, concerns about "headline risk" can be expected to play an especially significant role in decision-making by public pension plans.[96]

One recent survey illustrates how public pension plans approach bargaining differently than other types of investors. In a 2020 survey of senior in-house legal counsel at seventy institutional investors, respondents were asked to identify their top three negotiating priorities when they invest in a private equity fund.[97] Among the various options available to respondents, the survey included an option for imposing stronger fiduciary

91. For a detailed discussion of this fee transparency movement, see William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294, 320–21, 327 (2020).

92. *See id.* at 328–29.

93. *See* Josh Kosman, *Scott Stringer Eyes Looser Pension Rules for Private-Equity Firms*, N.Y. POST (Feb. 23, 2021, 5:12 PM), https://nypost.com/2021/02/23/scott-stringer-eyes-looser-pension-rules-for-private-equity/.

94. *See* Clayton, *supra* note 91, at 334–43.

95. *See* Kosman, *supra* note 93 ("[New York City Comptroller Scott] Stringer argues that the rule has lately deprived the city's pensions for employees, teachers, police and firefighters of promising deals with top-performing buyout firms. Last year, three such deals worth a total of $843 million fizzled because of the rule.").

96. *See* Isobel Markham, *Hitting the Headlines: Reputational Risk in VC*, PRIV. EQUITY INT'L (May 29, 2018), https://www.privateequityinternational.com/hitting-headlines-reputational-risk-vc/ ("There are a number of trustees, mostly at state pension plans but some universities, that seem to be as focused on reputational issues and social issues as they are on returns. Managers of pension plans can feel they're required by trustees to not invest in certain types of companies . . . .").

97. *See* Clayton, *supra* note 89, at 50.

duties/standard of care on the managers of the private equity funds that they invest in. Interestingly, only 22% of the non-public pension plan respondents included this as one of their top three negotiating priorities.[98] This result, considered in isolation, seems to be consistent with the contractarian view that sophisticated contracting parties can identify more efficient contractual alternatives to fiduciary duties.[99] But that view is seriously called into question by the public pension plan responses. Unlike the other investor types, 59% of public pension plans identified fiduciary duties/standard of care as one of their top three negotiating priorities,[100] as shown in the chart below.

Figure A

Fiduciary Duties / Standard of Care as a Top 3 Negotiating Priority			
Investor Type	# of LPs	Total LPs	%
Public Pension	17	29	59%
All Others	9	41	22%
Total	26	70	37%

While we do not know for certain what accounts for this difference, one plausible explanation is that public plans' heightened concerns about headline risk and internal policies are influencing their decision-making. Whatever the reason, the contrast in attitudes between public pension plans and other investor types with respect to this important term is striking, particularly given the extraordinary size of the collective investment in private equity funds by public plans.

B. States and Localities Are Insulated from Market Forces

In addition to the non-market-based issues discussed above, the state and local officials making decisions about how to fund and manage public pension plans are often more insulated from market forces than other types of institutional investors. State and local officials ultimately must answer to two audiences. First, when a state or locality wants to issue debt to fund a

98. *See id*.

99. *See, e.g.*, Ribstein, *supra* note 1, at 290, 299 ("[Contractual mechanisms] substitute for costlier and often ineffective corporate-type monitoring devices, including the use of independent directors, owner voting, and fiduciary duties. . . . Substituting these incentive devices for monitoring is a particularly efficient tradeoff in private-equity firms given the high costs of constraining the discretion of expert managers.").

100. See Clayton, *supra* note 89, at 50 for a more detailed discussion of the survey and the survey results.

new initiative or infrastructure project, they have to persuade investors in the municipal bond market that the state or locality is sufficiently well-positioned to pay off its existing obligations such that it can afford to take on new debt. Second, state and local officials that want to be reelected will eventually have to seek the support of the voters, and if voters believe that officials have done a poor job running the plan, they can vote them out of their positions.

There are reasons to question, however, whether either of these audiences is likely to do a very good job imposing discipline on public pension plan officials. Approximately $4 trillion of municipal debt issued by state and local governments was outstanding as of 2019.[101] What makes this market particularly distinctive is the conservative risk profile of the typical investor. Bonds issued by state and local issuers are commonly marketed as "widow and orphan" securities because they are perceived as safe for vulnerable and risk-averse investors.[102] Defaults in this market tend to be uncommon because state and local governments typically pledge their full "faith and credit" or taxing power for general obligation bonds.[103] For revenue bonds, issuers commonly pledge dedicated revenue streams as security.[104] In other words, the taxpayers of the state or municipality are effectively guaranteeing the bond, whether they know it or not.

For these reasons, when someone invests in a municipal bond, they are typically justified in feeling confident that the risk of default is relatively low. While this does not eliminate investor scrutiny of the creditworthiness of the issuing government body,[105] it almost certainly takes some of the pressure off.

Democratic accountability is thus an important form of discipline in this area. State and local officials must answer to voters at every election. But voters face challenges that must be overcome before the ballot box can serve as an effective source of discipline on state and local pension officials. Pension management is a complex concept for the average voter to

101. *See* Fixed Income Outstanding, SECS. INDUS. & FIN. MKTS. ASS'N, https://www.sifma.org/resources/research/fixed-income-chart/ (choose "All Years"; then click "19") (last visited Dec. 15, 2021).

102. Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1460–61 (2013) ("Municipal securities are marketed to investors as 'widow and orphan' securities—i.e., safe for vulnerable and risk averse investors—because state and local government issuers rarely default or obtain discharge." (footnote omitted)).

103. *See id.* at 1461.

104. *See id.*

105. *See* Jacquelyn Gillette, Delphine Samuels & Frank S. Zhou, *The Effect of Credit Ratings on Disclosure: Evidence from the Recalibration of Moody's Municipal Ratings*, 58 J. ACCT. RSCH. 693 (2020) (finding that municipal bond investors demand more disclosure from municipalities with lower credit ratings).

understand. As a result, for voting to serve as an effective check on pension mismanagement, there is a basic knowledge and sophistication barrier that must be overcome. In addition, even if voters can clearly identify pension mismanagement, that will typically be one of many relevant issues in a political race, and it may get overwhelmed by other considerations.

For all these reasons, the politicians and staff in charge of managing public pension plans are often less accountable to market forces than similarly situated individuals in other types of large institutions that invest in private equity funds.

C. Public Pension Plans and ESG

The rise of the ESG movement has been one of the biggest trends in global finance in recent years.[106] While private equity firms have adopted many ESG principles into their operations,[107] private equity in general has been slower to embrace ESG than publicly-traded companies and registered investment funds.[108] Some cynics argue that the ESG movement has actually been a strategic advantage for private equity-backed portfolio companies because they can largely avoid the glare of public scrutiny.[109]

Institutional investors in Europe have been more focused on ESG in private equity than U.S. investors as a general matter, and European private equity fund managers have responded with more developed ESG

106. *See* Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018, 10:09 AM), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=3ab5b3041695.

107. *ESG and the Private Markets: Navigating the Application of ESG in the Private Markets*, PITCHBOOK 8, 10–11 (Apr. 28, 2021), https://files.pitchbook.com/website/files/pdf/PitchBook_Analyst_Note_ESG_and_the_Private_Markets.pdf ("[P]rivate capital fund managers are feeling pressure from LPs and other stakeholders to think within a sustainable investment framework. Our 2020 survey indicated that GPs are increasingly receiving questions from potential investors. Many are working to incorporate sustainable investment thinking into their business models.").

108. *See* Julie Segal, *The Pressure Is on Private Equity to Take ESG Seriously*, INSTITUTIONAL INV. (Feb. 1, 2021), https://www.institutionalinvestor.com/article/b1qcg33v33y7zl/The-Pressure-Is-on-Private-Equity-To-Take-ESG-Seriously ("Pensions and other institutions that want to hire private equity firms that consider the environmental impact or the diversity of a company's employees in its investment decisions may have to wait a while. Only 24 percent of private equity firms took environmental, social, and governance matters seriously and at the same time had a mature process in place to evaluate these factors before acquiring a company, according to a survey by Ernst & Young.").

109. *See* Patrick Jenkins, *The Private Equity Backlash Against ESG*, FIN. TIMES (July 19, 2021), https://www.ft.com/content/7e8edfd5-fccd-4f3c-9fda-c616b805c856 ("More freedom on governance has long been seen as a plus for private companies. As listed company governance has become stricter, so the advantage of private company status has increased.").

programs.[110] However, some of the largest public plans in the United States have also expressed a strong commitment to ESG principles in private equity funds.[111] This may not come as a surprise, given the prominent role that large U.S. public pension plans have played in promoting ESG in their public company investment activities.[112] U.S. public plans have also gained a reputation for strong engagement in publicly-traded corporations on these issues, including by voting their shares directly and filing shareholder proposals, among other things.[113]

As one scholar has argued, public pension plans should be well-suited to prioritize ESG considerations given that the primary "residual claimants" of public pension plans—those that will be most directly affected if the plans perform poorly—are public taxpayers.[114] Accordingly, rather than solely maximize the wealth of beneficiaries, this approach argues that it makes sense for public pension plans to seek to promote the welfare of the public

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110. *See* Axel Seemann et al., *The Expanding Case for ESG in Private Equity*, *in* GLOBAL PRIVATE EQUITY REPORT, *supra* note 26, at 27, 28 ("There's also a wide gap in adoption between the PE industry in North America and that in Europe. While 80% of the top 20 EU-based institutional investors have committed to either the PRI, the UN's Net-Zero Asset Owner Alliance or the Task Force on Climate-related Financial Disclosures, less than half of the top 20 North American institutions have done so . . . .").

