IPA
Institute for Portfolio Alternatives

July 10, 2020

Via E-mail

Ms. Vanessa A. Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Email: *rule-comments@sec.gov*

Re: File Number S7-25-19, *Amending the "Accredited Investor" Definition*

Dear Secretary Countryman:

The Institute for Portfolio Alternatives ("IPA")[1] submits the following comments on the referenced rule proposal, which seeks to modernize the "accredited investor" definition. We applaud the Commission's recent efforts to work with the Department of Labor ("DOL") to develop a consistent framework surrounding investment advice for retirement savers and to ensure that retirement savers have access to the investment tools they need to secure a dignified retirement. Specifically, we thank the Commission for working with the DOL to issue guidance providing Employee Retirement Income Security Act of 1974 ("ERISA") fiduciaries with a framework to evaluate private fund investment availability to defined contribution (*e.g.*, 401(k)) plan participants. We now ask the Commission to complete the effort that the DOL began and provide Main Street retirement savers with access to private funds. Specifically, we ask the Commission to make it easier for private funds to accept defined contribution plan investments.

Under the Investment Company Act ("40 Act"), a private investment fund that either (1) has 100 or fewer beneficial owners, or (2) has exclusively "qualified purchasers" as interest-holders – is not required to register as an investment company. Under the current SEC framework, a defined benefit plan is treated as a single investor and may itself be a qualified purchaser. Defined contribution plans, however, are treated differently and have an additional "look through" requirement. Instead of the plan counting as a qualified purchaser, defined contribution plans are required to "look through" and count

[1] The IPA represents SEC-registered non-listed investment vehicles that provide alternative portfolio diversifying investment ("PDI") products for Main Street investors that have low correlation to the equity markets and were historically available only to institutional investors. Over the last 20 years, for example, private real estate as measured by the NCREIF Fund Index – Open-end Diversified Core Equity (NFI-ODCE) – has had a low correlation of .20 to the S&P 500 according to Morningstar, Inc.

each participant to ensure that *individual participants* are qualified purchasers. This results in private funds prohibiting defined contribution plans from investing.

From the 1990s through the 2000s, SEC staff attempted to level the playing field by providing defined contribution plans with access to private funds through a series of No-Action letters. While a positive first step, the benefits of these No-Action letters have been very limited. Although the No-Action letters provided a pass on the "look through" requirement, it required managers to design opaque funds with limited participant visibility into underlying private funds. This lack of opacity has turned into claims in ERISA litigation. The litigation has chilled consideration by plan fiduciaries.

Under staff guidance, a private fund can accept a defined contribution plan investment while continuing to rely Sections 3(c)(1) or 3(c)(7) of the '40 Act if:

- The participants' discretion is limited to allocating assets to generic investment options while the plan fiduciary solely decides to make any particular private fund investment or to withdraw assets from private fund investments;
- The plan limits investment in each private fund to less than 50% of its assets invested in any investment option; and
- No representation is made to participants that any specific part of their contributions or any specific portion of the assets allocated to a generic investment option is invested in the fund.

These rules — particularly the last one — have led to unintended consequences. They effectively require the development of investment products that provide little information about managers, asset allocation, and fund glide paths. ERISA provides robust participant protection, and rules such as these prevent participants from those protections by denying access to the benefits of private funds within the safety of the ERISA system. Plan participants want transparent access to and about private funds through their retirement plans.

There is a simple solution to address this problem. We strongly encourage the Commission to issue guidance stating that a defined contribution plan is considered the beneficial owner for determining: (1) the number of investors in a private investment fund, and (2) whether all private fund investors are "qualified purchasers" for all defined contribution plan investments that are "designated investment alternatives."[2] If the Commission is unwilling to completely harmonize the '40 Act's rules for defined benefit and defined contribution plans, at a minimum the Commission should issue a regulation allowing

[2] Under the Department of Labor's regulation governing *Fiduciary requirements for disclosure in participant-directed individual account plans*, a "designated investment alternative" means "any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment alternative" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan." See 29 CFR 2550.404a-5(h)(4).

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a private fund to accept defined contribution plan investments while the plan provides disclosures naming the manager, current allocation, and expected or fixed future allocation.

Making this change will provide American retirement savers with access to private investment funds and afford them strong investor protections.[3]

"Look Through" Background and Solution

The current "look through" requirements are the outgrowth of Commission interpretations that predate ERISA and have not been updated to reflect the negative impact on defined contribution plan participants due to lack of access to private funds.

