DCALTA
Defined Contribution
Alternatives Association

March 4 2020

Preston Rutledge
Assistant Secretary
Employee Benefits Security Administration
200 Constitution Avenue, NW
Suite S-2524
Washington, DC 20210

Dear Mr. Rutledge:

This letter follows up on DCALTA's February 24, 2020 meeting. DCALTA appreciates the time you and your staff took to meet with us and your thoughtful questions. As requested, we have attached a PowerPoint discussing the SEC's "qualified purchaser" rule. We have also attached disclosures that a plan that has and currently includes alternative investments is providing its participants as well as a recent article showing how pension funds around the world have proactively allocated a greater portion of their assets to alternatives in the twelve years since the Great Financial Crisis. Finally, we have provided additional information related to the factors that we would expect a prudent fiduciary to consider and understand before adding a multi-asset class fund that contains alternative investments, like private equity, to a plan's core lineup or as the plan's default investment option.

DCALTA supports the inclusion of professionally managed and diversified portfolio of alternative assets as a modest component of a multi-asset class fund, such as a target date fund, within a defined contribution plan's investment options. We note that ERISA fiduciaries for decades have utilized private equity and other alternative investments to enhance investment performance, increase diversification and mitigate portfolio risks. In defined benefit plans, where plan sponsors bear the cost of poor investment performance, most large plans invest in private equity and other alternatives. In the defined contribution space however, plan fiduciaries have tended to provide plan participants with investment lineups that largely consist of mutual funds and collective investment trusts that invest in bonds or long-only public equity. Some of this disparity can be attributed to SEC rules that complicate product design. However, much of the complacency in the defined contribution space is directly driven by a belief that innovation creates litigation risk and also that, while not optimal, the investment options provided to current defined contribution savers are adequate. Meanwhile, the retirement security of defined contribution savers could be materially enhanced by simply leveling the playing field with defined benefit participants.

At bottom, it is important for the Department to remind plan fiduciaries that all types of investments are subject to the same fiduciary responsibility rules. Moreover, the decision to exclude certain asset classes is – in itself – a decision subject to the same standard. This means

that plan fiduciaries must determine that an investment in an alternative investment like private equity is, among other things, prudent and made solely in the interest of the plan's participants and beneficiaries. In determining whether to include an investment option containing alternative investments like private equity, plan fiduciaries are required to engage in the same due diligence process and undertake the same type of analysis that they would in making any other investment decision. Last, plan fiduciaries face the same duty to regularly monitor these investments and consider whether they continue to be prudent.

When considering more complex or sophisticated investment structures, plan fiduciaries may need to seek outside expertise or obtain additional education to better serve the investment needs of plan participants.

When evaluating more complex products, we would expect plan fiduciaries to focus on the following considerations:

- Liquidity
  - Plan fiduciaries should consider the impact of potential illiquidity on the multi-asset fund to which private equity investments serve as a component. In this regard, considerations include whether illiquidity would impact participants' ability to reallocate their accounts to another available investment alternative or obtain a distribution from the plan by liquidating their investment in the multi-asset fund.
  - We encourage the Department to provide a statement or other guidance signaling that limited liquidity may be in a participant's best interest. Retirement plans are designed for long-term investing. To the extent a participant has a long investment horizon, we hope that the Department could acknowledge that a participant may benefit from an illiquidity premium and that less tradeable investments may reduce the risk of churning.
- Time Horizon / J-Curve
  - Plan fiduciaries should consider the attributes of an alternative investment like private equity's time horizon and how that may impact participant gains/losses depending on the entry and exit of their investments.
  - As new solutions are created, this is an apparent issue that product manufacturers and plan fiduciaries will seek to address. We hope that the Department will not encourage any specific method to address the risk that start-up costs will be borne by early investors whereas gains from the sale of underlying assets could yield surplus gains for later investors. Instead, the Department should encourage plan fiduciaries to understand these issues and the

various approaches taken by managers to eliminate and/or mitigate these risks.

- Valuation
  - Plan fiduciaries should understand the methodology that will be used to value alternative investments like private equity investments and how often the investments will be valued. Plan fiduciaries may seek to understand the different valuation methodologies that may be appropriate for different types of underlying assets. Ultimately though, fiduciaries should be comfortable that valuation procedures are objective.
  - Like the J-Curve, valuation is a factor that different products address in different ways. For interim valuations, some use a prior period`s valuation plus interim cash flows. Others use third-party automated modeling. Still others use methods like interim marks. We hope that the Department will encourage plan fiduciaries to understand the methods of interim valuation that an investment fund may use without identifying a single method. For reported valuations, we hope that the Department will confirm its existing guidance and simply require independent valuation.
- Fees
  - Plan fiduciaries should understand the entire fee structure to assess the potential impact of fees on the returns on alternative investments like private equity. We note that while private equity investments may bear higher fees than other typical plan investments on an absolute level, the prudence of a plan fiduciary's decision will be evaluated based on a fiduciary's consideration of the potential for risk-adjusted returns net of fees.
  - On fees, we hope that the Department could provide guidance reaffirming that its focus on fees has been based on the idea that plan fiduciaries focus on evaluating expected risk adjusted performance net of fees. Much like annuities, alternative investments like private equity may support higher fees by providing a greater expected level of return at a targeted risk level.
  - Unlike typical mutual funds, a substantial portion of the typical private equity fees are only realized when the investment achieves certain pre-set performance levels, creating an alignment of interest between the asset manager and the participants.
- Private Equity Management
  - Plan fiduciaries should assess the capabilities of the party or parties that will be responsible for the alternative investment or private

equity component of the asset allocation fund. Factors to consider include (i) track record, including historical investment returns, (ii) staffing and resources, and (iii) investment philosophy and strategy for selecting underlying private equity investments.

- This consideration is typical of the type of analysis that a plan fiduciary considers in selecting any active asset manager.

- Legal Structure of Private Equity Component
  - Plan fiduciaries should understand the implications of the private equity component's legal structure. One consideration is whether the private equity component will be managed by a party acting as a fiduciary within the meaning of ERISA.
  - In the short term it is likely that the bulk of these vehicles will be structured as collective investment trusts. If the SEC modernizes its "qualified purchaser" rules, we would expect to see more mutual funds include alternative investments or private equity sleeves. Much like with other asset classes, plan fiduciaries should understand the differences between a collective investment trust and a mutual fund.

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We hope that the information and materials provided are helpful to you. If you have any questions or concerns regarding the foregoing or anything else related to this request, please do not hesitate to contact DCALTA's counsel David Levine at (202) 861-5436 or dlevine@groom.com or Kevin Walsh (202) 861-6645 or kwalsh@groom.com.

Best regards,

Jonathan Epstein

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