July 30, 2020

VIA ELECTRONIC SUBMISSION

The Honorable Jeanne Klinefelter Wilson
Acting Assistant Secretary
Employee Benefits Security Administration
200 Constitution Ave NW
Washington, DC 20210

Re: Notice of Proposed Rulemaking on Financial Factors in Selecting Plan Investments Amending "Investment duties" Regulation at 29 CFR 2550.404a-1
(RIN 1210-AB95)

Dear Acting Assistant Secretary Klinefelter Wilson:

The American Investment Council ("AIC" or "we", as applicable) is pleased to submit this letter in response to the Department of Labor's (the "Department") proposed rule "Financial Factors in Selecting Plan Investments" (the "Proposed Rule"). We appreciate the Department's efforts to modernize guidance related to how plan fiduciaries make investment decisions. The Proposed Rule provides an opportunity to harmonize the investment processes fiduciaries use when they make investment decisions for defined benefit and defined contribution pension plans. By encouraging both sets of fiduciaries to consider all available investment factors, the Department can encourage overdue innovation in the types of investments that are made available in defined contribution plans.

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investments. In this effort, the AIC develops, analyzes, and distributes information about the private equity, growth capital and private credit industry and its contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity, growth capital and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

The preamble to the Proposed Rule largely focuses on whether a fiduciary can consider environmental, social, and governance ("ESG") investment factors while at the same time complying with the duty of loyalty imposed by Section 404(a) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). However, the rule itself does more. It contains a complete restatement of the rules surrounding all investment decision making – not just those impacting ESG.

Because of the extensive breadth of the Proposed Rule, we write to provide input to and to ask the Department, in the final rule, to continue fostering innovation in the defined contribution plan marketplace and to avoid inadvertently restricting this same innovation it has already sought to foster.[1] Our suggestions are a "natural extension" of issues identified in the Proposed Rule.

Below we highlight three areas where the Department should build on the Proposed Rule to foster innovation by:

- Emphasizing the importance of considering a wide range of factors when considering an investment; fees should be evaluated in the context of their impact on risk-adjusted performance net of fees.
- Clarifying that the framework for evaluating investments provides no special encouragement for plan fiduciaries to select passively managed investment options over actively managed options (or vice versa).
- Listing a diverse list of investments to the extent the Department includes a list of assets a fiduciary might consider as part of a prudent process.

By adopting our suggestions, the Department would help foster innovation — such as the consideration of private equity — by fiduciaries who currently fear that any deviation from a narrow range of investment products simply invites litigation. Studies of private equity funds find that private equity returns – net of fees and of carried interest – consistently outperform public market alternatives while providing diversification, lower volatility and protection in times of market stress.[2] A recent study estimates that the top 25% of private equity funds have outperformed the S&P 500 by 7.4% on an annual basis.[3] To illustrate this impact more fully, consider that a $10,000 investment in a retirement account that earned 7% annually from the S&P 500 over 30 years would result in an ending balance of $76,123. Alternatively, if the same $10,000 had been invested in a private equity fund that earned 7.3% above the S&P 500 annually, the ending balance would be $551,299, resulting in an increase in retirement savings of 624%.[4] Moreover, private equity has achieved these superior returns while subjecting investors to less

[1] This approach would build on the information letter it issued on June 3, 2020 stating that a prudent fiduciary may include a private equity component inside a defined contribution plan's default investment option. *See*, EBSA Information Letter to Jon Breyfogle (June 3, 2020).
[2] *See*, e.g., David Robinson & Berk Sensoy, Cyclicality, Performance Measurement and Cash Flow Liquidity in Private Equity, 122 J.Fin Econ. 251 (2016); Robert Harris et al., Private Equity Performance: What Do We Know?, 69 J of Fin. 1851 (2014); Voya Investment Management, An Overview of Private Equity Investing 3, 7 (Oct. 2017).
[3] Robert Harris et al., Private Equity Performance: What Do We Know?, 69 J of Fin. 1851, 1873 (2014).
[4] *Id. See also* Committee on Capital Markets Regulation, Expanding Opportunity for Investors and Retirees: Private Equity at 15 (November 2018).

risk than the S&P 500.[5] Defined contribution plan participants would clearly be better served if fiduciaries were encouraged to consider private equity.

Below, we focus on defined contribution plan participants because defined benefit plan fiduciaries already embrace private equity. We also note evidence that defined benefit plans outperform defined contribution plans by 1.5% annually.[6]

Our hope is that plan participants will soon have greater access to private equity inside their retirement plans. We believe the Department can help enhance participant outcomes by incorporating the following into its final rule.

