

June 24, 2020

The Honorable Eugene Scalia  
Secretary of Labor  
U.S. Department of Labor  
200 Constitution Ave NW  
C-2318  
Washington, DC 20210

Dear Secretary Scalia:

The undersigned groups, which advocate on behalf of consumers, workers, investors, and retirees, write to express our grave concerns regarding the Department's June 3rd information letter concerning the use of private equity investments in designated investment alternatives made available to retirement savers through individual account plans, such as 401(k) plans. Far from providing the benefits touted without any supporting evidence by the private equity industry, these investments are likely to saddle middle-class retirement savers with high costs and lock them into unnecessarily complex investments that underperform publicly available alternatives. For the reasons discussed below, we urge the Department to withdraw the letter.

The letter outlines the factors a plan sponsor would have to consider in deciding whether to include a professionally managed asset allocation fund with a private equity component as a designated alternative for an ERISA covered individual retirement plan. However, because of its limited, one-sided consideration of the risks and benefits of private equity investments and its failure to consider the inability of most plan sponsors to conduct the necessary evaluation, it exposes retirement plan participants to unwarranted risks and fails to ensure that retirement plan participants will be adequately protected from those risks.

The letter accepts unchallenged the private equity industry's claim that plan participants with longer investment horizons who invest a portion of their assets in private equities are likely to receive "enhance[d] retirement outcomes when compared to investment choices containing only publicly traded securities." But there are good reasons to challenge this assumption, starting with the fact that, in the absence of standardized performance calculations, private equity funds can and do manipulate those performance comparisons. As a result, the enhanced outcomes this letter assumes as a benefit of the proposal are far from guaranteed.

On the contrary, a recent analysis by an Oxford University economist shows that the median private equity buyout fund has basically matched performance of equities in public markets since 2006.<sup>1</sup> Meanwhile, given the broad dispersion of returns among private equity funds, investors would need to be consistently invested in top-quartile funds to enjoy the out-performance

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<sup>1</sup> Julie Segal, The 'Inconvenient Fact' Behind Private Equity Outperformance, Institutional Investor (June 04, 2020) <https://bit.ly/3e2fRjF> (citing Ludovic Phalippou, An Inconvenient Fact: Private Equity Returns & The Billionaire Factory (June 10, 2020). University of Oxford, Saïd Business School, Working Paper. Available at SSRN: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3623820](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623820)).

backers of this proposal claim, and that is extraordinarily difficult to achieve.<sup>2</sup> Many if not most private equity investors aren't getting any out-performance to reward them for the high fees, heightened risks and illiquidity associated with these investments. And industry trends suggest that any out-performance private equity has enjoyed in the past is likely to narrow dramatically or disappear entirely in coming years, just as vulnerable retirement savers are gaining "access" to these alternative investments.<sup>3</sup>

The information letter also falsely assumes that, because retirement savers generally have a longer investment horizon, they necessarily hold retirement plan investments over the long term. In fact, however, employees who change jobs frequently and who either cannot or do not wish to leave their retirement savings invested through a former employer, may make frequent changes in their retirement investments. A Bureau of Labor Statistics study that followed baby boomers through most of their careers found, for example, that, on average, people in that study held nearly 12 jobs between the ages of 18 and 48. Only 10 percent held zero to four jobs.<sup>4</sup> The resulting frequent turnover in retirement plan investments makes private equity a particularly poor choice for most retirement savers.

That problem is exacerbated by the fact that the information letter contemplates allowing private equity investments to be held as part of a collective investment trust (CIT). Because CITs can only be held within an employer-sponsored retirement plan, this structure compounds the illiquidity associated with private equity itself. While the information letter specifies that funds would have to include a liquidity component to allow for participant-directed deposits and withdrawals, we are concerned that inadequate attention has been paid to the liquidity challenges these investments could pose.

We appreciate that the policy outlined in the letter would apply only where private equity is included as part of a professionally managed and broadly diversified fund. We are concerned, however, that this still leaves gaping holes in investor protections. As noted above, the letter would permit private equity to be included in CITs, which in addition to being less transferable, do not afford the same degree of transparency as SEC-registered mutual funds. This increases the challenge for plan fiduciaries seeking to determine whether the fund is an appropriate option for plan participants. In addition, CITs are not subject to the same limitations on illiquid assets that mutual funds are held to under SEC rules. As a result, retirement savers could be exposed to much higher concentrations of private equity investments in CITs than they would be in mutual funds, notwithstanding the letter's statement that private equity investments would be subject to "a target allocation that does not exceed a specified portion of the fund's assets."