111. *See id.* at 33 ("European LPs have demonstrated more commitment to ESG than their counterparts in North America, but the biggest institutions in the US and Canada, including the CPP Investment Board, CDPQ, CalPERS and the California State Teachers' Retirement System, are firmly on board.").

112. *See* Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1982–84 (2020) ("Although European players are in the lead [on incorporating ESG into public corporation investments], U.S. public pension assets are not far behind. . . . Public fund pioneers seeded the sustainable investing and ESG markets and continue to play major roles in this growing sector." (footnote omitted)).

113. *See id.* at 1983–84 ("American public pension funds also practice engagement. They vote their shares directly, even when they invest through intermediary asset managers that vote on behalf of their other investor clients. They seek informal influence with company leaders. They even take the more unusual step of filing shareholder proposals." (footnote omitted)).

114. *See* Paul Rose, *Public Wealth Maximization: A New Framework for Fiduciary Duties in Public Funds*, 2018 U. ILL. L. REV. 891, 894 (2018) (arguing that in a public fund, "the government and taxpayers . . . bear almost all of the risk should a public fund fail. In practice, individual participant claimants function more like senior creditors with fixed claims that have little real risk that they will not be received."); *see also* David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106 (2014) (advocating for a "member-first," and not a "fund-first" approach to public pension fund investments).

more generally.[115] This contrasts with how we would expect private investors to act in markets that are truly private.[116]

In coming years, if American investors are going to behave more like institutional investors in Europe with respect to ESG issues in private equity funds, that movement will likely be led by public pension plans.[117] Whether such a movement would be likely to produce net benefits for the private equity industry and for society more broadly is a subject of extensive debate.[118] Either way, these incentives certainly mark a departure from the conventional rational, self-interested actor.

IV. EFFECT #2: INVESTOR PROTECTION CONSIDERATIONS IN PRIVATE MARKETS

Large-scale public pension investment in private equity has also increased the number of ordinary people who are affected by the operations of private equity funds. Based on the SEC's rhetoric, it appears that concern for pension stakeholders has been a significant motivating factor behind the agency's interventions over the years.

A. Pension Stakeholders

1. Public Servants, Vulnerable Residents, and Taxpayers

Public pension plans invest the retirement savings of public servants, including teachers, firefighters, policemen, and others. As a result, the adverse effect of fraud or any other undesirable activity in a private equity fund with public pension plan investors will ultimately extend to ordinary people, not just high-net-worth individuals.

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115. *See* Rose, *supra* note 114, at 913 ("A public wealth orientation allows pension fund trustees to consider all of the impacts of various investments—including positive and negative externalities that would be borne by the taxpayers—in determining how to invest. This will likely result in an increased focus on what has been labeled as a socially responsible investment, and it will also likely affect the time horizon of investments.").

116. *See id.* at 895 ("Private investors might ignore certain effects, such as uncompensated harms from pollution, depleted natural resources, or widespread health problems, because the government absorbs the costs of such externalities.")

117. *See, e.g.*, Anna Gordon, *CalPERS' Project to Measure ESG in Private Equity Has 100 Organizations, $8 Trillion Participating*, CHIEF INV. OFFICER (Jan. 19, 2022), https://www.ai-cio.com/news/calpers-project-to-measure-esg-in-private-equity-has-100-organizations-8-trillion-participating/.

118. *See, e.g.*, Aleksandar Andonov, Roman Kräussl & Joshua Rauh, *Institutional Investors and Infrastructure Investing*, 34 REV. FIN. STUD. 3880, 3930 (2021) (finding that public pension plans perform worse than private institutional investors, and that ESG preferences and regulations explain 30% of their underperformance).

Sometimes, plan beneficiaries themselves can be exposed. However, because pension benefits are commonly afforded significant constitutional and statutory protections, the "ultimate guarantors" of public pension plans are often the taxpayers in the relevant jurisdiction.[119] This means that some of the most important stakeholders of public pension plans are taxpayers and residents in the state who rely on state services. Vulnerable residents are affected by problematic pension investments because when a plan's investment performance is weak, the state or local government will have to allocate more money than originally projected to pay its pension obligations. One way to accomplish this is by reallocating funds away from other government services (like education or welfare services) to make room for those payments. The other option is for the state or local government to raise taxes, spreading the burden across all taxpayers across the state or locality. Either way, many of those who bear the cost are likely to be underprivileged residents, and not well-heeled investors who can afford to sustain a substantial risk of loss.

Another plausible reason for policymakers to be more concerned about public pension stakeholders than the stakeholders of other types of institutional investors is because there is a body of academic research showing problematic investment practices by public pension plans. Studies have shown public pension staff making investment decisions to minimize personal career risk[120] and directing investments to politically connected companies,[121] among various other questionable investment practices.[122] Far more extreme forms of self-interested behavior—including bribery, pay-to-

119. *See* ISAACS, *supra* note 12.

120. *See, e.g.*, Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 472 (1996) (finding that institutional investor employees show a willingness to allow value to be transferred to fund managers in complex ways that are difficult for outsiders and superiors to detect, but not in ways that can be more easily observed and scrutinized); Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, *The Structure and Performance of the Money Management Industry*, BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECONOMICS, 1992, at 339, 339–79 (finding significant underperformance by pension plans attributable to agency problems, including actions taken by pension employees to shift responsibility for poor performance).

121. *See, e.g.*, Daniel Bradley, Christos Pantzalis & Ziaojing Yuan, *The Influence of Political Bias in State Pension Funds*, 119 J. FIN. ECON. 69, 80–81 (2016) (finding that local political connection bias is stronger for state pension funds with a higher percent of politically affiliated trustees and that states with more influential politicians in Congress tend to invest more heavily in politically connected local firms).

122. *See, e.g.*, Aleksandar Andonov & Joshua D. Rauh, The Return Expectations of Public Pension Funds 5, 32 (Nov. 23, 2021) (unpublished manuscript), https://academic.oup.com/rfs/advance-article/doi/10.1093/rfs/hhab126/6433685 (finding that public pension plans engage in "excessive extrapolation," which is the error of placing excessive weight on the plan's past returns, and that they act on those assumptions by increasing their "long-term allocations to risky assets").

play schemes, and other kinds of corruption by pension trustees and staff[123]—have also been documented in the pension context.[124] In addition, unlike private sector institutions, public pension plans are also frequently subject to statutory limits on the salary levels that they can pay their plan managers,[125] and many important positions are filled by political appointees who may not have investment expertise.[126] Scholars posit that this can make it difficult for

123. *See, e.g.*, Brendan Pierson, *N.Y. Pension Fund Manager Charged with Taking Bribes Pleads Guilty*, REUTERS (Nov. 8, 2017, 6:43 PM), https://www.reuters.com/article/us-new-york-corruption-pensions/n-y-pension-fund-manager-charged-with-taking-bribes-pleads-guilty-idUSKBN1D83AP; Matthew Dolan, *Jury in Detroit Pension Case Convicts Former Treasurer, 2 Others*, WALL ST. J. (Dec. 8, 2014, 6:45 PM), https://www.wsj.com/articles/jury-in-detroit-pension-case-convicts-former-treasurer-2-others-1418082345; Associated Press, *Former CEO of CalPERS Is Sentenced to Prison for His 'Spectacular Breach of Trust,'* L.A. TIMES (May 31, 2016, 3:51 PM), https://www.latimes.com/business/la-fi-calpers-buenrostro-20160531-snap-story.html; Marc Lifsher, *New York State Pension Fund Trustee Pleads Guilty to Taking Bribes*, L.A. TIMES (Oct. 7. 2010), https://www.latimes.com/archives/la-xpm-2010-oct-07-la-fi-hevesi-20101007-story.html; Associated Press, *Guilty Plea in Fraud Case Tied to New York Pension*, N.Y. TIMES (Dec. 4, 2009), https://www.nytimes.com/2009/12/04/nyregion/04pension.html#:~:text=Guilty%20Plea%20in%20Fraud%20Case%20Tied%20to%20New,million%20worth%20of%20illegal%20gifts%20to%20state%20officials; CHRIS TOBE, KENTUCKY FRIED PENSIONS: A CULTURE OF COVER-UP AND CORRUPTION (2013).

124. *See* Paul Rose, *Public Fund Governance and Private Fund Fees* (Ohio State Univ. Moritz Coll. L., Working Paper No. 358, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805452 ("Corruption in public pension funds is not new or confined to transactions with private funds.").

