DOL Provides 401(k) Plans a Path to Private Equity Investments

June 10, 2020

On June 3, the Department of Labor issued an information letter that provides a roadmap for including private equity as an investment option for participant-directed individual account plans (such as 401(k) plans) in a manner that complies with the requirements of Title I of ERISA. While much of the guidance in the letter is not new or novel, and in many respects simply applies the Department's long-standing interpretations of ERISA, it should serve to lower hurdles that have existed for plan fiduciaries who wish to offer plan participants access to private equity (or other illiquid investments) as part of a diversified portfolio of investment options by alleviating the concern that the fiduciaries would be alleged to have breached their duties under ERISA merely by making such an investment option available to plan participants.

The Department's guidance states unequivocally that a fiduciary that follows an objective, thorough and analytical process can, consistent with its ERISA fiduciary duties, offer 401(k) plan participants the opportunity to invest in private equity, with the objectives of allowing all participants to better diversify their portfolios, providing participants with longer investment horizons the opportunity to better align their investments to those horizons and offering all participants the opportunity for the superior net-after-fee returns realized by institutional investors, including defined benefit plans, from such investments. Moreover, the guidance explains how a fiduciary can conduct such a process consistent with ERISA's fiduciary duties and offers practical solutions on managing the liquidity constraints that are inherent in private equity. While not expressly addressed in the letter, which focused on investment products with a private equity component, the logic of the guidance could also be applied to the introduction of other forms of alternative investments into a multi-asset class fund, so long as the fiduciary tailors its analysis and evaluation of the risks unique to that category of investment.

The investment structures presented for the Department's consideration in the context of the information letter were collective investment funds that have a specified target private equity allocation, with the remainder of the fund's portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values. This liquid component of the fund serves two purposes. First, it diversifies the exposure of the fund to the private equity investments by including investments in a range of asset classes with different risk and return characteristics and investment horizons. Second, it provides the liquidity needed to fund participant-directed deposits and withdrawals from the fund as well as capital contributions to the underlying private equity investments. While the guidance does not require there to be a specific limit on the investment structure's holdings of illiquid securities, the Department notes that to address liquidity concerns a fiduciary could limit the percentage of the fund permitted to be invested in private equity investments, and points by analogy to the 15% limitation on illiquid investments applicable to registered open-end management investment companies (or mutual funds).

The Department noted that other investment structures would also fit within its guidance. These might include a separately managed account or a "fund of funds" that invests in other funds, including a fund invested primarily in private equity. We believe that the guidance would also apply to a plan fiduciary's selection of an investment option organized as a mutual fund. Importantly, however, none of the structures considered would permit plan participants and beneficiaries to invest directly into private equity investments on a stand-alone basis. Such a private equity only vehicle would present a series of additional concerns that are mitigated, if not eliminated, when private equity is part of a larger managed investment alternative with the liquidity features noted above.[1]

The Department noted that while defined benefit plans often include private equity investments, a fiduciary considering such an investment option for a participant-directed defined contribution plan needs to consider the "important differences" in offering such an investment choice. For example, the Department touches on the fact that the private equity investments will need to be valued other than by reference to market quotations by suggesting that the fiduciary could ensure that they be independently valued according to agreed-upon valuation procedures that satisfy the Financial Accounting Standards Board Accounting Standards Codification ("ASC") 820, "Fair Value Management and Disclosures."

To authorize an investment vehicle with such a private equity component, the plan fiduciary must compare that investment option with "appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component" and evaluate the associated risks and benefits.

[1] The Department's guidance does not afford any relief from the current prohibition on retail investment in private funds, although the Chairman of the Securities and Exchange Commission (who was consulted by the Department in connection with this guidance) said in 2019 that the SEC was considering ways in which retail investors could access private funds.

Considerations that the Department recommended a plan fiduciary take into account in making its determination include the following:

- whether such an investment alternative would offer plan participants the opportunity to invest their accounts among more diversified investment options within an appropriate range of expected returns net of fees and taking into account diversification of risks over a multi-year period;

- whether the fiduciary has the skills, knowledge and experience to make the required determinations or whether the plan fiduciary needs to seek assistance from a qualified investment adviser or other investment professional;

- whether the investment alternative itself is managed or overseen by investment professionals that have the capabilities, experience and stability to do so given the nature, size and complexity of the private equity activity; and

- the plan's features and participant profile (including participant ages and contribution and withdrawal patterns) and liquidity needs as they relate to the participants' ability to access funds in their accounts (*e.g.*, loans and distributions when employees separate from service with the sponsoring employer), and to change investment selections.

As with all investment alternatives available in a participant-directed retirement plan, the Department noted that fiduciaries must periodically review whether the investment vehicle that includes the private equity component continues to be prudent and in the best interests of plan participants, taking into account the considerations outlined above and any other factors that the plan fiduciary deems appropriate in light of its fiduciary duties under ERISA. Finally, the fiduciary must determine whether plan participants will be provided with adequate information regarding the character and risks of the investment alternative to enable the participants to make an informed assessment regarding making or continuing an investment in the fund. The Department noted that such disclosure would be "especially important" in the case of a plan relying on the limited fiduciary liability provisions of ERISA section 404(c) and/or deciding that the investment alternative should be a qualified default investment alternative for the plan.

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