May 27, 2021

Acting Assistant Secretary Ali Khawar
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., N.W., Suite N-5677
Washington, D.C. 20210

Dear Acting Assistant Secretary Khawar:

One of the policy priorities of the previous administration was to increase defined contribution plan participants' "access" to private investments, a policy it pursued without adequately considering the potential costs and risks such investments might pose to vulnerable workers and retirees. The Department played a role in advancing that goal when it issued an information letter last June setting forth key factors plan fiduciaries to defined contribution plans would have to consider to meet their fiduciary duty under ERISA when deciding whether to include, as a designated investment alternative, a multi-class asset allocation fund that includes a private equity component. The undersigned individuals and organizations – representing investors and consumers, workers, retirees, and academics – are writing to urge you to withdraw the letter until the Department is able to fully analyze its legal and policy underpinnings and its potentially harmful effects.

We have three main concerns regarding the information letter that we urge you to address:

- It fails to give adequate consideration to the capacity of the typical plan sponsor, offering a defined contribution plan to its workers, to conduct the independent analysis that would be required to make a prudent selection or to provide appropriate oversight of plan investment alternatives that include private equity exposure. There is strong evidence to suggest that the majority of defined contribution plan sponsors would not be well-equipped to fulfill those responsibilities.

- It cites the potential for private funds to out-perform public market investments, but fails to cite any evidence to support this assumption and ignores evidence that calls industry's claims of out-performance into serious question. By repeating industry's out-sized performance claims, it could lead plan sponsors and plan participants to over-estimate potential returns and under-estimate the potential risks of private equity when weighing their investment menu selections.

- It contemplates permitting funds with a private equity component in certain types of investments – including collective investment trusts ("CITs") and target date funds – without adequately weighing the particular risks they could pose to defined contribution plan participants.

The information letter lays out the factors plan fiduciaries would need to consider when selecting investment alternatives with private equity exposure for inclusion on plan investment menus. There is strong evidence to suggest, however, that only the most sophisticated plan sponsors would be able to meet these fiduciary obligations, a problem that is made worse by the often misleading reporting of returns and fees by private equity funds. For example, twice in recent years the Securities and Exchange Commission ("SEC") has issued risk alerts identifying serious and widespread compliance failures among private funds.[1] Among the most serious compliance problems identified in the 2018 and 2020 alerts were: a variety of practices that led to over-billing, including failure to follow stated valuation procedures; preferential treatment for certain clients with potentially harmful impacts on other clients, including inequitable allocation of both investment opportunities and fees and expenses; failure to establish or follow ethics rules; and undisclosed conflicts of interest too numerous to detail here. Because the SEC has not identified the funds that are guilty of these compliance failures or brought enforcement actions to end these practices, plan sponsors have no way of knowing whether the private equity investments included in plan investments are engaged in these practices or whether these funds are among those receiving unfavorable treatment in the allocation of investment opportunities or fees.

The fact that the private equity investments would be offered through professionally managed diversified funds does not alleviate this concern. The institutional investors who participate as limited partners in private equity investments continue to raise concerns about the lack of adequate regulatory protections, including with regard to legal loopholes that enable general partners to adopt "hedge clauses" that limit their fiduciary obligations; lack of fee and expense transparency; lack of access to information about leverage that is important for assessing fund risks; and lack of information about compliance issues.[2] That may help to explain why recent research indicates that even many of the most sophisticated institutional investors fail to negotiate the most favorable terms when investing in private equity.[3] There is no reason to believe the funds that would be eligible to serve as defined contribution plan investments under this policy would be exempt from this concern.

When institutional investors fail to negotiate the most favorable terms regarding their private equity investments that, in turn, significantly impacts the performance they receive on those investments. The more they overpay, the less likely they are to achieve the above-market returns that have been offered as the chief selling point for including funds with exposure to private equity on plan menus. Given the opacity of private fund investments, how will plan sponsors assess whether a fund has negotiated favorable terms or is, instead, losing out on significant

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[1] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, Observations from Examinations of Investment Advisers Managing Private Funds (Jun. 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf; SEC Office of Compliance Inspections and Examinations, National Exam Program Risk Alert, Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018), https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[2] *See e.g.*, The Institutional Limited Partners Association ("ILPA"), Welcome Letter to SEC Chairman Gary Gensler (Apr. 21, 2021), https://ilpa.org/wp-content/uploads/2021/04/2021.4.20-ILPA-Welcome-Letter-to-Chairman-Gensler-Final.pdf; Daniel M. Hawke, Arnold and Porter Advisory, Leading Institutional Investors Urge SEC to Take Action in Private Equity Market (Feb. 20, 2019), https://www.arnoldporter.com/en/perspectives/publications/2019/02/institutional-investors-urge-sec.

[3] Begenau, Juliane, and Emil Siriwardane. "How Do Private Equity Fees Vary Across Public Pensions?" Harvard Business School Working Paper, No. 20-073, January 2020. (Revised July 2020.)

potential earnings because of their failure to do so? Put another way, how will they assess whether they are getting sufficient benefits from the private equity exposure to justify the added costs and risks? These informational asymmetries will be an even greater challenge for individual plan participants if they are asked to select between retirement plan investment alternatives that include exposure to private equity.