125. *See* Alexander Dyck, Paul Martins Manoel & Adair Morse, Outraged by Compensation: Implications for Public Pension Performance 13, 28 (unpublished manuscript), http://faculty.haas.berkeley.edu/morse/research/papers/DyckMorseManoel.pdf (finding that constraints on public plan compensation negatively impact fund performance); Christine Williamson, *Pension Funds Face Challenge in Recruitment*, PENSIONS & INVS. (Apr. 1, 2019, 1:00 AM), https://www.pionline.com/article/20190401/PRINT/190409985/pension-funds-face-challenge-in-recruitment ("[T]he compensation differential between pension fund investment management and [private sector] money managers is an ever-present issue in recruiting top talent . . . ."); Arleen Jacobius, *Public CIO Pay Getting Renewed Attention*, PENSIONS & INVS. (July 23, 2018, 1:00 AM), https://www.pionline.com/article/20180723/PRINT/180729976/public-cio-pay-getting-renewed-attention ("[P]ublic pension plan [chief investment officers] make a fraction of what they could make at a corporate pension fund, endowment, foundation or money management firm."); Madison Marriage, *Pension Pay Dilemma Becomes Acute*, FIN. TIMES (Feb. 7, 2015), https://www.ft.com/content/af31b7a4-ad39-11e4-bfcf-00144feab7de ("Generous executive pay at pension schemes is controversial, especially when members face reductions in benefits[.]").

126. Research shows that politically appointed trustees make less effective pension management decisions. *See, e.g.*, Bradley et al., *supra* note 121, at 88; Aleksandar Andonov, Yael V. Hochberg & Joshua D. Rauh, *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041, 2084 (2018) ("In the public pension context, the presence of politicians on boards appears to work against pension funds' primary objective of delivering the benefits promised to the participants as efficiently as possible for taxpayers."); Simon C.Y. Wong, *Public Pension Funds Perform Better When They Keep Politics at Bay*, HARV. BUS. REV. (July 19, 2016), https://hbr.org/2016/07/public-pension-funds-perform-better-when-they-keep-politics-at-bay ("Interference by elected officials—from imposition of local economic development obligations to excessive constraints on head count and compensation that impede

public pension plans to compete with private sector employees for talented personnel to manage their plan's investments.

2. State and Local Pension History of Underfunding

The issues above are compounded by a history of questionable funding practices by state and local pension plans. At the time that public pension plans began building large investment positions in private equity, many state and local plans were also experiencing significant funding shortfalls[127] that attracted widespread attention from scholars and critics.[128] This history of underfunding exacerbates concerns about pension underperformance because when a plan is underfunded, it makes the margin for error even smaller. Investment losses will more quickly result in a state cutting certain services for vulnerable residents and/or raising taxes on residents in the state.

Prior to the COVID-19 pandemic, it was estimated that state and local pension plans had unfunded liabilities worth multiple trillions of dollars.[129] While some states had healthy funding levels, the gap between well-funded plans and poorly-funded plans had never been wider.[130] As will be discussed below, recent market events have led to improvements in many public plans' funding status across the nation, but problems in individual states and localities still remain, and there is reason to be wary that the improved status may be delicate.[131]

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recruitment of talented staff—has contributed to poor investment choices, higher total costs, diminished organizations, and disappointing performance . . . .").

127. For extensive national statistics on the funding status of state and local pension funding across the country between 2002 and 2017, see *EFA: State Pensions*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/releases/z1/dataviz/pension/ (last updated Dec. 18, 2020).

128. *See infra* notes 132–134 and accompanying text.

129. Specific estimates vary depending on accounting assumptions. *See e.g.*, Thurston Powers, Bob Williams & Jonathan Williams, *Unaccountable and Unaffordable 2018*, AM. LEGIS. EXCH. COUNCIL (Mar. 20, 2019), https://www.alec.org/publication/unaccountable-and-unaffordable-2018/ (estimating unfunded liabilities of approximately $6 trillion); *Hidden Debt, Hidden Deficits: The 2019 Update*, Hoover Institution, Stanford University (June 11, 2019), https://www.hoover.org/news/hidden-debt-hidden-deficits-2019-update (estimating unfunded liabilities of approximately $4 trillion); *The State Pension Funding Gap: 2017*, PEW CHARITABLE TRS. 2, 4 (June 2019), https://www.pewtrusts.org/-/media/assets/2019/06/statepensionfundinggap.pdf [hereinafter *Pew Brief June 2019*] (estimating unfunded liabilities of approximately $1.28 trillion).

130. *See Pew Brief June 2019*, *supra* note 129, at 1 (noting that "the disparity between well-funded public pension systems and those that are fiscally strained ha[d] never been greater").

131. *See* Liz Farmer, *Stock Market Helps State Pension Debt Hit 10-Year Low, but Crisis Still Looms Large*, FORBES (Sept. 23, 2021, 10:15 AM), https://www.forbes.com/sites/lizfarmer/2021/09/23/stock-market-helps-state-pension-debt-hit-10-year-low-but-crisis-still-looms-large/.

Underfunding has been a prominent source of concern for many academics and policymakers over the years,[132] with many projecting serious problems for cities and states that persistently fail to make sufficient contributions.[133] Prior to the pandemic, several studies suggested that high pension costs had started to crowd out investments in areas like education, welfare, and infrastructure in some jurisdictions.[134] Even the most optimistic of scholarly commentators were acknowledging that a significant percentage of public plans would require enormous contribution increases to avoid serious problems.[135] This history of underfunding has generated concerns about intergenerational fairness, as future generations of taxpayers are the ones who have to bear the burden of increased taxes and/or reduced state services in the wake of prolonged underfunding.[136]

As noted above, recent market events have led to a sudden, dramatic improvement in the funding status of public pension plans across the country. According to Pew Charitable Trusts, the aggregate projected funded ratio for state and local plans across the country was 69% in 2020 (the second-lowest funded ratio since the financial crisis of 2008), but by 2021 the projected ratio had swung to 84% (the highest funded ratio since the financial crisis of

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132. In many states, pension debt has vastly exceeded other forms of debt over the years. In Illinois, for example, state and local governments had $466 billion of unfunded pension obligations before the pandemic, which tripled their bond debt of $155 billion. *See* Mary Williams Walsh, *As Virus Ravages Budgets, States Cut and Borrow for Balance*, N.Y. TIMES (May 14, 2020), https://www.nytimes.com/2020/05/14/business/virus-state-budgets.html.

133. *See, e.g.*, John Mauldin, *The Coming Pension Crisis Is So Big that It's a Problem for Everyone*, FORBES (May 20, 2019, 9:47 AM), https://www.forbes.com/sites/johnmauldin/2019/05/20/the-coming-pension-crisis-is-so-big-that-its-a-problem-for-everyone/?sh=376bab6637fc; *America's Public Pension Funding Crisis Worsens*, ECONOMIST (June 4, 2020), https://www.economist.com/finance-and-economics/2020/06/04/americas-public-pension-funding-crisis-worsens.

134. *See, e.g.*, TRACY GORDON ET AL., URBAN INST., FISCAL DEMOCRACY IN THE STATES: HOW MUCH SPENDING IS ON AUTOPILOT? 19, 26 (2019), https://www.urban.org/sites/default/files/publication/100728/fiscal_democracy_in_the_states_how_much_spending_is_on_autopilot_6.pdf; *Pew Brief June 2019*, *supra* note 129, at 2 (noting that "[p]ension contributions went up 424 percent in Illinois, 267 percent in Kentucky, and more than 100 percent in New Jersey from 2007 to 2017, reducing resources available for other important public priorities"); Sarah Anzia, *A Silent Pension Crisis is Eating Away Local Government Services. Here's What You Need to Know*, WASH. POST (Aug. 5, 2019), https://www.washingtonpost.com/politics/2019/08/05/silent-pension-crisis-is-eating-away-local-government-services-heres-what-you-need-know/.

135. *See* Jamie Lenney et al., *The Sustainability of State and Local Government Pensions: A Public Finance Approach*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2021, at 1, 3, https://www.brookings.edu/wp-content/uploads/2021/03/15872-BPEA-SP21_WEB_Lenney-et-al.pdf (noting that while their findings do not suggest an imminent crisis for most pension plans, "there is significant heterogeneity across plans, with some plans requiring large contribution increases to achieve stability").

136. *See* Christian Gollier, *Intergenerational Risk-Sharing and Risk-Taking of a Pension Fund*, 92 J. PUB. ECON. 1463 (2008); GORDON ET AL., *supra* note 134, at vii–viii.

2008).[137] Even though contribution rates by public plans have gotten better in recent years,[138] the improvement in funding status was driven almost entirely by an unprecedented run-up in the stock market, with the S&P 500 swinging from approximately 2,300 in March 2020 to over 4,500 by September 2021.[139] However, even though these returns have greatly improved funding ratios in the short run, they have also led experts to decrease long-term expected annual returns in the industry dramatically.[140] In fact, as of 2021, the returns that public pension plans are assuming their plans will achieve on their investments are a full percentage point lower than the returns that experts project are actually realistic.[141] Accordingly, in coming years, to maintain fiscal health, state and local pensions will likely need to achieve a much higher percentage of their growth through contributions rather than investment returns.

B. These Factors Have Actually Shaped the SEC's Approach to Private Equity

As noted above, private equity funds generally qualify for exemptions to each of the federal securities laws, except for the requirement that managers register under the Advisers Act. This requirement to register under the Advisers Act is a relatively recent phenomenon. Just over a decade ago, it was relatively easy for private investment funds to avoid registering and remain almost entirely off the agency's radar.[142] But following the financial

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137. *The State Pension Funding Gap: Plans Have Stabilized in Wake of Pandemic* 4, PEW CHARITABLE TRS. (Sept. 2021), https://www.pewtrusts.org/-/media/assets/2021/09/the_state_pension_funding_gap.pdf [hereinafter *Pew Brief Sept. 2021*].