I. The Department Should Clarify That A Prudent Fiduciary Should Weigh A Wide Range Of Available Investment Factors

In the preamble to the Proposed Rule, the Department states "facts and circumstances relevant to a comparison of investments or investment courses of action would include consideration of the level of diversification, degree of liquidity, and potential risk and return in comparison to available alternative investments."[7] Elsewhere, the Department states "the proposed rule does not revise the requirements that a fiduciary give appropriate consideration to 'a number of factors'".[8]

We applaud the Department for recognizing that plan fiduciaries must balance multiple factors such as liquidity and its impact on risk-adjusted investment performance. We are concerned that perceived litigation risk and industry norms have caused the defined contribution investment market to become homogeneous and focused on an unnecessarily narrow list of considerations. In recent years, more and more defined contribution plans have moved to offering passively managed mutual funds or collective investment trusts that provide daily liquidity where the investment strategy is the sole variety to choose from — e.g., large cap equity index versus core bond index.[9] This "path of least resistance" marketplace stands in contrast to the investment diversity and innovation seen in defined benefit plans. Defined benefit plans (1) use private funds, mutual funds, separately managed accounts, interval funds, and other investment structures, (2) use products at various points across the liquidity spectrum – ranging from immediate liquidity during market hours to lockups of many years, and (3) pay managers based on many factors including assets managed and/or the performance an investment may generate.

Because of this current landscape, we ask that the text of the final rule emphasize or highlight the following:

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[5] Voya at 7.
[6] Alicia H. Munnell et al., Investment Returns: Defined Benefit vs. Defined Contribution Plans, Center For Retirement Research at Boston College 3 (Dec. 2015), https://crr.bc.edu/wp-content/uploads/2015/12/IB_15-1211.pdf
[7] *Financial Factors in Selecting Plan Investments*, 85 FR 39113, 39117 (June 30, 2020).
[8] *Id.* at 39116.
[9] Rob Kozlowski, *Shifts in 401(k) options illustrate spotlight on fees*, Pensions & Investments (August 5, 2019).

- Diversification as an important factor a plan fiduciary might consider with respect to each investment option.
- Correlation as an important factor a plan fiduciary might consider.
- While fees are an important consideration, they should, in the future, not be treated as a sole initial screening consideration where other considerations are only taken into account after the completion of a fee screen.
- The complexity of an investment should not be a bar to an investment selected by a "prudent expert" under ERISA.

A. The Importance of Diverse Investment Structures

We ask the Department to remind plan fiduciaries in the final rule that a prudent fiduciary should thoughtfully consider the value of increased diversification, as defined broadly, and how this consideration interacts with other key considerations when evaluating investment options. The Department has long highlighted the importance of diversification.[10] However, "diversification" has often been treated more as a consideration that is important for building an investment menu than as a factor that may be relevant within each investment option. The final rule is an opportunity to highlight that diversification can provide advantages not only at the investment lineup level but within specific plan investments. Participants benefit when plan lineups and investments offer different liquidity terms, different investment strategies, and different fee structures. Variation ensures that plans are not designed to benefit a generic "plan participant" but are instead designed to meet the needs of the different individuals who participate.

For example, the Department should state that the investment decision to offer only products with daily liquidity is itself a fiduciary decision and that a prudent fiduciary should include in their list of potential considerations whether better, more diversified, outcomes could be generated by offering participants the opportunity to invest in funds further down the liquidity spectrum (e.g., that offer weekly, monthly, or quarterly liquidity) in exchange for a higher risk-adjusted rate of return. For investors with a long time horizon and who are unlikely to make investment changes, such as a 25 year old who anticipates retiring at age 65, the Department should be surprised that today's plans largely bar the participant from forgoing the ability to make investment changes over some intermediate horizon in exchange for an investment – like private equity – that is less correlated to the market and can offer a premium expected return. As described above, less liquid investments typically carry a performance premium, and today's participants are not served by rules that encourage fiduciaries to offer maximum liquidity in exchange for tradeoffs that reduce performance or increase risk.[11,12]

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[10] *E.g.*, Investing and Diversification, https://www.dol.gov/agencies/ebsa/laws-and-regulations/laws/pension-protection-act/investing-and-diversification (accessed July 27, 2020).