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<sup>2</sup> J.P. Morgan Asset Management, Investing in private equity, Essentials for achieving enhanced private equity returns (February 2018) <https://bit.ly/2UOPyi0>, at 4 ("The dispersion of returns among private equity investments is substantial in absolute terms and relative to other segments of the investment universe. For example ... , the average dispersion of returns from top to bottom quartile among private equity funds is over 1,900 basis points (bps). ... It is our view that the return enhancement objective will not be achieved by merely matching average or median industry performance. A private equity investment strategy must be formulated with the goal of consistently delivering industry-leading (e.g., top-quartile) performance.")

<sup>3</sup> Phalippou, An Inconvenient Fact.

<sup>4</sup> Jeffrey R. Young, How Many Times Will People Change Jobs? The Myth of the Endlessly-Job-Hopping Millennial, EdSurge (July 20, 2017) <https://bit.ly/2N4nRxm>.

We are particularly concerned that the policy would allow private equity investments in target date funds, which are frequently used as qualified default investment alternatives (QDIAs) and relied on by small savers. Target date fund investors are disproportionately among the least financially sophisticated and most financially vulnerable of all investors, leaving them particularly poorly equipped either to assess or to weather the risks associated with private equity investments, including the liquidity risks. Furthermore, because target date funds are often used as default options in 401(k) plans, workers could end up being defaulted into these investments without giving adequate consideration to the risks they may pose. The letter's statement that the fund fiduciary has a special obligation to "determine whether plan participants will be furnished with adequate information regarding the character and risks of the investment alternative" when the fund is used as a QDIA does not adequately address this concern, particularly since most plan sponsors will themselves lack the financial sophistication to make that determination.

Finally, many of the protections afforded by ERISA rely on plan sponsors to fulfill their fiduciary obligation to make prudent selection of investments offered through the plan. But, as the letter itself acknowledges, "As compared to typical public market investments available in individual account plans, private equity investments tend to involve more complex organizational structures and investment strategies, longer time horizons, and more complex, and typically, higher fees. . . . In addition, valuation of private equity investments is more complex because private equity investments often have no easily observed market value, and there is often an element of judgment involved in valuing each of the portfolio companies prior to their sale by the investment fund or other liquidity event (e.g., initial public offering)." Recent research documents that even the most sophisticated institutional investors often fail to negotiate favorable terms and significantly over-pay for their private equity investments.<sup>5</sup> Meanwhile, previous research has shown that many plan sponsors lack financial literacy and struggle to assess even much simpler, more transparent products, such as mutual funds. If a plan sponsor doesn't recognize excessive costs in an index mutual fund, and many apparently don't, they are not going to be able to assess whether a fund's exposure to private equity is appropriate and represents good value for participants in its plan. Indeed, we suspect that those who have that level of financial sophistication are a tiny minority.

Compounding the problem, those who lack that financial sophistication are likely to turn to financial professionals to assist them in making those selections, without understanding that the financial professionals they rely on may have significant conflicts of interest and have no fiduciary duty to place the client's interests first. It is notable, for example, that in adopting Regulation Best Interest, the SEC was explicit in stating that it is not a fiduciary standard. Nor does it apply to advice to retirement plans. So, unless the Department restores protections in the overturned conflict of interest rule that extended fiduciary protections to small retirement plans, and unless it adopts a high fiduciary standard for that advice, these small plan sponsors and their employees will be vulnerable to conflicted recommendations from financial professionals

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<sup>5</sup> Juliane Begenau and Emil Siriwardane, How do private equity fees vary across public pensions?, Harvard Business School Working Paper 20-073, Mar. 2020, available at [https://www.hbs.edu/faculty/Publication%20Files/20-073\\_ee592ae3-9f30-4fdd-9473-fcd3f8ca938e.pdf](https://www.hbs.edu/faculty/Publication%20Files/20-073_ee592ae3-9f30-4fdd-9473-fcd3f8ca938e.pdf). (The study finds that "pensions would have earned \$45 billion more ... had they each received the best observed terms in their respective funds. There are also large pension-effects in the sense that some pensions systematically pay more fees than others when investing in the same fund.")

pushing highly remunerative funds with a private equity component without regard to the best interests of retirement plan participants.

For these reasons, we urge you to withdraw the information letter until the Department can conduct a more careful and balanced analysis of the potential risks and benefits of including a private equity component in retirement plan investments.

AFL-CIO

American Economic Liberties Project

American Federation of State, County and Municipal Employees (AFSCME)

Americans for Financial Reform Education Fund

Better Markets

Center for Popular Democracy

Communications Workers of America (CWA)

Consumer Action

Consumer Federation of America

Economic Policy Institute

Eileen Appelbaum (Co-Director, Center for Economic and Policy Research)

Institute for Agriculture and Trade Policy

National Education Association (NEA)

National Employment Law Project

Private Equity Stakeholder Project

Public Citizen

Revolving Door Project

United Steelworkers (USW)

U.S. PIRG