138. *See id.* at 1 (noting that "contribution increases, which came after years of states shortchanging their systems, are part of an upward trend over the past 10 years").

139. *See S&P 500* (^GSPC), YAHOO! FIN, https://finance.yahoo.com/quote/%5EGSPC?p=%5EGSPC (last visited Dec. 13, 2021). Importantly, the stock market's poor performance in early 2022 has reversed some of these gains. *See* Heather Gillers, *Pensions' Bad Year Poised to Get Worse*, WALL ST. J. (May 10, 2022), https://www.wsj.com/articles/pensions-bad-year-poised-to-get-worse-11652175002#:~:text=Quarterly%20public%20pension%20returns%20last,pandemic%20sent%20markets%20into%20turmoil. (discussing the negative returns faced by public plans in the first quarter of 2022).

140. *See Pew Brief Sept. 2021*, *supra* note 137, at 6 ("[D]ownward adjustments to the outlook for these asset classes mean that we expect the typical pension fund to return approximately 6% annually over the next 20 years.").

141. *See id.* (noting that Pew Charitable Trusts' expected long-term return of 6% "is significantly lower than historical long-term returns of 8% . . . and a full percentage point lower than the current average assumed rate of return for state-sponsored retirement funds of around 7%").

142. Pursuant to the now defunct "private adviser exemption," any investment adviser that had fewer than fifteen clients and that did not hold itself out to the public as an investment adviser could avoid registration with the SEC. Now, the set of exemptions is much narrower and nearly all private fund advisers of substantial size must register with the SEC.

crisis of 2008, Congress amended the Advisers Act so that most private equity managers have to register with the SEC and are subject to regular examinations by the agency.[143] In fact, in the early-2010s, the SEC even established a special unit entirely dedicated to examining private funds,[144] and it has maintained a robust presence ever since, examining hundreds of private equity fund managers each year.[145] In effect, this Private Funds Unit[146] serves as a full-time police presence in the industry.[147] During the initial wave of examinations, the Private Funds Unit found many problematic industry practices,[148] and they expressed particular concern for what they perceived as a widespread lack of transparency with investors.[149]

Following these changes, the SEC received questions about why it had established such a robust regulatory presence in a market that was exclusively limited to investors that were (or should have been) sophisticated. In response, the SEC repeatedly invoked the massive presence of public pension plans in the industry.[150] When explaining why the poor governance practices found in the examinations described above were so problematic, the SEC repeatedly noted as an explanatory rationale that poor governance in private funds directly harms the public employees whose retirements are invested in public pension plans.[151] Other prominent public figures have made similar

143. *See Private Fund Adviser Overview*, U.S. SEC. & EXCH. COMM'N (Oct. 21, 2016), https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm ("The Dodd-Frank Act replaced the old 'private adviser' exemption with narrower exemptions for advisers that advise exclusively venture capital funds and advisers solely to private funds with less than $150 million in assets under management in the United States.").

144. *See* Greg Roumeliotis & Sarah N. Lynch, *Exclusive: SEC Forms Squad to Examine Private Funds – Sources*, REUTERS (Apr. 7, 2014. 6:55 AM), https://www.reuters.com/article/us-sec-privatefunds/exclusive-sec-forms-squad-to-examine-private-funds-sources-idUSBREA360M420140407.

145. *See Risk Alert* 2020, *supra* note 40.

146. *See* Wyatt, *supra* note 38 ("OCIE has taken another step towards knowledge building and deeper specialization by creating the Private Funds Unit . . . which is dedicated to examining advisers to private funds, including private equity advisers.").

147. *See Risk Alert* 2020, *supra* note 40 ("OCIE . . . is frequently asked about its observations from these examinations as well as common deficiencies and compliance issues. Many of the deficiencies discussed [in the Risk Alert] may have caused investors in private funds ("investors") to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest . . . .").

148. *See, e.g.*, Bowden, *supra* note 15 (noting that "violations of law or material weaknesses in controls" were found in over 50% of managers examined, and that managers regularly charged "hidden fees that [we]re not adequately disclosed to investors" and shifted expenses to investors "without proper disclosure that [those] costs [were] being shifted to investors").

149. *Id.* ("Lack of transparency and limited investor rights have been the norm in private equity for a very long time.").

150. *Id.* ("The biggest investors in private equity include public and private pension funds, endowments and foundations, which account for 64% of all investment in private equity in 2012.").

151. *See supra* note 15 and accompanying text.

comments about the engagement of public pension plans in private investment funds.[152]

More recently, regulatory concerns about private equity have been revived during the tenure of Chair Gary Gensler. At various times in 2021, Chair Gensler raised many familiar concerns about private equity funds and indicated that the SEC was considering additional regulatory interventions to mitigate conflicts of interest and increase transparency in the industry.[153] In defense of these possible changes, Chair Gensler repeatedly referenced the benefits they would bring to public pension plans and pension beneficiaries,[154] echoing the justifications raised by former SEC officials for regulatory scrutiny of private equity.

Then, in February 2022, the SEC released a rulemaking proposal that, if implemented, will dramatically increase mandatory disclosure in the industry and impose other unprecedented interventions.[155] As observed by Hester Peirce, the lone commissioner who voted against the proposal, these changes mark a "sea change" in the SEC's approach to private investment funds.[156] Once again, the commissioners' comments in support of the proposal,[157] and the language of the proposal itself,[158] suggest that concern for public pension plans and their stakeholders are one of the SEC's driving motivations for introducing the proposed changes.

152. *See, e.g.*, Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1936 (2017) ("Many pension funds are not in fact well positioned to prudently select hedge funds or other non-registered investments and may be attracted to those types of investments because they have not prudently funded and invested the pension fund in the past. Thus, they chase the impossible dream of using above-market returns to fill a hole left by previous underinvestment and poor investing, creating a probability that when the impossible dream does not come true, the hole is even larger.").

153. *See* Gensler, Remarks at ILPA Summit, *supra* note 16 ("I have asked the staff to consider what recommendations they could make to bring greater transparency to fee arrangements. . . . I've asked staff how we can better mitigate the effects of conflicts of interest between general partners, their affiliates, and investors. This could include considering the need for prohibitions on certain conflicts and practices.").

154. *See supra* note 16 and accompanying text.

155. *See infra* Section VI.A.1.

156. Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking (Feb. 9, 2022) (transcript available at https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922) ("Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds.").

157. *See supra* note 18 and accompanying text.

158. *See* Feb. 2022 SEC Proposed Rule, *supra* note 19.

V. EFFECT #3: IMPLICATIONS FOR CAPITAL FORMATION DYNAMICS IN PRIVATE EQUITY

A. Investors Have Complained of a Manager's Market for Contract Terms for Years

The private equity industry has enjoyed a remarkable run of fundraising success over the past two decades.[159] Private equity managers have benefited from several factors working in their favor, including a long period of low interest rates. Low interest rates have helped to increase the returns of leveraged investment strategies, and they have also incentivized institutional investors to look for riskier investments to compensate for low returns in fixed income markets.

One common complaint from institutional investors is that, with so many investors looking to allocate capital to private equity and the perception that only a select group of managers can achieve outperformance, they are hesitant to negotiate aggressively against managers for fear of being "frozen out" of their funds. Institutional investors have commonly held the view that if they push back too hard on governance terms, the high-performing managers will be happy to give their place in the fund to someone else.[160] Investors report that this concern is exacerbated by the fact that there is only a limited number of private equity fund managers with attractive track records, giving these managers greater confidence that they can push back and still have potential clients.[161]

Many investors claim that this dynamic has led to an equilibrium where private equity fund governance terms throughout the market have become increasingly favorable to managers over time[162]—a factor that could help to explain the SEC's problematic findings in the mid-2010s[163] and more recently.[164] Another way to describe this complaint is that capital formation

159. *See Private Markets 2021: A Year of Disruption*, MCKINSEY & COMPANY 11 (Apr. 2021), https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review (reporting that private market assets under management have grown by $4 trillion in the past decade, an increase of 170%).

160. *See supra* note 22 and accompanying text.

161. *See, e.g.*, Preeti Singh, *Coming to Terms: Private-Equity Investors Face Rising Costs, Extra Fees*, WALL ST. J. (Dec. 20, 2021), https://www.wsj.com/articles/coming-to-terms-private-equity-investors-face-rising-costs-extra-fees-11640001604 (quoting an institutional investor as saying: "I'm agreeing to expenses and terms that are far more adverse since I started investing 15 years ago . . . . But what can I do? If I create a fuss I won't get a seat at the table.").

162. *See supra* notes 21–22 and accompanying text.

163. *See supra* notes 149–151 and accompanying text.