[11] Concern with short-term redemptions is mitigated by the fact that plan participants very rarely exercise their right to shift assets among investment options. *See* Committee on Capital Markets Regulation, *supra* n. 4 at 62 (average monthly transfers represented only 0.18% of 401(k) balances from April 2017 to June 2018…[i]n Q2 2018, on average only 0.015% of balances were traded daily). Similarly, service withdrawals, loan activity, and separation from service do not represent a material strain on liquidity. According to a 2018 Vanguard study ("How America Saves"), during 2016, only 2% of aggregate plan assets were borrowed, only 3% of participants took in service withdrawals, and 82% of participants who separated from service either remained in their employer's plan or rolled

B. The Importance of Considering "Correlation" of Investments

An investment factor that the Department has not identified but that the Department should specifically highlight is "correlation". The Department should state that correlation to other investments is itself an investment factor. Investments can be volatile and some investments tend to move in correlation to each other. For example, when public equities go down, exchange traded REITs tend to go down. Other investments can be less correlated. Examples include public equities when compared to a private real estate fund or a private equity fund. Public equities reflect market manias and panics while private funds reflect the value of the underlying assets. When building a portfolio, the addition of less correlated asset classes is generally understood to enhance returns and reduce volatility.[13] Explicitly stating that "correlation" is itself an investment factor would encourage defined contribution plan fiduciaries to evaluate asset classes beyond the largely stock and bond portfolios used in many defined contribution plans today. This approach would enhance risk mitigation by providing greater diversification across asset classes. This concept is already well understood and incorporated into the investment strategy of most large defined benefit plans.

C. The Interaction of Investment Factors and Fees

Another area where the Department should provide a clear statement about the need to balance investment factors relates to fees. Participants bear the cost of fees. Fiduciaries should evaluate fees. Nobody reasonably argues that fees do not matter. However, plan fiduciaries should not be encouraged to focus on fees without regard to other factors. The current litigation tsunami has already encouraged this single-minded focus on fees to the potential detriment of long-term retirement outcomes. Instead, the Department should encourage fiduciaries to focus on fees as a factor that impacts investment performance at a given level of risk. That is, rather than putting fees into one bucket and risk-adjusted performance into a separate bucket, a prudent fiduciary should be encouraged to consider fees as part of the expected performance decision.

Today, many fiduciaries first run a "fee" screen and only then evaluate expected risk-adjusted performance. ERISA does not require or prescribe this. By separating the two factors,

over their savings to an IRA or new employer plan. Moreover, any potential liquidity issues, in any healthy company, are mitigated with new entrants that provide liquidity for the relatively small amount of leakage suggested by the Vanguard study. Vanguard, How America Saves 2018, https://pressroom.vanguard.com/nonindexed/HAS18_062018.pdf (accessed July 28, 2020).

[12] We recognize that most defined contribution plan fiduciaries will desire to ensure that all investment options included within the defined contribution plan comply with the liquidity and other requirements of Section 404(c) of ERISA, which insulates plan fiduciaries from fiduciary liability for participants' investment decisions in a participant directed plan. To meet these requirements plan participants must be able to change their investment allocations "with a frequency which is appropriate in light of market volatility to which the investment alternative may reasonably be expected to be subject." These liquidity concerns could be easily addressed by including liquid securities within an investment option that includes private equity and other less liquid investment alternatives within the investment option.

[13] *E.g.*, Securities Exchange Commission: Beginners' Guide to Asset Allocation, Diversification, and Rebalancing, https://investor.gov/additional-resources/general-resources/publications-research/info-sheets/beginners-guide-asset (accessed July 26, 2020).

plan fiduciaries are harming participants by denying them access to investments like actively managed funds, private equity, private real estate, hedge funds, and other portfolio diversifying alternatives. These types of investments can all enhance participant outcomes despite their higher level of fees when compared to passively managed index funds. This rulemaking provides the Department with the opportunity to put fees into their proper context consistent with ERISA's purpose — maximizing long term retirement outcomes for American retirement savers.

D. Prudent Experts Consider Complex Investments As Well As Simpler Investments

The Department should state in the final rule that complexity is not an investment factor. ERISA has a uniform standard for both defined benefit and defined contribution plans. In the defined benefit space, it has long been understood that a fiduciary cannot simply rule out "complex" investments. All plan fiduciaries are held to a "prudent expert" standard. To the extent that a fiduciary needs help evaluating investments, ERISA directs a fiduciary to seek the assistance of experts. Under this standard, a fiduciary is required to attempt to select the investment options that are most likely to lead to a secure retirement for the plan's participants. In the defined contribution space, plan fiduciaries should be reminded that their obligation is not to "select the best option that participants can easily understand." Plan participants should not miss out on high quality investment options simply because they themselves are not experts. The Department's multi-layered approach to investment review and disclosure already protects plan participants. Instead, plan fiduciaries should select the best investment alternative even if that investment has a complex strategy.

