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Education ▲ Networking ▲ Advocacy

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September 24, 2021

The Honorable Jason Smith
Ranking Member
Committee on the Budget
United States House of Representatives
507 Cannon House Office Building
Washington, DC 20515

**Re: Section 138312 of the *Amendment in the Nature of a Substitute* (pg. 689)**

Dear Congressman Smith:

I am contacting you as president of the Alternative & Direct Investment Securities Association ("ADISA")[1], to express concern about language included in Sec. 138312 of the Amendment (referenced above and hereby called "Sec. 138312") that would make certain investments impermissible for individual retirement accounts (IRAs) to own. The language in question would disallow investments in securities the issuer of which requires investors to meet minimum levels of assets or income (or minimum levels of education or specific licenses or credentials) in order to invest. In light of the harm that will likely accompany any such proscription, as discussed below, we request the removal of this language from the bill.

What Section 138312 Would Do:

Section 138312 would, in brief, bar the holding in IRAs of publicly-issued securities such as non-exchange traded REITs and BDCs along with other privately-issued investments. While such vehicles are registered with the SEC for public sale, Sec. 138312 would prohibit these investments insofar as they impose net worth and income standards in order to satisfy various state "blue sky" laws. As we shall show, this language would pick up many categories of assets used by many investors of all wealth levels in their retirement savings. It would result in confusion, lower returns and/or greater volatility for IRA owners, difficulty of administration, and reduction in tax revenue.

What Section 138312 Would Not Do:

Section 138312 would not necessarily affect the amount of money any given individual might contribute to an IRA, only the mix of investments held in the account. IRA balances can be comprised of many asset classes (including traditional and alternative), and assets kept in IRAs are there to appreciate; the IRA owner as an investor hopes its balance will grow. If the value of assets that do not impose a wealth or income or other requirement for purchase (e.g., publicly traded stocks or mutual funds) appreciates or depreciates over time, it affects the overall value of the IRA – likewise with the value of

[1] ADISA is the largest association of the alternative direct investment industry in the United States. Founded in 2003, ADISA has approximately 4,500 members who employ over 220,000 investment professionals, together serving the interests of more than 2 million investors throughout the country. Direct and alternative investment programs serve a critical need in the creation and ongoing management of diversified investment portfolios.

assets that impose a wealth or income hurdle for purchase. The latter typically provide non-correlation or diversification benefits, however, and their proposed exclusion can only be expected to increase the volatility of the remaining portfolios in IRAs, to the detriment of their owners and the retirement savings system in general.

Overview:

The language in question would pick up nearly all private placements made under Securities Act Section 4(a)(2) and Regulation D, Rule 506, adopted by the Securities and Exchange Commission (SEC) thereunder. Such offerings are effectively made only to "accredited investors," as defined in Regulation D, and Regulation D Rule 501 as applied to individual investors establishes net worth, income and/or licensing requirements. In practical terms, this would mean that IRAs could not own privately issued securities and other pooled investment vehicles that invest in private opportunities. In addition, while such vehicles are registered with the SEC for public sale, the language in question would reach non-exchange traded real estate investment trusts (REITs) and business development companies (BDCs); these funds impose net worth and income standards to satisfy various state "blue sky" laws.

ADISA does not take a position on the issues associated with investment by IRAs in individual issuers or businesses. What is of immediate concern to ADISA and its members is the fact that the language in question sweeps in all securities where there are issuer-imposed minimum wealth or income (or other) criteria and does not exclude or exempt interests in pooled investment vehicles. Some of these funds make private offerings and thus impose the accreditation requirements discussed above; others – such as non-exchange-listed REITs and BDCs - are publicly offered but have criteria for investment imposed by state "blue sky" laws. Given that such vehicles are primarily intended for broad use by investors, including retirement savers, their inclusion within the ambit of the scope of the proposed bar on investment by IRAs appears to target such funds without much if any justification.

A large percentage of the shares issued by these pooled investment vehicles are currently held in IRAs, as such vehicles are designed for and managed to generate investment returns which investors may not be able to achieve through other investment options. Such vehicles provide important sources of income, growth and, more importantly, diversification from traditional markets (potentially protecting investors during periods of significant public market dislocations). The fact that they impose minimum criteria for investment is a function of their offering method or structure, as determined by federal and state securities laws and generally not in the control of the issuer. Placing all of these investment vehicles beyond the reach of IRAs for investment purposes would do an enormous disservice to those who use IRAs to accumulate savings for retirement. As we discuss below, the potentially far reaching and negative consequences of placing these investments beyond the reach of IRA owners are not justified by the fact that these investments impose net worth, income, or other requirements for purchase.