The rosy picture of private equity performance in the information letter exacerbates the concern that defined contribution plan fiduciaries are likely to over-estimate the potential benefits to retirement investors of access to investment options with exposure to private equity. Measuring private fund performance is a complex task, and the Department fails to offer any indication of how it reached its conclusion with regard to private funds' purportedly superior performance, or even any evidence that it conducted such an analysis. Our previous letter cited research by Oxford University economist Ludovic Phalippou showing that, while top funds have delivered out-size gains, the median private equity fund has basically matched the performance of equities in the public markets since 2006. A 2020 analysis from CEM Benchmarking, Inc. found that, between 1996 and 2020, the average private equity returns underperformed a composite of U.S., European and global small-cap equity indices.[4] These and other studies suggest that most private equity investors aren't getting any out-performance to reward them for the high fees, heightened risks, and illiquidity associated with those investments.[5] In order to ground its approach in economic evidence, and provide a better model for how plan fiduciaries should weigh these issues, the Department needs to conduct a more rigorous and balanced analysis of this critically important question.

Finally, as we noted in our previous letter, the Department contemplates allowing investments with private equity exposure in certain fund types that raise particular concerns, including target date funds and CITs. Inclusion of private equity exposure in target date funds raises concerns because these funds are often used as Qualified Default Investment Alternatives ("QDIAs") and relied on by the least financially sophisticated plan participants. If this occurs, many retirement plan participants will be defaulted into the funds with private equity exposure without understanding the potential risks. Allowing private equity exposure in CITs is also problematic, since SEC limitations on mutual funds related to the percentage of assets that can be held in non-liquid investments, disclosure requirements, and oversight would not apply. This would further complicate the task of both plan fiduciaries and plan participants in evaluating these investments.

In light of these concerns, we urge the Department to withdraw the June 2020 information letter, or at least suspend its implementation, while it takes the following three actions:

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[4] Alexander Beath and Christopher Flynn, "Benchmarking the Performance of Private Equity Portfolios of the World's Largest Institutional Investors: A View from CEM Benchmarking," Journal of Investing 30, no. 1 (2020): 67-87.

[5] *See, e.g.,* Richard Ennis, "Institutional Investment Strategy and Manager Choice: A Critique," Journal of Portfolio Management 46, no. 5 (2020): 104-117, finding that, between 2006 and 2014, buyout funds underperformed a custom equities benchmark that reflected their risk and the types of investments they made; Samir Sonti, CUNY School of Labor and Urban Studies, on behalf of the American Federation of Teachers and Americans for Financial Reform Education Fund, Lifting the Curtain on Private Equity, A Guide for Institutional Investors and Policymakers (2021), https://www.aft.org/sites/default/files/private-equity-report-2021.pdf; *also*, https://www.pefeederfund.com.

- Revise the information letter to incorporate a more complete and balanced analysis of the potential risks and rewards of private investments in order to support more informed decision-making by defined contribution plan fiduciaries with regard to the appropriateness of these investments for their employees.

- Include a warning to plan fiduciaries that, where they lack the financial knowledge and sophistication to assess the appropriateness of the investments and provide the necessary oversight, they must either get disinterested advice from a fiduciary who has the requisite expertise or refrain from including the investments on the plan menu.

- Study developments since the information letter was released to determine the extent to which funds with private equity exposure have been, or are anticipated to be, added to plan menus, what process is being used in their selection, and whether those funds are being designated as QDIAs. The study should pay particular attention to any private equity exposure in CITs, including how the liquidity component is structured, the percentage of assets held in private equity, and the disclosures that are provided.

We believe these steps are necessary to help ensure that defined contribution plan fiduciaries base any decisions about whether to add funds with private equity exposure to plan menus on a balanced consideration of the benefits and risks. It would also help arm the Department with the information it needs to ensure that retirement plan participants are not being put at undue risk.

Thank you for your attention to our concerns.

AFL-CIO

Alliance for Retired Americans

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

Americans for Financial Reform Education Fund

Better Markets

Center for Economic and Policy Research

Center for Popular Democracy

Chicago Consumer Coalition

Columbia Consumer Education Council

The Committee for the Fiduciary Standard

Communication Workers of America

Consumer Action

The Consumer Assistance Council, Inc.

Consumer Federation of America

Economic Policy Institute

Eric F. Gerding, Professor of Law and Wolf-Nichol Fellow, University of Colorado Law School*

Institute for Agriculture and Trade Policy

Institute for Policy Studies, Global Economy Project

National Education Association (NEA)

Laura Katz Olson, Distinguished Professor, Lehigh University*

Private Equity Stakeholder Project

Public Citizen

Strong Economy for All Coalition in New York

United for Respect

United Steelworkers

Virginia Citizens Consumer Council

* Affiliation provided for identification purposes only.