Before ERISA's 1974 enactment, the Commission recognized there were strong arguments for implementing investor protections for certain retirement plans. Specifically, the Commission recognized investor protections were important for retirement plans where participant decisions (i.e., whether to contribute or how to invest the corpus) impacted the individual retirement income amount as opposed to plans where participants had no authority.

In 1941, the Commission began treating contributory pension plans differently than non-contributory pension plans. "Contributory" plans were plans where an employer sold shares of itself to employees (i.e., where employees could determine how much to contribute). "Non-contributory" plans — like traditional defined benefit pension plans — were plans where employers did not pay their employer for access to money in retirement.

At the time, the Commission was the primary regulator offering protections to Americans saving for retirement. In that posture, the SEC's general counsel concluded that voluntary, contributory plans are "securities" while non-contributory plans were not.[4] By doing this, the Commission put itself in a position to regulate defined contribution plans. However, the Commission made no efforts to regulate defined contribution plans other than when employee contributions were invested in the securities of the employer sponsoring the plan.

In 1979, the Supreme Court affirmed that non-contributory retirement plans are not securities.[5] This opinion ("*Daniel*") cited the 1941 general counsel opinion to demonstrate that the SEC had never considered non-contributory plans to be securities. In the same opinion, the Court explained that the

[3] Updated guidance would only allow private funds to accept investments from defined contribution plan participants (who are not themselves qualified purchasers) if the plan's fiduciaries determined that making the investment option available was "solely in the interest of the participants and beneficiaries" and had made that determination "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [adult] acting in a like capacity and familiar with such matters would use." ERISA Section 404. This standard of care imposed on an ERISA fiduciary has been described as "the highest known to law." *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982), *cert denied*, 459 U.S. 1069 (1982).

[4] *See* Opinions of Assistant General Counsel, [1941-1944 Transfer Binder] CCH Fed.Sec.L.Serv. ¶ 75,195 (1941).

[5] *Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 553 (1979).

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Commission had viewed contributory plans differently. Shortly after the decision was released, the Commission noted that while it could regulate defined contribution retirement plans, it did not intend to do so.[6]

This changed in 1992 when Commission staff began regulating defined contribution retirement plan investments. In November of that year, staff interpreted *Daniel* as allowing the SEC to conclude the interest of [401(k)] plans "are securities and therefore . . .the participants in the 401(k) plan should be considered holders of outstanding securities for purposes of Section 3(c)(1)." [7]Additionally, Staff interpreted *Daniel* to mean "all the employee participants in the … 401(k) plan [had to] be counted as beneficial owners" for purposes of determining if there was ownership of more than 10% of a private investment company's voting securities.

In a 1994 No-Action letter ("PanAgora"), staff concluded that a participant who decides whether or how much to invest in a private fund is the "beneficial owner" for purposes of determining if a private fund has 100 investors under Section 3(c)(1) of the '40 Act.[8] With the PanAgora decision, the staff effectively closed the doors to the private markets for defined contribution plans. Private funds could not accept investments from defined contribution plans without ensuring that each plan participant was himself or herself a qualified purchaser, or without ensuring that, taking each participant into account, the fund would have fewer than 100 investors.

Months later, staff signaled its recognition of certain consequences from the earlier No-Action letters, stating:

> [O]ur conclusion in PanAgora was based on the fact that in that case "a defined contribution plan participant ... [could] decide whether or how much to invest in a private investment company...." We might reach a different conclusion under different circumstances. For example, if a participant selects a generic investment option, only a portion of which is directed by the plan trustee to a particular 3(c)(1) entity, the rationale for counting each participant separately might not apply."[9]

The following year, in its Standish, Ayer & Wood No-Action Letter, staff permitted an investment fund to treat a participant-directed defined contribution plan as a single beneficial owner for purposes of Section 3(c)(1) of the '40 Act.[10] The fund stated it would obtain representations from investing plans that: "a Plan participant's discretion will be limited to allocating his or her account among a number of generic investment options; the decision to invest in the Fund, and the amount of assets invested, will be solely within the discretion of a Plan fiduciary; and immediately following any

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6 *Employee Benefit Plans*, Release No. 33-6188, 45 Fed. Reg. 8960 (Feb. 1, 1980).

7 *Intel Corp.*, Fed. Sec. L. Rep. P 76,432 (S.E.C. No - Action Letter Nov. 18, 1992).

8 *The PanAgora Grp. Tr.*, 1994 WL 174138, at *6 (S.E.C. No - Action Letter Apr. 29, 1994).

9 *Latham & Watkins*, Fed. Sec. L. Rep. P 76,959 (S.E.C. No - Action Letter Dec. 28, 1994).

10 *See Standish, Ayer & Wood, Inc. Stable Value Group Trust* (S.E.C. No - Action Letter Dec. 27, 1995).