164. *See supra* note 40.

has been *too easy* for managers in private equity, enabling them to push for imbalanced terms without losing significant market share.[165]

The enormous shift of public pension capital to private equity funds has certainly contributed to the high demand for private equity fund investments over the years. Interestingly, a large body of research suggests that state and local pension plans had perverse incentives to over-invest in risky investments like private equity funds for many years.[166]

B. Incentives to Increase Risk Rather Than Raise Taxes or Cut Services

Defined benefit public pension plans know in advance the amount of future liabilities that they are required to satisfy. If a plan is lagging behind in saving for those future liabilities, the officials running that public plan have a few options. One is to increase taxes and direct the additional cash flow to pension fund assets. For obvious reasons, however, publicly elected officials will often find this option unattractive, as voters are likely to be sensitive to tax increases. Another option would be to cut other tax-funded services and redirect the funds to the pension plan. This will often be similarly unattractive, as public officials will risk losing the support of voters who were the recipients of those services. Doing this may also be socially suboptimal if the terminated services were providing a useful social function.

Another option—one that may be more politically palatable—would be to increase the risk of the plan's investment portfolio, including by investing in assets like private equity. By increasing risk, public officials can increase the expected future return of the portfolio without increasing taxes or cutting other government-sponsored services. As noted above, many scholars have criticized public plans for over-investing in risky assets over the years, arguing that it makes public pension systems vulnerable to market

165. Traditional law and economics theory would predict that governance terms should not change as bargaining power shifts in a contracting setting. However, industry participants generally agree that this is not how things work in the private equity industry. For a detailed discussion of this phenomenon, see Clayton, *supra* note 89.

166. *See generally* Novy-Marx & Rauh, *supra* note 65; Jeffrey R. Brown & David W. Wilcox, *Discounting State and Local Pension Liabilities*, 99 AM. ECON. REV. 538 (2009); Robert Novy-Marx & Joshua D. Rauh, *Public Pension Liabilities: How Big Are They and What Are They Worth?*, 66 J. FIN. 1207 (2011) [hereinafter Novy-Marx & Rauh, *Public Pension Liabilities*]; Alicia H. Munnell, Jean-Pierre Aubrey & Mark Cafarelli, *The Funding of State and Local Pensions: 2013–2017*, CTR. FOR RET. RSCH. AT B.C. 5 (2014), https://crr.bc.edu/wp-content/uploads/2014/06/slp_39.pdf; Odd J. Stalebrink, *Public Pension Funds and Assumed Rates of Return: An Empirical Examination of Public Sector Defined Benefit Pension Plans*, 44 AM. REV. PUB. ADMIN. 92 (2014); Robert Novy-Marx & Joshua D. Rauh, *Linking Benefits to Investment Performance in U.S. Public Pension Systems*, 116 J. PUB. ECON. 47 (2014); Andonov et al., *supra* note 57; Jeffrey Diebold, Vincent Reitano & Bruce McDonald, *Sweat the Small Stuff: Strategic Selection of Pension Policies Used to Defer Required Contributions*, 36 CONTEMP. ECON. POL'Y 505 (2017).

downturns.[167] This incentive to increase public pension risk-taking beyond what would otherwise be prudent has been characterized as "gambling" with public finances by various commentators,[168] judges,[169] and popular media sources.[170] Nevertheless, to the extent that voters are likely to be less sensitive to excessive investment portfolio risk than tax increases and cuts in government services, public officials will have an additional incentive to take on risk.

Notably, public pension investment in private assets has been steadily increasing in the wake of the pandemic.[171] While it is difficult to determine how much of this activity is being driven by the kinds of incentives described above versus other objectives,[172] these non-market incentives are a fact of life in the public pension context.

C. Public Pension Accounting Rules Long Incentivized Over-Investment in Risky Assets Like Private Equity

Looking back over the past two decades, the incentives described above were further exacerbated for many years by public sector accounting rules. These rules allowed state and local officials to obscure underfunding problems and reduce their required pension contributions by investing in risky assets.[173] Efforts were made in the mid-2010s to reform those rules, though some critics argue that perverse incentives to invest in risky investments like private equity still remain.[174] Studies have shown that over the years there was a link between the increased investment in risky assets by

167. *See supra* notes 63–65 and accompanying text.

168. Tenreiro, *supra* note 67.

169. *See, e.g.*, *supra* note 152.

170. *See, e.g.*, Gaviria et al., *supra* note 69.

171. *See* Gillers, *supra* note 5 ("Government retirement funds are pumping record sums into private equity, defying concerns about risk and cost as they try to plug pension shortfalls."); Harriet Agnew & Josephine Cumbo, *Pension Funds Seek Returns in Private Assets as Public Market Outlook Dims*, FIN. TIMES (Nov. 29, 2021), https://www.ft.com/content/e4ae2283-0787-4f57-a23c-aa43d55c6745 ("Large funding deficits are driving pension plans to plough money into private assets in pursuit of returns, heightening the risk of crowded trades and subdued gains . . . .").

172. For example, given low interest rates and high stock valuations in the current market, alternative investment options are limited.

173. *See infra* Section V.C.2.

174. *See, e.g.*, Deborah Lucas, Towards Fair Value Accounting for Public Pensions: The Case for Delinking Disclosure and Funding Requirements 5 (Oct. 2017) (unpublished manuscript), http://mitsloan.mit.edu/shared/ods/documents/?PublicationDocumentID=4595 (criticizing GASB 67 and 68 because they "le[ave] plan sponsors with discretion over how to determine expected returns and how to define what constitutes an unfunded liability for purposes of discount rate determination").

state and local plans and the magnitude of those plans' underfunding problems.[175]

1. Where Public Pension Accounting Rules Come From

Accounting standards in the United States are promulgated by private, nonprofit organizations. The standards for private sector businesses are established by the Financial Accounting Standards Board ("FASB"), and the standards for state and local governments are set by the Governmental Accounting Standards Board ("GASB"). On the surface, these organizations have much in common.[176] However, notwithstanding some of these similarities, GASB's authority (or lack thereof) is much different than FASB's. All private sector entities that are subject to the federal securities laws are legally required to observe FASB's standards.[177] FASB is also subject to oversight by the SEC. By contrast, state and local governments can choose to follow GASB's standards, but they are under no obligation to do so.[178] GASB also operates free from SEC oversight.

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175. *See, e.g.*, Andonov et al., *supra* note 57, at 2560 ("We find that U.S. public pension funds with a higher level of underfunding per participant invest more in risky assets and use higher liability discount rates, consistent with our intuition that these pension funds have stronger incentives to report a lower funding deficit and reduce the required contribution payments today."); Paul Rose & Jason Seligman, *Are Alternative Investments Prudent? Public Sector Pension Use and Fiduciary Duty*, J. ALT. INVS., Winter 2016, at 5, 16 (finding that plans with lower-funded ratios are more inclined to invest in alternative investments and that the proportion of alternative investments is "strongly and positively related to investment return assumptions"). These findings are consistent with a long line of research showing that public plan administrators are more likely to engage in opportunistic accounting practices in times of fiscal stress. *See, e.g.*, Barbara A. Chaney, Paul A. Copley & Mary S. Stone, *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 J. ACCT. & PUB. POL'Y 287 (2002); Tim V. Eaton & John R. Nofsinger, *The Effect of Financial Constraints and Political Pressure on the Management of Public Pension Plans*, 23 J. ACCT. & PUB. POL'Y 161 (2004).

176. For example, the principles released by both organizations are designated as the "Generally Accepted Accounting Principles" in their respective spheres, and the same parent organization that appoints directors to the FASB—the Financial Accounting Foundation—also appoints the GASB directors. *See generally About the GASB*, GOVERNMENTAL ACCT. STANDARDS BD., https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176168081485 (Sept. 2021). The two organizations even share the same building and mailing address. *See id.*

177. *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Remarks at the Financial Accounting Foundation Trustees Dinner (May 20, 2014) (transcript available at https://www.sec.gov/news/speech/2014-spch052014mjw) ("Because accounting standards adopted by the FASB are the core of the financial reporting required by the federal securities laws, a strong relationship between the SEC and FASB is vital.").

178. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET iv (2012), https://www.sec.gov/files/munireport073112.pdf ("There are no uniformly applied accounting standards in the municipal securities market and the Commission generally lacks authority to prescribe the accounting standards that municipal issuers must use.").

Many have argued that these structural differences weakened GASB's ability to pass strong and effective standards out of fear that cities and states would opt out of GASB standards if they were too rigorous and adopt their own.[179] Even though GASB standards have been criticized by various scholars and industry commentators over the years,[180] they have been widely followed by state and local governments.[181]

2. How GASB Rules Incentivized Risk-Taking

a. Original Rules: GASB 25 and 27

Prior to 2014, GASB 25[182] and 27[183] governed the reporting of pension liabilities by cities and states. Under these standards, state and local governments were instructed to fund pension liabilities so that the expected future value of pension assets equaled the expected future value of pension liabilities. Accordingly, when reporting the amount of pension liabilities that they had promised to public employees, cities and states following GASB were instructed to report the discounted present value of those liabilities. The

179. *See, e.g.*, James Naughton & Holger Spamann, *Fixing Public Sector Finances: The Accounting and Reporting Lever*, 62 UCLA L. REV. 572, 579 ("Some have speculated that [poor decision-making by GASB] is due to incompetence or capture by the regulated public entities from where GASB's members hail."); Israel Klein, *It's Time to Mind the GASB*, 54 SAN DIEGO L. REV. 565, 591 (2017) (noting that GASB is "incentivized to relax stringent disclosure requirements in order to induce adoption"); Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 752 (2009) (noting that GASB "has been criticized as being subject to regulatory capture"); George P. Shultz & David G. Crane, *It's Time for Truth in State and Local Government Finances*, CITYWATCH (Aug. 19, 2019), https://www.citywatchla.com/index.php/2016-01-01-13-17-00/los-angeles/18276-it-s-time-for-truth-in-state-and-local-government-finances (noting that at GASB, it is "much easier for the regulated to control their regulator" than in other settings).