Walling off these types of investment vehicles, which are an important source of returns and, perhaps more importantly, diversification, will diminish the ability of IRAs to carry out their important role in retirement savings and undermine the ability of IRAs to serve the purpose for which they were created by Congress. If nothing else, the language included in Sec. 138312 raises what can be accurately characterized as policy issues, and such should be dealt with (if at all) in legislation that is the subject of full and robust debate and not placed in a bill designed to support budgetary demands.

Discussion:

Legislation that would restrict the ability of IRAs to purchase and hold entire classes of investment securities based solely on the fact that such investments establish criteria for investment that implicate wealth, income and/or licensure raises the following concerns, examined in this order:

1. There is no evidence of an existing problem with the inclusion of investment products offered to accredited investors in retirement savings account: quite the contrary, in fact.

2. The broad definition proposed is likely to sweep up a host of asset classes which have minimal, externally-imposed suitability requirements, complicating retirement savings management in unexpected and detrimental ways.
3. If this stipulation goes into effect with a 2-year period for liquidation of the assets in question—which are typically illiquid—then devaluation is sure to occur: illiquid assets will undergo a forced liquidation at subpar pricing and terms, meaning the ensuing tax revenue that might be collected will also be much less than the fully performing asset.
4. Regulators and the IRS have already acted on valuation issues on unconventional assets, and new methods for making and reporting valuations are only beginning to be reflected.
5. Other mechanisms are already being proposed which address the size of the accounts that some very wealthy individuals may have in IRAs.

1. Advantage of Non-correlated Investments for Portfolios

Since modern portfolio theory began, it is no surprise that some allocation of retirement or long-term funds into non-correlated investments proves advantageous; it is how the individual investor can mimic the success of the endowment model. That middle class investors can allocate into diversified products, including non-correlated alternatives such as non-exchange listed REITs and BDCs, can serve to shield investors from market downturns. [2]

According to a 2020 report from the GAO, over two million IRA investors placed a part of their savings into "unconventional" products in 2016.[3] While individual product breakdowns are not available, it is generally understood and accepted that a meaningful portion of these investments are in the types of pooled investment vehicles – e.g., private equity funds, venture capital funds, non-exchange listed REITs and BDCs - that impose some form of net worth or income minimum.

Recent industry data indicate an increasing trend for individuals to invest in non-correlated investment product, especially with the younger generations who have long investment horizons.[4] It only stands to reason that for all levels of retirement savers, some allocation into non-correlated products should complement a retirement portfolio of only traded stocks and bonds. Placing a bar on such investment products solely because they impose net worth or income requirements would amount to a limit on the ability of IRA owners who meet those criteria to achieve their retirement goals.

Walling off these types of investment vehicles will diminish the ability of IRAs to carry out their important role in retirement savings and undermine the ability of IRAs to serve the purpose for which they were created by Congress. As it would apply to an enormous swath of carefully constructed and well-managed pooled investment vehicles, the language in Sec. 138312 should be dealt with in legislation that is the subject of full and robust debate and not placed in a bill designed to support budgetary demands.

2. Proposed IRA Legislation Poorly Defines Applicable Asset Classes

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[2]In a 10-year period covering the Great Recession 1999-2009, the 60% equity/40% bond ratio after fees returned 0% while the heavily managed Yale, Harvard, and Stanford portfolios with non-correlated alternatives performed from 135% to 198% in total, while the S & P 500 lost 35% (Wildemuth, D. *Wise Money: How the Smart Money Invests.* McGraw Hill, 2012. Pp. 64-65).

[3]GAO, *Individual Retirement Accounts: IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets*, GAO-20-210 (Washington, D.C.: January 2020).

[4] 78% of Millennials and 70% of Gen Xers endorse using alternatives compared with only 58% of boomers (Natixis Global Asset Management Survey, http://durableprotfolios.com 2014).

Just as the current IRS rule has difficulty defining precisely the "unconventional" asset classes, the proposed legislation on IRAs defines poorly who may be affected by the text of Sec. 138312:

> "(7) No part of the trust funds will be invested in any security if the issuer of such security…requires the individual on whose behalf the trust is maintained to make a representation to the issuer or such other person that such individual—(A) has a specified minimum amount of income or assets…."

This definition would broadly cast a net over nearly all private funds and over many investment products duly registered with the SEC and regulated as "public" funds. A potential unintended consequence of this broad definition would be confusion and disregard for the GAO's recommendation to provide "more information for taxpayers with unconventional assets,"[5] using the more widely accepted understanding of "unconventional" as excluding pooled vehicles intended for long term investment.

Moreover, as we pointed out in section 1, the assumption that publicly traded stocks and bonds should be the only components of retirement accounts is a highly disadvantaged and outdated line of thought. Many financial experts and organizations, including our own, stand ready to assist in describing modern definitions of the various non-correlated investment products; they are not realistically described in Sec. 138312, and as a result will cause further confusion.