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purchase of Fund units by a Participating Plan, less than 50% of the assets of a generic investment option will be invested in the Fund." In footnotes, staff further stated:

> [t]he 50% representation is intended to ensure that a Plan participant's decision to allocate assets to a generic investment option is not the substantial equivalent of a decision to invest in the Fund. By incorporating this representation in its response, the staff does not suggest that a higher percentage investment necessarily would mean that a Plan's participants must be treated as the beneficial owners of an underlying 3(c)(1) issuer's securities. Nor does the staff foreclose the possibility that different facts from those stated here might justify treating a Plan as a single beneficial owner. The staff does not intend to respond to No-Action requests, however, that involve a generic investment option seeking to invest more than 50% of its assets in a 3(c)(1) issuer if the request does not otherwise differ materially from the facts described in the incoming letter.[11]

In 2001, the staff took additional steps toward restoring access to private funds for defined contribution plan participants.[12] Staff expanded the Standish, Ayers, & Wood's exception to the "look through" requirement to apply to funds relying on 3(c)(7). Again, staff required a fund to receive series of representations from the investing plan. These include:

- Other than the plan trustees acting in their capacity as plan fiduciaries, a plan participant's investment discretion will be limited to allocating his or her account among a number of designated investment options, each of which has an identified generic investment objective;
- The decision to (i) invest the assets of an designated investment option in a Section 3(c)(7) fund (both initially and subsequent to the initial investment), (ii) withdraw the assets from the Section 3(c)(7) fund and (iii) determine the amount of assets invested, will be made solely by one or more plan fiduciaries, without direction from or consultation with any plan participant other than plan trustees acting as plan fiduciaries;
- Immediately following the purchase of any Section 3(c)(7) fund's securities by a designated investment option, at least 50% of the assets of the option will consist of securities or property other than securities of the Section 3(c)(7) fund;
- No representation will be made to Plan participants that any specific portion of their contributions to, or account balances under, the plan, or any specific portion of the relevant designated investment option, will be invested in the Section 3(c)(7) fund. If the plan delivers any information to plan participants that mentions an investment in a Section 3(c)(7) fund, it will be accompanied by a disclaimer to the effect that no assurances can be given that the designated investment option will continue to invest its assets, or the same portion of its assets, in the Section 3(c)(7) fund.

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[11] *Id.*, at *3.

[12] *The H.E.B. Inv. & Ret. Plan*, 2001 WL 533465, at *12–13 (S.E.C. No - Action Letter May 18, 2001).

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In the 2000s, some defined contribution plans tried to include private funds in target-date funds. The first movers were some of the largest plan sponsors, and they designed "white label" products designed to comply with the No-Action letter guidance. Unfortunately, the guidance fit poorly with ERISA's rules governing the fiduciary requirements for disclosure in participant-directed individual account plans.[13] Participants expect more transparency than white label funds provide, which make no commitment to retain specific managers or allocate a specific amount to those managers. As a result, litigation ensued. In October 2015, Intel was sued for including private funds in its target date funds.[14] In February 2016, Verizon was sued.[15] For plan fiduciaries, it became clear that designing white label options to comply with the SEC's No-Action letters attracts litigation. Both lawsuits continue to be litigated. The combination of increased litigation and the needed opacity have chilled innovation in the market, and impacted the options for 401(k) investors.

On June 18, 2019, the Commission issued its "Concept Release on Harmonization of Securities Offering Exemptions" ("Concept Release").[16] In the Concept Release, the Commission asked if it should allow "investment(s) out of retirement or other similarly federally-regulated accounts" to "invest in pooled investment funds, such as private funds under Section 3(c)(1) of the Investment Company Act." It also asked if target date retirement funds should be allowed to "seek a limited amount of exposure to exempt offerings."

Most recently, on June 3, 2020, the Department of Labor issued an information letter designed to address plan fiduciaries' litigation fears.[17] The letter states that, "[T]here may be many reasons why a fiduciary may properly select an asset allocation fund with a private equity component as a designated investment alternative for a participant directed individual account plan." In the accompanying press release, Secretary of Labor Scalia stated that, "The Letter helps level the playing field for ordinary investors and is another step by the Department to ensure that ordinary people investing for retirement have the opportunities they need for a secure retirement."[18] And Chairman Clayton said that the letter, "will provide our long-term Main Street investors with a choice of professionally managed funds that more closely match the diversified public and private market asset allocation strategies pursued by many well-managed pension funds as well as the benefit of selection and monitoring by ERISA fiduciaries."[19]

This background demonstrates that the Commission never intended to bar defined contribution plans from investing in private funds, and that today's status quo is harmful to Main Street investors

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13 29 C.F.R. 2550.404a-5.