180. *See, e.g.*, Terrance O'Reilly, *A Public Pensions Bailout: Economics and Law*, 48 U. MICH. J.L. REFORM 183, 194 (2014) ("GASB's standards . . . are significantly looser than those that ERISA imposes on private sector plans."); Naughton & Spamann, *supra* note 179, at 574 (arguing that GASB standards are outdated and ineffective and in need of fixing).

181. *See* Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663, 671 (2015) ("Although GASB standards are not federal law and GASB has no enforcement authority, its reporting standards are generally recognized by state and local governments as authoritative . . . ."); Naughton & Spamann, *supra* note 179, at 576 ("Most U.S. states and local entities prepare financial reports in accordance with a separate set of GAAP developed by the [GASB].").

182. Government Accounting Standards Rule 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans," was adopted in November 1994 and is summarized at http://www. gasb.org/st/summary/gstsm25.html.

183. Actuarial Standard of Practice #27, "Selection of Economic Assumptions for Measuring Pension Obligations," was adopted September 2007 and is available at http://actuarialstandardsboard.org/pdf/asops/asop027_109.pdf.

appropriate discount rate, according to GASB 25 and 27, was the expected return of the assets held in the pension plan's investment portfolio.[184]

Under these rules, the amount that cities and states were required to contribute to their pension plans in any given year was based on this discounted liability figure—so the smaller the discounted liability, the less the city or state would have to contribute to its plans. Thus, by causing a plan to invest in riskier assets, city and state officials could reduce the size of the required contribution to be made by the government, thereby opening up funds to be allocated to other items in the budget.[185] And, since they were only required to publicly report the discounted value of the liabilities, city and state officials could also make their unfunded liabilities *appear smaller* to the public by investing in a higher percentage of pension portfolios in risky assets.[186]

The GASB 25 and 27 approach was inconsistent with basic finance theory and was roundly rejected by economists.[187] The only way to increase the expected return of a pension plan's investment portfolio was to invest the plan's assets in riskier investments. When a pension plan is invested in risky assets, the average expected returns are higher than if the plan were invested in low-risk assets, but there is also a higher chance that the risky investments will produce far lower returns than expected, or no returns at all.[188]

Studies suggest that using a higher discount rate to calculate the present value of public pension obligations had a significant impact on actual funding practices for many years. According to one estimate, if states had to discount their obligations using a risk-free rate, their reported unfunded liabilities

184. *See* Novy-Marx & Rauh, *Public Pension Liabilities*, *supra* note 166, at 1211 ("Government Accounting Standards Board (GASB) ruling 25 and Actuarial Standards of Practice (ASOP) item 27 stipulate that public pension liabilities are to be discounted at the expected rate of return on pension assets.").

185. *See* Eileen Norcross & Emily Washington, *The Crisis in State and Local Pensions*, MERCATUS CTR. AT GEORGE MASON UNIV. 2, https://www.mercatus.org/system/files/Norcross-Pensions-CrisisEP.pdf (last visited Mar. 16, 2022) ("Using a high discount rate lowers the [annual required contribution] to pension funds.").

186. *See* Andonov et al., *supra* note 57, at 2555 (noting that "[t]he unique regulation of U.S. public pension funds links their liability discount rate to the expected return on assets, which gives them incentives to invest more in risky assets in order to report a better funding status").

187. *See* Jeffrey R. Brown & David W. Wilcox, *supra* note 166, at 538 ("Finance theory is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities.").

188. *See* Lucas, *supra* note 174, at 8–9 ("A more charitable interpretation of the GASB rule is that it is being used to create estimates that answer a distinctly different question, which is: How much has to be set aside today so that on average investment returns cover projected benefit payments? It implicitly assumes that the right funding policy is to hold an amount of assets that on average will be sufficient to meet obligations over time, while allowing that other sources of government revenue may have to be redirected if returns prove to be inadequate.").

would have gone up dramatically, their funded ratios[189] would have plummeted, and their annual required contribution[190] (on average) would have doubled.[191] Research has shown that these practices also created a number of indirect problems as well, distorting the spending and employment decisions made by state and local governments over the years.[192] Instead of ratcheting back new obligations in response to the burgeoning underfunding problem in recent decades, states were actually increasing the size of their new pension liabilities by making retirement packages more generous.[193]

The massive increase in public pension plans' investments in risky assets—including private equity funds—over the past two decades was thus part of a much broader and more complex story.

189. Funded ratios show the percentage of a public pension plan's liabilities that are backed by actual funds in the plan.

190. The "annual required contribution" refers to the amount under GASB 25 and 27 that a public employer must pay into its pension fund to cover the cost of benefits accrued in that year to pay off any unaccrued unfunded liabilities in no more than thirty years. *See* GOVERNMENTAL ACCT. STANDARDS BD., GUIDE TO IMPLEMENTATION OF GASB STATEMENTS 25, 26, AND 27 ON PENSION REPORTING AND DISCLOSURE BY STATE AND LOCAL GOVERNMENT PLANS AND EMPLOYERS: QUESTIONS AND ANSWERS 13–15 (1997).

191. *See* Diebold et al., *supra* note 166, at 507 ("If states were required to discount their obligations using a riskless rate unfunded liabilities estimates would increase by 210%, funded ratios would decline by 33%, and the ARC from states would double, on average.").

192. Research has shown that these accounting issues distorted the spending and employment decisions made by state and local governments over the years. By giving the impression that future pension benefits required lower annual contribution amounts than was realistic, GASB accounting made state and local employees appear less expensive than they actually were. For example, Naughton et al. empirically showed that this led states to overinvest in public sector workers relative to the resources that they had available. They constructed a dataset consisting of reported GASB pension costs from 1990–2009 and the amount that the pension costs would have been if states had been required to use the FASB discounting rules. Their regression results show that the larger the difference between the costs calculated under the GASB method and the FASB method, respectively, for any time period, the more likely states were to over-invest in workers during that time period. *See* James Naughton, Reining Petacchi & Joseph Weber, *Public Pension Accounting Rules and Economic Outcomes*, 59 J. ACCT. & ECON. 221, 239 (2015) ("We also find that pension understatements are associated with higher future labor costs. Importantly, we find that the positive relation between pension funding gap understatement and future labor costs is associated with the inherent methodology in the GASB rules, which systematically understate the funding gap . . . .").

193. *See* Robert Clark et al., *The Evolution of Public Sector Pension Plans in the United States*, *in* THE FUTURE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS 239, 256 (Olivia S. Mitchell & Gary Anderson eds., 2009) ("The main story of the past three decades has been the increased generosity of state retirement plans. States have reduced the normal retirement age, increased the generosity parameters, and reduced the number of years in the averaging period. As a result, replacement rates [the percentage of a worker's pre-retirement income paid after retirement] have risen significantly.").

b. Updated Rules: GASB 67 and 68

Due in part to widespread scholarly criticism of GASB 25 and 27,[194] GASB released updated standards that went into effect in 2013 and 2014, respectively.[195] Under GASB 67 and 68, public plans are supposed to use a "blended" discount rate when discounting pension liabilities to present value. Instead of using the expected rate of return of the assets in the plan's investment portfolio to discount all of the plan's liabilities, GASB 67 and 68 direct plans to use the expected return only to the extent that the plan's assets are projected to be sufficient to satisfy benefit payments. To the extent that the plan's actuaries project that there will be an unfunded balance of benefit payments after the plan's assets are depleted, plans are supposed to use a high-quality, tax-exempt municipal bond rate to discount that balance. Because public pension plans invest so much of their portfolios in risky assets, a municipal bond rate is significantly lower than the expected return of most plans. As a result, for plans that project to have unfunded balances, applying this lower interest rate results in higher liability figures than if the higher rate were applied to all of the plan's liabilities.

Another significant change introduced by GASB 67 and 68 related to the presentation of pension liabilities. Under GASB 67 and 68, if there is a net pension liability after subtracting the fair value of pension assets from the pension obligation (as measured following the approach above), it must be recognized in the financial statements of state and local governments. Under GASB 25 and 27, disclosure of this figure was only required in the footnotes to the financial statements.[196]

GASB 67 and 68, which are the rules that still apply to public pension plans, have generally been viewed as an improvement, but not a complete solution, to the problems observed in GASB 25 and 27.[197] Critics have

194. *See, e.g.*, *supra* note 166 and accompanying text.

195. Government Accounting Standards Rule 67, "Financial Reporting for Pension Plans—An Amendment of GASB Statement No. 25," went into effect on June 15, 2013, and is summarized at https://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219444. Government Accounting Standards Rule 68, "Accounting and Financial Reporting for Pensions—An Amendment of GASB Statement No. 27," went into effect on June 15, 2014, and is summarized at https://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219492.