<u>3. Two-year Period of Relinquishment will Negatively Impact Current Investors</u>

Presumably the proposed two-year "sunset" period is tailored to the IRS three-year statute of past inspection of records; however, such a short period is unworkable and would cause considerable financial loss in value (and thus in tax revenue). Many non-correlated investment products have long holding periods (e.g., 7 to 10 year minima) similar to long-term savings accounts with minimum holding periods of 10 years. To demand early conversion of these products may violate the needed holding periods, causing devaluation; this would be a realized loss to investors. Many of these products are intentionally not structured for sudden liquidation which might occur as they become no longer eligible to be held by IRA custodians.

What is seen as an inherent value of illiquid funds[6] (i.e., their structure built on longer holding periods which allows the fund manager to make longer-term investments without concern for interim liquidity), almost ensures that funds converted "early" will face unnecessary devaluation. The GAO points out this difficulty of liquidation and the likely detrimental effect on account balances in its report of 2015.[7]

<u>4. Ongoing Valuation Improvements</u>

The adoption by the Financial Industry Regulatory Authority (FINRA) in April 2016 of new requirements relating to valuations for illiquid securities (such as those issued by non-exchange listed REITs, among others), spurred efforts in the alternative investment industry to provide more clarity around the valuation of illiquid investment products. These regulatory changes and the industry's response helped provide investors with net asset values for direct participation programs and other non-exchange traded securities even when not readily marketable. These appraisals—which were not fully at play during the data last used by the GAO in compiling its recommendations to House Ways & Means

[5] GAO-20-210, pg. 25.

[6] Research showed that on average in 2014, illiquidity itself gained a value of approximately 1.4% over liquid funds (Whitman, K. The Hidden Cost of Liquidity: How Alternatives Can Reward long-Term Investors. *Alternative Investment Quarterly*, January 2014).

[7] GAO, *Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets*, GAO-170192 (Washington, D.C., December 2015).

(GAO 2020-201)-- have increased transparency and confidence investors need for products such as non-traded REITs, which have grown as investors seek to mitigate traded product volatility.

From several GAO reports to the House Ways & Means Committee (e.g., GAO 15-16, GAO 17-102, GAO 20-201), there have been calls to make more comprehensible the rules surrounding the reporting of unconventional assets in IRAs. These calls are understandably centered around the calculation of fair market value. That said, the alternative investment industry, under the oversight of FINRA and the SEC, has moved to improve that clarity with new reporting. All of the GAO reports mentioned above use measurements prior to the full implementation of this movement.

5. Other Mechanisms and Wealth

The underlying purpose of IRAs is to facilitate growth in assets for the retirement saver above and beyond the simple pace of inflation—otherwise the investment asset choices would be limited to the equivalent of a bank savings account. Thus, there is a desire on the part of the investor to diversify beyond a limited savings account for increased gain over what is closer to an endowment model's longevity, given one begins retirement savings in early career. Of course, any investment (even so-called risk free) contains risk, especially risk that a fund's value will be eroded, especially if not balanced in diversity. Many investors choose to place a portion of their IRA into assets that are private or otherwise non-exchange listed funds for the purpose of balancing out the volatility associated with market-correlated investments. This balanced strategy provides benefits for many investors.[8] In that sense, there is nothing "unconventional" about these non-correlating and diversifying investment vehicles, and no objective reason to subject them to a divestiture requirement.

That there should be some overall limit on how much a given investor can keep in an IRA is a completely separate question from how an investor manages his or her assets within that IRA. Given the superiority of diversified portfolio performance over time, restricting IRAs to only market-correlated funds can only serve to increase the wealth gap. It becomes a question of free choice: should investors choosing more diversity be punished for using balanced portfolio theory, or should investors simply not be given the option of being rewarded by it? Restricting the access to and use of pooled investment funds that use (by necessity, in most cases) wealth or other metrics for entry will not in and of itself prevent large balances within IRAs (if that is a goal). The high-level IRA balances are there for the stated purpose of retirement savings, presumably to be withdrawn and taxed during a lower income period of retirement.

For all these reasons, we strongly urge that Sec. 138312 be stricken. There is no need, but great detriment in, prohibiting IRA investment in securities that involve a wealth or income or other test for investment. ADISA stands ready to assist in any analysis or to help in any way as your committee considers these issues and continues the good work it does on behalf of your constituents and the American people. Thank you for the consideration of ADISA's comments.

Respectfully submitted,

Matthew Malone
President

cc: Drafting committee- Catherine Bowman (Bowman Law), John Grady (ABR Funds), John Harrison (ADISA), and Thomas Rosenfield (HillStaffer)

[8] GAO-20-102 indicates that about 9,000 IRAs in total held up to 25% of their value in unconventional assets.