14 *See Sulyma v. Intel Corporation Investment Policy Committee et al.*, No. 5:15-cv-04977 (N.D. Cal. 2015).

15 *See Jacobs v. Verizon Communications Inc.*, No. 1:16-cv-01082 (S.D.N.Y. 2016).

16 Concept Release on Harmonization of Securities Offering Exemptions, 84. Fed. Reg. 30,460 (June 26, 2019).

17 DOL Information Letter to Jon W. Breyfogle (Jun. 3, 2020).

18 Employee Benefits Securities Administration Press Release No. 20-1160-NAT (June 3, 2020).

19 *Id.*

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seeking an appropriate allocation to private funds and remains an inadvertent outcome of earlier guidance.

To reiterate, the solution to address the inequity for 401(k) investors that do not have access to the same retirement solutions as institutional investors is simple. The Commission can issue guidance stating that a defined contribution plan is considered the beneficial owner for determining: (1) the number of investors in a private investment fund, and (2) whether all private fund investors are "qualified purchasers" for all defined contribution plan investments that are "designated investment alternatives."[20] While we believe it is appropriate and timely to harmonize the '40 Act's rules for defined benefit and defined contribution plans, at a minimum the Commission should issue a regulation allowing a private fund to accept defined contribution plan investments while the plan provides disclosures naming the manager, current allocation, and expected or fixed future allocation.

Open-Ended Mutual Funds

Rule 22e-4 prohibits open-ended mutual funds from investing more than 15% of a fund's total assets in illiquid investments. This limit harms investors in target-date funds because target-date funds are designed to be long-term investments. Additionally, the 15% limit has led to an anchoring bias for target-date funds that are structured in ways that are not subject to the 15% limit.

Allowing target-date mutual funds to increase their allocation to illiquid investments would serve many of the same purposes and address many of the same issues described elsewhere in this letter. Long-dated target-date funds can reasonably expect that inflows will exceed outflows. People invest in target-date funds not only for their current holdings, but also to benefit from having a manager of the fund's glidepath. For someone who is twenty-plus years away from retirement, it makes little sense to invest in a target-date fund if the investor does not intend to allow the manager to manage the glidepath for an extended period of time. These investors with a long horizon would benefit if the fund managers were able to allocate a greater percentage to illiquid investments. When target-date funds near the expected retirement date of the fund holders, it makes sense for target-date funds to become more liquid.

Amending Rule 22e-4 to increase the upper bound to 30% for long-dated target-date funds would help younger investors, would help address the current unlevel playing field between individuals saving for their own retirement and foundations, endowments, and other institutional investors, and would reduce the investor harm caused by managers of other products using the 15% limit to anchor the boundaries of their products.

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[20] Under the Department of Labor's regulation governing *Fiduciary requirements for disclosure in participant-directed individual account plans*, a "designated investment alternative" means "any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment alternative" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan." See 29 CFR 2550.404a-5(h)(4).

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In conjunction with amending the upper limit, the Commission could also amend Rule 22e-4 to allow managers of funds that exceed the 15% threshold through valuation changes more time (currently one business day) before the managers become required to notify the fund's board and develop a plan for bringing the fund below the 15% limit. Not only is the 15% limit too low, but the current liquidity risk management rules discourage managers from approaching that limit.

Recent Trends

Since the issuance of the PanAgora Letter, there have been three significant shifts affecting the outcomes for retirement plan participants. These issues are exacerbated by Rule 22e-4's low cap on illiquid investments.

First, employers have moved away from offering traditional defined benefit plans. Due to a demographic shift resulting in a rapidly aging U.S. population, employers have increasingly chosen to close or freeze defined benefits plans in order to control costs. Defined contribution plan assets now make up over fifty percent of all pension plan assets and 51 percent of the private sector U.S. workforce only has access to defined contribution plans.[21]

Second, companies can now take advantage of rules that allow them to stay private longer. By raising the maximum allowable shareholder threshold from 500 shareholders to 2,000 shareholders, excluding employees with shares of stock when making the shareholder calculation, the 2012 Jumpstart Our Business Startups Act (and certain amendments contained in the Fixing America's Surface Transportation Act) allows more companies to extend the time before going public.[22] Current investment regulations have not addressed the need for the *100 million* American workers participating in defined contribution plans to gain access to investments in emerging or high growth companies and industries.