196. *See* Divya Anantharaman & Elizabeth Chuk, The Impact of Governmental Accounting Standards on Public-Sector Pension Funding 3 (July 8, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438074 ("[A]ny net pension liability determined by subtracting the fair value of pension assets from the pension obligation . . . is to be recognized on the financial statements of state and local governments for the first time. Prior to these changes, GASB standards only required footnote disclosure of the unfunded liability.").

197. *See* Lucas, *supra* note 174 ("It is fair to say that GASB 67 was a major disappointment for proponents of accounting reform. . . . Despite its shortcomings, GASB 67 deserves credit for opening the door to accounting reform.").

argued that because the expected return of a plan's investment portfolio is still used under the new rules, state and local plans continue to have incentives to over-invest in risky assets to obfuscate their underfunding problems notwithstanding the passage of GASB 67 and 68.[198] Thus, while GASB 67 and 68 are better than GASB 25 and 27,[199] scholars and policymakers generally agree that public sector accounting still has significant room for improvement.[200]

VI. POLICY CONSIDERATIONS

A. Private Equity Regulation

1. The February 2022 SEC Proposed Rule

Publicly-traded companies must comply with an extraordinarily detailed set of mandatory disclosure rules and processes when they raise

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198. Studies show that state and local governments have used the discretion granted to them under GASB 67 and 68 to project that their assets will be sufficient to fund all liabilities. *See* Sheila Weinberg & Eileen Norcross, *GASB 67 and GASB 68: What the New Accounting Standards Mean for Public Pension Reporting*, MERCATUS ON POL'Y (June 2017), https://www.mercatus.org/system/files/mercatus-weinberg-gasb-67-68-mop-2017-v1.pdf (noting that Kentucky and Illinois did not apply the blended rate to some of their largest pension plans, notwithstanding the fact that the pension in these states were among the worst-funded in the country).

199. Some more recent studies have found that GASB 67 and 68 have benefited public pension governance. One study found that funding contributions by state and local governments to their plans has gone up since 2014. *See* Anantharaman & Chuk, *supra* note 196, at 5. Another found that after the introduction of GASB 67 and 68, housing prices in counties from states with larger pension liabilities as a percentage of total GDP have grown more slowly relative to their adjacent counties, suggesting that homebuyers have been factoring the burden of state pension liabilities into the amount they are willing to pay for their homes. *See* Grace Haoqing Fan, Economic Consequences of Public Pension Accounting Rule Changes: Evidence from Housing Markets and Local Economies 36 (Jan. 2020) (unpublished manuscript), https://d30i16bbj53pdg.cloudfront.net/wp-content/uploads/2020/01/FAN_Grace_JMP.pdf. While this study did not examine whether the reported liabilities were accurately calculated, it did show that the increased visibility of unfunded liabilities in pension financial statements has led to an increase in public attention on underfunding.

200. *See* Emily Kessler et al., *Better Measurements: Risk Reporting for Public Pension Plans* 17 (Harv. Kennedy Sch. Mossavar-Rahmani Ctr. For Bus. & Gov't, Working Paper No. 128, 2019), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/PENSION_FINAL%2C%2010july19.pdf ("While recent guidance from the GASB, the ASB, and the BRP has established a basis for improved reporting that focuses on similar issues and practices, conference participants agreed that more needs to be done, and acknowledged that most plans disclose few if any risk measures beyond the liability sensitivity analysis required by the GASB. Moreover, despite the common themes of guidance from all three organizations, no standard or consistent reporting requirements for comprehensive risk measurement have yet emerged. Finally, and perhaps most significantly, though most plans conduct these types of analysis internally, there is little or no risk reporting provided to or designed for non-fiduciaries.").

capital. Historically, if a company or an investment fund qualified for exemptions to the 1933 Act, the 1934 Act, the Investment Company Act, and the Advisers Act, that entity's capital-raising activities were generally left alone under those statutes. This approach implicitly adhered to the idea that sophisticated parties can be assumed to bargain for effective terms and to agree on effective transaction processes without any need for intervention.

As noted above, in the private equity context, this approach took a significant turn in the early-2010s when the SEC formed the Private Funds Unit and introduced industry-wide examinations, among other things.[201] In effect, these policy actions reflected a view from the SEC that a completely hands-off approach to securities regulation was not working very well in private equity. As discussed above, public pension plans, and the non-market influence they have had on the market, help to explain why the SEC's approach to private equity has changed as much as it has over the past decade.[202]

Those earlier SEC interventions, however, seem rather insignificant compared to the proposed rules that the SEC released to the public in February 2022.[203] Among other things, the new proposed rules would:

- Require that all private equity fund managers provide investors with quarterly statements containing detailed information about fund performance, fees, and expenses;[204]
- Require that all private equity fund managers obtain an audit for each fund that they manage annually and notify the SEC upon any modification of an auditor's opinion regarding financial statements or termination of an auditor's engagement;[205]
- Prohibit all private fund advisers (including those that are not registered with the SEC pursuant to the Advisers Act), from engaging in a robust set of activities and practices that the SEC views as contrary to the public interest and the protection of investors (including charging fees for unperformed services and for expenses associated with an SEC examination or investigation of the manager);[206] and
- Prohibit all private fund managers (including those that are not registered with the SEC pursuant to the Advisers Act) from

201. *See supra* notes 144–145 and accompanying text.
202. *See supra* Section IV.B.
203. *See* Feb. 2022 SEC Proposed Rule, *supra* note 19.
204. *Id.* at 17–18.
205. *Id.* at 99–100.
206. *Id.* at 132–33.

> providing certain forms of preferential treatment that would have a material negative effect on other investors.[207]

Notably, in addition to the February 2022 proposed rule, which primarily regulates the relationship between managers and investors, the SEC also issued proposed amendments to mandatory reporting requirements on Form PF to address systemic risk.[208] No longer a periodic report, the proposed amendments would require managers to report changes within one business day of certain triggering events.[209] Similar changes are being considered by the SEC to require enhanced reporting by large operating companies as well.[210]

These proposed changes have prompted significant criticism.[211] Critics argue that interventions are unnecessary and that policymakers should instead assume that private fund investors will use their resources and sophistication to make sound investment decisions and structure their investments effectively.[212] While a detailed analysis of the SEC's proposal and its critics is beyond the scope of this Article, this Article's analysis does raise questions about whether the assumptions underlying these contractarian criticisms are true.

This Article's analysis does not, however, suggest that the SEC should have a blank check to intervene in private funds. As the SEC looks to take these unprecedented regulatory steps, any future interventions should be calibrated to respond to the impediments to effective bargaining in private equity. Establishing clear theory for what those impediments are and how

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207. *Id.* at 162–63; *see also* Kirkland & Ellis, *SEC Proposes Sweeping Rule Changes for Private Fund Advisers* (Feb. 10, 2022), https://www.kirkland.com/publications/kirkland-aim/2022/02/rule-changes-for-private-fund-advisers-1.

208. *See supra* note 37.

209. *See* U.S. Sec. & Exch. Comm'n, Proposed Rule: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers (Jan. 26, 2022), https://www.sec.gov/rules/proposed/2022/ia-5950.pdf.

210. *See* Paul Kiernan, *SEC Pushes for More Transparency From Private Companies*, WALL ST. J. (Jan. 10, 2022, 6:00 PM), https://www.wsj.com/articles/sec-pushes-for-more-transparency-from-private-companies-11641752489.

211. *See, e.g.*, Peirce, *supra* note 156; Editorial Board, *The SEC's Private Market Takeover*, WALL ST. J. (Mar. 15, 2022), https://www.wsj.com/articles/the-secs-private-market-takeover-gary-gensler-hester-peirce-11647375870.

212. *See, e.g.*, Peirce, *supra* note 156 ("[T]he Commission judges it wise to divert resources from the protection of retail investors to safeguard these wealthy investors who are represented by sophisticated, experienced investment professionals. I disagree with both assessments; these well-heeled, well-represented investors are able to fend for themselves, and our resources are better spent on retail investor protection. . . . [T]he proposal's focus on protecting private fund investors by shaking information loose from what *we* deem to be uncommunicative private funds and shutting down practices *we* deem to be unfair is a departure from the Commission's historical view that these types of investors can fend for themselves.").

they affect bargaining outcomes is an important part of doing this. Yet, as illustrated by the wide gap between the contractarian views held by the proposal's critics and the views of the SEC's private funds rulemaking staff, this effort is not easy, particularly given the lack of publicly available information about how bargaining works in this space. The need for thoughtful scholarship in this area has thus never been stronger.

2. Special Rules for Public Pension Plans?

Public pension plans raise a distinctive set of issues in private equity funds. So what if, instead of imposing industry-wide interventions, the SEC imposed rules that apply only to public plans? Do the distinctive characteristics of public pension plans justify imposing a special set of restrictions and/or protections that go beyond the requirements that apply to other investors? Could the SEC even do this, assuming it wanted to?

One possible option would be for the SEC to use the accredited investor standard[213] to exclude public plans that show severe signs of mismanagement. If, for example, underfunding and low contribution rates were to become a sufficiently serious problem across states and localities, the SEC could adjust the standard to exclude public plans that are failing to satisfy baseline contribution rates and/or funding ratios. The SEC has repeatedly indicated that the goal of the accredited investor standard is to identify "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."[214] In severely underfunded plans, even though state officials have access to sophisticated advice, it might be fair to question whether they are actually using those resources to seek the best interests of their pension beneficiaries and taxpayers. Moreover, as discussed above, when the portfolio of an underfunded public pension plan performs worse than expected, there is a good chance that many of the individuals who bear the cost of that underperformance will be low-income and/or vulnerable residents of the state.[215] With the authority set forth in section 2(a)(15), the SEC could make

213. *See supra* note 29 and accompanying text.

