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DC plans still slow on moving alts into lineups

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Joshua Lichtenstein believes the Labor Department would work with the SEC on a proposal.

Illiquid investments aren't heavily featured in the defined contribution plans today, but as the shift away from defined benefits plans continues, some in the industry say it's just a matter of time before that changes.

"Not only are people that only have a 401(k) plan solely responsible for making the decision to put away money for retirement, but they are also are solely responsible for determining how to invest that money and they just don't have the same types of investment options available that the fiduciaries of a defined benefit plan do," said Joshua Lichtenstein, a New York-based partner at Ropes & Gray LLC.

Kevin Albert, New York-based managing director and head of global business development at Pantheon Ventures LLC, a global private equity, infrastructure, real assets and debt manager, said alternative investments gaining mainstream adoption in DC plans is inevitable. "It's such a glaring anomaly that it hasn't happened yet that it's just a question of time," he said.

Pantheon declined to disclose specifics of its DC business.

The reasons why it hasn't happened boils down to federal regulation and policy and a fear of litigation, attorneys said.

For a registered fund to invest more than 15% of its assets in private funds, the staff of the Securities and Exchange Commission says it must limit its investor base to accredited investors, like high-net-worth individuals, banks, insurance companies and pension funds. And under the Employee Retirement Income Security Act, DC plan sponsors must offer investment lineups that feature daily liquidity and investments options with competitive fees. The fee provision has been the basis for numerous class-action lawsuits in recent years.

Proponents of expanding access to illiquids in DC plans say the investments offer diversification and higher expected returns over their more liquid counterparts.

SEC Chairman Jay Clayton has said he's interested in expanding investment options for Main Street investors. During a discussion last month at the U.S. Chamber of Commerce in Washington, David Rubenstein, co-founder and co-CEO of the private equity and alternative investment firm Carlyle Group LP, asked Mr. Clayton if the agency is making progress on this front. "We are studying it," he replied.

Several sources said the SEC is working on a concept release on alternative investments in DC plans. An SEC spokeswoman declined to comment.

"There's a good chance, probably the best in a number of years, that we're going to get some movement," said Michael G. Doherty, a partner at Ropes & Gray. "I think the SEC staff wants to move things along."

Mr. Lichtenstein said if the SEC makes a move to expand investment options for DC plans, it's likely the DOL would be willing to work together to "figure out how any loosening of these standards could be given a practical effect in 401(k) plans."

The DOL, which under the Trump administration has filed two advisory opinions in 28 months, far fewer than preceding administrations, didn't respond to a request for comment.

"It's our hope that both DOL and the SEC proceed down a positive pathway, whether they do it in tandem or however is best for them, but I think it is important and helpful that both regulators are taking a look at this," said Jason Mulvihill, chief operating officer and general counsel for the American Investment Council, an advocacy group for the private equity industry.

Jonathan Epstein, president of the Defined Contribution Alternatives Association, a non-profit that seeks to expand the use of alternatives in DC plans, said he thinks there's an appetite in Washington to put DC and DB plans on a level playing field "when it comes to the investments that are being offered. It's a logical step to not have fear of litigation from sponsors and fiduciaries who are wanting to enhance their participants' outcomes."

Among DC plan executives, one of the first questions they pose when presented with something new centers on whether any peers are doing something similar, said James Veneruso, Summit, N.J.-based senior vice president and defined contribution consultant in Callan LLC's fund sponsor consulting group.

"It's almost a chicken-and-the-egg situation where no one will do something until other people are doing it so you always have to have that first mover," Mr. Veneruso said.

Private real estate — the illiquid asset class sources believe has had the most traction — is included in 48% of custom target-date fund strategies for employer-sponsored DC plans, according to research from the Defined Contribution Institutional Investment Association released in March.

As of March 31, private real estate was present in 8.3% of the 71 unique, off-the-shelf target-date glidepaths that Callan tracks. That's up from 5.5% out of 64 glidepaths in 2014.

Mr. Veneruso pointed to the public's familiarity with real estate as a potential reason why it's being adopted more so than other illiquid investments. "People live in houses so they get it," he said. "They don't necessarily deal with private equity or hedge funds in their daily lives."

Lew Minsky, DCIIA president and CEO, said large DC plans with the staff and scale to build custom options are generally the ones incorporating illiquid investments, namely private real estate.

A recent survey from the Chicago-based Plan Sponsor Council of America found that 11.4% of 401(k) plans reported having alternative investments as options in their plans, 80.2% of which were offered as a mutual fund.

However, Jack Towarnicky, executive director of the PSCA, said that because most participants typically select a plan's default option, there isn't a call to add alternative investments in a broad capacity. "The demand isn't there," he said.

Moreover, Mr. Veneruso said the stock market's strong performance over the past decade means the calls to expand the use of alternatives aren't deafening.

Legal concerns

And still, litigation concerns persist. Notably, Intel Corp.'s investment policy committee asked the Supreme Court in February to clarify ERISA rules for sponsors' duties and participants' responsibilities in understanding investment menu changes and policies.

A participant alleged that plan executives violated their ERISA obligations by offering too many alternative investments in the DC plans' lineups and the plans' disclosures of investment information were inadequate. The investment policy committee has argued that the participant missed the three-year deadline for filing ERISA claims.

A U.S. magistrate judge ruled for Intel in March 2017. The judge rejected a 401(k) plan participant's argument that plan disclosures about investments were inadequate and that the participant lacked sufficient information about the plan's alternative investments. However, the 9th U.S. Circuit Court of Appeals reversed the decision, saying the participant didn't have sufficient knowledge and that the statute of limitations didn't apply.

Under existing regulations, plan sponsors do not want to subject themselves to lawsuits, so they'd rather offer low-fee, high-liquidity funds, Mr. Lichtenstein said. "It acts as an impediment to putting these types of private investment options on the 401(k) investment lineup even if you're able to find a way to thread the needle through the existing guidance and get exposure to those," he said.

Mr. Minsky said DC plan stakeholders need to shift the focus away from fees, which are a piece of the puzzle. "The low-cost investment lineup that underperforms still leaves people with a worse outcome," he said.

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