Third, there has been a significant rise of 401(k) plan investment litigation. Defined contribution plans face scrutiny for the investment alternatives that they make available on an almost daily basis.[23] In comparison, it is almost impossible to sue a defined benefit plan for fiduciary investment decisions.[24] If the Commission does not act to allow defined contribution plans access to more transparently designed private funds, the threat of litigation is likely to reduce the positive impact of the joint DOL and Commission steps designed to modernize the plan investment landscape.

Monetary Impact of the Harm

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[21] Bureau of Labor Statistics, TED: The Economics Daily, 2018 (Oct. 2, 2018).

[22] 17 CFR § 240.12g(1)-12(g)4; 12(h)(3)

[23] *See, e.g.*, *Burgess et al. v. HP Inc. et al.*, No. 16-cv-04784 (N.D. Cal. 2016); *Lutz, et al. v. Kaleida Health, et al.* No. 18-cv-01112 (W.D.N.Y. 2018); *Hay v. Gucci America, Inc. et al.*, No. 17-cv-07148 (D.N.J. 2017); *Kruger v. Novant Health, Inc.*, No. 14-cv-00208 (M.D.N.C. 2014); *Damberg et al. v. LaMettry's Collision, Inc. et. al.*, No. 16-cv-01335 (D. Minn. 2016); *Bell et al. v. Pension Committee of ATH Holding Company, LLC, et al.*, No. 15-cv-02062 (S.D. Ind.); *DuCharme v. DST Systems, Inc. et al*, No. 17-cv-00022 (W.D. Mo.).

[24] *Thole v. U.S. Bank N.A.*, 140 S. Ct. 1615, 1622 (2020).

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Defined benefit plans invest heavily in private funds. Defined contribution plans do not. Rules that prevent defined contribution plan participants from investing in the same private funds as defined benefit plan participants have created two different classes of retired American workers. One group benefits from the $2.9 trillion dollar private markets, while the other can only take advantage of a declining $1.4 trillion public market.

The consequence of this disparity is a stark difference in the investment performance of defined benefit plans compared to that of defined contribution plans. Data shows that between 1990 and 2012, defined benefit plans were the superior performer, with a 0.7 percent higher rate of return compared with defined contribution plans.[25] While this is great news for the 17 percent of Americans that participate in defined benefit plans, it comes at the expense of the 60 percent of Americans who participate in defined contribution plans.[26] This may be especially consequential for less-educated workers. By 2004, the most educated members of the U.S. workforce were twice as likely to participate in defined benefit plans compared to the least educated workers. This difference in access to higher yield investments is therefore most consequential for the less-educated workers who are shut out of private investments.[27]

American workers increasingly view retirement plans as lifetime income generation vehicles rather than savings plans. Over 80 percent of employees report they expect their retirement plan to create income that will be available during retirement.[28] The current "look through" requirements have constrained the ability of defined contribution plan investors and fiduciaries to implement the creative and progressive strategies necessary to secure the futures of the millions of Americans depending on their defined contribution plans for retirement income.

When offered and as explained above, the products made available to defined contribution plans are suboptimal. These products are white-labeled, which not only leads to more litigation, but also impedes performance. The process of white-labeling creates administrative overhead that diverts fiduciary attention away from judicious plan design. Because white-labeled products have generic names, investors view them as opaque. This is out of step with the current trend toward greater transparency and increased investor responsibility. Plan participants are, invariably, less likely to educate themselves about funds that have generic names and will be less proactive in seeking information about the impact of fund performance on their retirement income.

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[25] Alicia H Munnell, Jean-Pierre Aubry & Caroline V. Crawford*, Investment returns: Defined benefit vs. defined contribution plans*, Issue in Brief 15-21 (2015).

[26] Jennifer E. Brown, Joelle Saad-Lessler & Diane Oakley, *Retirement in America: Out of Reach for Working Americans?*, National Institute on Retirement Security (2018).

[27] Natalie Sabadish & Monique Morrissey, *Retirement Inequality Chartbook: How the 401(k) revolution created a few big winners and many losers*, Economic Policy Institute (2013).

[28] Angela M. Antonelli, *Generating and Protecting Retirement Income in Defined Contribution Plans: An Analysis of How Different Solutions Address Participant Needs*, Georgetown University McCourt School of Public Policy Center for Retirement Initiatives (2019).

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There was a time when it made sense for the Commission to regulate define contribution plans. In 1941, there was no robust regulatory framework for retirement plans, and unscrupulous employers raising capital off their labor could harm employees. Since ERISA's enactment, however, subsequent SEC rules have not adapted to recognize ERISA's protections, the increase in private market opportunities, and the need for American retirement savers to have access to all of the tools of other investors. We ask that the Commission address these issues and modernize its rules and guidance for today's market.

If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at (202) 548-7190.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

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