214. Regulation D Revisions; Exemption for Certain Employee Benefit Plans, 52 Fed. Reg. 3015, 3017 (Jan. 30, 1987) (to be codified at 17 C.F.R. pts. 230, 239).

215. *See supra* Section IV.A.1.

updates to the accredited investor definition[216] without congressional approval.[217]

Changing the accredited investor standard in this way would give public plans strong *ex ante* incentives to avoid falling below the specified thresholds for contribution rates and funding ratios. But this form of regulation would also be a very blunt instrument for addressing concerns about public pension plans, and legal challenges would almost certainly follow.[218] Given the challenges associated with affording special regulatory treatment to public plans, applying different regulatory rules to public pension plans is likely unrealistic for the SEC.

B. Is Private Equity Too Public to Fail?

With public pension plans so heavily invested in private equity funds, the fiscal health of state and local governments across the country has become closely interconnected with—and partially dependent on—the performance of the private equity industry.[219] This raises an interesting question: With so much public money on the line, how is the federal government likely to respond when the industry falls on hard times?[220]

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216. In fact, as recently as 2020, the SEC made a number of significant amendments to the accredited investor definition. *See* Accredited Investor Definition, 85 Fed. Reg. 64234, 64234 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230, 240).

217. Section 2(a)(15) of the Securities Act enumerates certain categories of accredited investors, but that section specifically authorizes the SEC to prescribe additional categories "on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management." 15 U.S.C. § 77b(a)(15). Public pension plans with assets in excess of $5 million is one of the categories that was added to the definition of accredited investors by the SEC. The full accredited investor definition, including all of the additional categories that have been set forth by the SEC, can be found in Rule 215 of the Securities Act. Interestingly, ever since 2010, the SEC has been statutorily required to undertake a review of the accredited investor standard for natural persons every four years and make its own determination as to whether the standard should be updated. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(b) (2010). While this provision only requires the SEC to review the accredited investor standards that apply to natural persons, it illustrates the broad discretion that the SEC has to enact changes to the accredited investor standard.

218. *See, e.g.*, Lucia v. Sec. & Exch. Comm'n, 138 S. Ct. 2044 (2018) (striking down as unconstitutional the SEC's system of using in-house judges to decide conflicts); NASDAQ Stock Market, LLC v. Sec. & Exch. Comm'n, 961 F.3d 421 (D.C. Cir. 2020) (holding that the SEC does not have authority to challenge the reasonableness of stock exchange fee rules using section 19(d) of the Securities Exchange Act of 1934); N.Y. Stock Exch. LLC v. Sec. & Exch. Comm., 962 F.3d 541 (D.C. Cir. 2020) (invalidating a pilot program initiated by the SEC to study the market effects of broker-dealer incentive programs).

219. *See* Bethany McLean, *Too Big to Fail, COVID-19 Edition: How Private Equity is Winning the Coronavirus Crisis*, VANITY FAIR (Apr. 9, 2020), https://www.vanityfair.com/news/2020/04/how-private-equity-is-winning-the-coronavirus-crisis.

220. Many argue that the federal government has already subsidized the private equity industry in significant ways. Most famously, the long-time taxation of carried interest profits by private

We got an initial look at the issue of federal bailouts in spring 2020, when the federal government had to decide how to respond to the COVID-19 crisis. To the surprise of some,[221] the federal government did not allow private equity-backed portfolio companies to gain access to PPP loans. As various commentators have noted, however, the private equity industry did receive certain indirect bailouts in other forms.[222] Looking further back in time, some have also argued that the federal response to the financial crisis of 2008 also served as an indirect bailout of the private equity industry.[223]

equity managers has long been understood by most academics as a subsidy to private equity with little substantive justification. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–4, 59 (2008) ("By getting paid in part with carry instead of cash, fund managers defer the tax on income derived from their human capital. Often, they are able to convert the character of that income from ordinary income into long-term capital gain, which is taxed at a lower rate. . . . The status quo treatment of a profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy." (footnotes omitted)); Thomas J. Brennan & Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L.J. 27 (2008). The extraordinarily long period of low interest rates overseen by the Federal Reserve is often viewed as another form of subsidy to the private equity industry. *See* McLean, *supra* note 219 ("[T]he era of low interest rates, which began with former Federal Reserve chairman Alan Greenspan and continues to this day, has been a huge boon to private-equity firms.").

221. *See generally* McLean, *supra* note 219.

222. One scholar has argued that even though private equity-owned portfolio companies were excluded from receiving PPP loans, the private equity industry's lobbying did not go unheard. The private equity industry benefited greatly from the decision of federal policymakers to expand its programs for buying corporate bonds and bond ETFs to include bonds and leveraged loans issued by companies whose credit ratings had been downgraded to junk status since the pandemic's outbreak. This provided a lifeline to the junk bond market generally and helped to ensure that they would continue to have access to cheap credit for new deals. *See* Arthur E. Wilmarth Jr., *The Pandemic Crisis Shows that the World Remains Trapped in a 'Global Doom Loop' of Financial Instability, Rising Debt Levels, and Escalating Bailouts*, 40 Banking & Fin. Serv. Pol'y Rep. No. 8, at 39 (2021), https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2814&context=faculty_publications ("Private equity firms and their allies aggressively lobbied the federal government to help their endangered portfolio companies. . . . The Fed's expansion of its corporate bond programs 'provided a lifeline to corporate debt rated below investment grade' and ensured that private equity firms would have 'continued access to cheap credit for new deals.' Many observers viewed the Fed's action as 'an indirect bailout of the private equity industry.'" (quoting Joe Rennison et al., *Federal Reserve Enters New Territory with Support for Risky Debt*, FIN. TIMES (Apr. 9, 2020), https://www.ft.com/content/c0b78bc9-0ea8-461c-a5a2-89067ca94ea4)); *see also* David Kocieniewski & Caleb Melby, *Private Equity Lands Billion-Dollar Backdoor Hospital Bailout*, BLOOMBERG (June 2, 2020, 4:00 AM), https://www.bloomberg.com/news/features/2020-06-02/private-equity-lands-billion-dollar-backdoor-hospital-bailout.

223. *See, e.g.*, McLean, *supra* note 219 ("Infuriatingly enough, the financial crisis in 2008 might even have saved private-equity firms from their sins. Never mind that they often overpaid for the companies they acquired, and loaded them up with so much debt that 'even a mild economic downturn could make it nearly impossible for those companies to repay their loans,' as *Fortune* [*Magazine*] put it. Thanks to all the cheap money made available by the Fed, companies owned by private-equity firms could simply refinance their debts at lower rates, thereby getting a fresh lease on life.").

However one characterizes the 2020 response, the COVID-19 pandemic recession turned out not to be a very good test case for the question of whether the federal government will bail out the private equity industry in response to an existential threat. While there was a short period of extreme uncertainty at the start of the pandemic, the industry weathered the storm extraordinarily well, with no discernible effect on investment returns.[224] Most perceived COVID-19 to be a temporary threat. Because private equity funds can avoid short-term liquidity crunches thanks to locked-in capital, many commentators anticipated at the very start of the pandemic that private equity would even be able to benefit from COVID-19 and emerge in a strong position.[225]

It is easy to imagine other market events, however, that would pose a more serious and lasting threat to the private equity industry. Given the enormous investment of public pension dollars into private equity funds, there is a significant public interest in keeping private equity from failing. Private equity managers are no doubt aware of this, raising the question whether these realities have introduced moral hazard into the way that private equity managers operate their businesses.

CONCLUSION

Large-scale investment in private equity funds by public pension plans has had a profound impact on the private equity industry. Using the SEC's three-part mission as an analytical framework, this Article identifies fundamental ways in which private equity has been shaped by public pension plans over the years. As a result, while one can disagree with exactly how the SEC has gone about intervening in private equity (and how it proposes to increase its scope of intervention), increased SEC oversight of the industry over the years and ongoing scrutiny of industry practices should not come as a particular surprise. Large-scale public pension investment in private equity has shaped how the private equity industry operates and increased the public's interest in what happens in this market.

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224. *See* MacArthur et al., *supra* note 26, at 3–4, 21, https://www.bain.com/globalassets/noindex/2021/bain_report_2021-global-private-equity-report.pdf ("It was a year of massive disruption—and private equity emerged unscathed. . . . By all indications, private equity weathered 2020's perfect storm without taking a hit to returns.").

225. *See, e.g.*, Hugh Son, Alex Sherman & Lauren Hirsch, *Private Equity Eyes Industries Crippled by Coronavirus: 'They Have Been Waiting For This*,*'* CNBC (Mar. 25, 2020, 2:29 PM), https://www.cnbc.com/2020/03/25/private-equity-eyes-coronavirus-hit-industries-theyve-been-waiting.html (quoting the head of M&A at a major Wall Street firm as saying: "They have been waiting for this type of market dislocation . . . . I don't think they wanted something quite this bad, but they did want a pullback in valuation").