II. The Department Should Clarify That It Is Not Encouraging Fiduciaries To Use Passively Managed Funds Over Actively Managed Funds

The Proposed Rule's regulatory impact analysis states that participants will benefit from the migration from ESG funds.[14] It does so by stating, "as plans invest less in actively managed ESG mutual funds, they may instead select mutual fund with lower fees or passive index funds."[15] This sentence is troubling as it can be read as an endorsement by the Department of passive investing. As the Department has acknowledged elsewhere in the Proposed Rule, investment decisions should not be based on any single investment factor. And, as we described in Section I, participants want investments that offer the best risk-adjusted performance net of fees. By being blindly managed, passively managed funds offer reduced fees but they do so largely by taking on the risk that investments on auto-pilot can perform as well over the long-run as investments where there is a driver.

[14] We are not taking a position one way or the other as to whether investors will benefit from migration from ESG funds. Our concern is that the Department appears to have framed the analysis so that the expected benefit to retirement investors is simply the difference in fees charged by an ESG fund when compared to those charged by a passive investment. As described in Section I, when calculating benefits, the Department, fiduciaries, and participants should measure gains and losses using risk-adjusted performance net of fees. We encourage the Office of Management and Budget to use this metric rather than simply comparing fees in its final regulatory impact analysis.

[15] *Financial Factors in Selecting Plan Investments* at 39121.

A more fundamental point though is that nothing in ERISA authorizes the Department to endorse one investment strategy over another. At various points in time (and in various markets), passive investments have outperformed active investments. However, the opposite has been true equally often. We encourage the Department to provide a framework that a prudent fiduciary could use to evaluate investments, but we caution the Department against nudging plans towards either active or passive management. Instead, passively and actively managed investment options should be evaluated in the context of overall expected net investment performance, as well as other investment considerations like diversification.

III. The Department Should Clarify And Expand The List Of Asset Classes That Plan Fiduciaries Might Consider

Section (c)(3)(i) of the Proposed Rule lists certain asset types that a fiduciary might consider as investment alternatives. Specifically, it provides the examples of "equity, fixed income, money market funds, diversification of investment alternatives, which might include target date funds, value and growth styles, indexed and actively managed funds, balanced and equity segment funds, non-U.S. equity and fixed income funds."[16] We ask the Department not to include a list in the final rule. Even though the list begins "for example", it is likely that fiduciaries will interpret the Department's list as providing a comprehensive list of the types of investments that they are required to consider.[17] As described in Section II, the Department should not endorse certain types of investments at the expense of others.

If the Department were going to include a similar list in its final rule, we ask that the Department include a more comprehensive list of asset classes. For example, the Department should include private market investments such as private equity, real estate, and hedge funds. These types of investments are already common in defined benefit plans and are becoming increasingly prevalent in defined contribution plans. Failure to include these already-used tools can only stifle innovation and lead to worse participant outcomes.

Finally, the Department should go beyond merely beginning any list of investment types with "for example" and should instead add that the list "is included for illustrative purposes and should not be interpreted as discouraging innovation."

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The AIC appreciates the opportunity to submit comments on the Proposed Rule and would be pleased to answer any questions you might have regarding our comments, or regarding the private equity, growth capital, and private credit industry more generally. This is the first time in 40 years that the Department has issued a proposal interpreting ERISA Section 404.

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[16] *Financial Factors in Selecting Plan Investments* at 39127.

[17] A historical example of this potential for unintended consequences involves qualified default investment alternatives ("QDIAs"). Subsequent to the enactment of the Pension Protection Act of 2006, significant investments were shifted from existing plan default investments to QDIAs. In 2016, the Department clarified that QDIAs are not the only appropriate investment choice as a default investment options. *See* Information Letter to Christopher Spence (Dec. 22, 2016). However, by that point in time, a significant shift of default investment assets to QDIAs had already occurred.

While the Proposed Rule is focused primarily on ESG, the Department has a real opportunity to enhance participant outcomes by encouraging needed innovation in the defined contribution investing space. We believe the comments that we have submitted would allow the Department to encourage such innovation and that such encouragement would be a logical outgrowth of the Proposed Rule for purposes of the Administrative Procedures Act.

Respectfully submitted,

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