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DOL: Plan Fiduciaries Can Include Private Equity Investment Options for Defined Contribution Retirement Plans

New DOL information letter sheds light on how US defined contribution retirement plans (such as 401(k) plans) may offer private equity investments in compliance with ERISA.

Key Points:

- Private fund sponsors and "fund of funds" can now potentially access large pools of defined contribution retirement plan capital that, as a practical matter, had been off limits.
- Financial institutions (and other investment managers) are likely to create investment vehicles designed to capture some of this market by creating appropriate multi-asset class vehicles that include private equity investments as a component.
- The DOL letter offers plan fiduciaries, including investment advisors and asset managers, helpful guidance on how to meet their ERISA obligations when designing, selecting, and offering participants an investment option that includes a private equity component.

The US Department of Labor (DOL) recently issued an information letter (DOL Letter)[1] that could provide sponsors of private equity and other private investment funds a new source of investor capital — some of the estimated US$8 trillion-plus in assets[2] held by defined contribution retirement plans (*i.e.*, 401(k), profit sharing, 403(b), and 457 plans). These plans typically permit participants to direct the investment of their individual accounts, but the plan fiduciaries' selection of those investment choices must comply with the Employee Retirement Income Security Act (ERISA). The DOL Letter confirms that including a private equity component as part of a multi-asset class vehicle would not, per se, violate ERISA fiduciary duties and sets forth the specific factors for plan fiduciaries to address when selecting and offering their plan participants such an investment vehicle.

Private Equity Funds as a Defined Contribution Investment

Defined contribution retirement plans have not traditionally offered private equity investments as part of their investment mix due to ERISA fiduciary concerns as to whether such investments satisfy ERISA's prudence standard, mainly because of their relatively higher investment fees, complexity with respect to ERISA valuation requirements, long-term investment horizon, and risk profile as well as practical concerns regarding investment liquidity. (Although the DOL Letter is specific to private equity investments, its principles could potentially apply to other private investment funds, such as venture capital, infrastructure, or real estate funds.)

Selecting plan investment funds is subject to ERISA's fiduciary obligations. This means that plan fiduciaries must satisfy a "prudent expert" standard and diversify the plan investments to minimize the risk of large losses. Fiduciary breaches can result in significant liability.

The DOL Letter is intended to alleviate some of these ERISA fiduciary concerns by both:

- Clarifying that offering a professionally managed asset allocation fund that has a private equity component does not, in and of itself, violate the fiduciary requirements of ERISA, as long as such investment is otherwise prudent

- Setting forth helpful guidelines on how a plan fiduciary could, in compliance with ERISA, make a prudent decision to add a private equity component as part of a plan's overall investment alternatives

Opportunities for Investment Mangers

In order to be an ERISA-compliant investment for a defined contribution retirement plan under the DOL Letter, the private equity fund would need to be, among other things, a component of an otherwise diversified, professionally managed multi-asset, multi-class allocation vehicle structured as a custom target date, target risk, or balanced fund (asset allocation fund). The DOL Letter contemplates that these asset allocation funds will take the form of collective investment funds or "fund of funds" vehicles designed to offset their aggregate private equity exposure with appropriate levels of liquid, non-private assets. The asset allocation fund may be either bespoke, set up by plan fiduciaries and managed with the aid of a professional investment advisor, or ready-made in the form of a pre-packaged offering put together by a financial institution. In all cases, professional investment managers would decide the makeup of the asset allocation fund and the allocation of investments among the fund's asset classes, including those to be allocated to private equity investments. Individual plan participants would make only the investment decision with respect to investing in the asset allocation fund and would not make any individually directed investment into a private equity fund. The DOL Letter, therefore, creates opportunities for financial institutions to create specific, appropriate asset allocation funds for defined contribution plans that include private equity investments as a component.

Depending upon how asset allocation funds are marketed (*e.g.*, broadly to all investors or targeted to defined contribution plans), they are likely to treated as "plan assets" under ERISA to the extent that ERISA plans make up more than 25% of the invested capital. As such, asset allocation funds will likely need to be managed as ERISA funds, with appropriate procedures for satisfying ERISA fiduciary, plan asset, and prohibited transaction rules.

Considerations for Private Equity Fund Sponsors

In order to gain access to defined contribution capital consistent with the DOL Letter, private equity sponsors will need to make their underlying private equity funds available through intermediate asset allocation funds. As noted above, such intermediate vehicles will need to offset their aggregate private equity exposure with appropriate levels of liquid, non-private equity assets.

- Private equity fund sponsors will likely collaborate with other managers to facilitate such vehicles, *e.g.*, independently managed asset allocation funds configured to include the sponsor's underlying funds, private-label managed products, joint venture structures, or other arrangements.

- Alternatively, private equity sponsors could organize their own asset allocation funds in order to engage directly with defined contribution plans and their fiduciaries. As noted above, as a practical matter, unless defined contribution plans represent less than 25% of the aggregate commitments to an asset allocation fund, the assets of the fund will be "plan assets," and the manager of the asset allocation fund will be an ERISA fiduciary and subject to ERISA's fiduciary, plan asset, and prohibited transaction rules.

Whether or not private equity sponsors participate in the construction of a defined contribution plan asset allocation fund, they may wish to consider how their products can be configured to assist investment managers and other plan fiduciaries in making their determination to include their fund in an asset allocation fund. By engaging proactively with investment managers and plan fiduciaries, private equity sponsors could anticipate and respond to plan- and manager-specific concerns, as manifested through asset allocation funds. For example, private equity offering and investor communication materials could be modified to take into account the need for participants to receive adequate information about the fund, as discussed further below.

Private equity sponsors should bear in mind that all or a portion of an asset allocation fund's investment could constitute "plan assets" under ERISA and, therefore, would need to be taken into consideration in determining whether benefit plan investors are "significant" (*i.e.*, represent 25% or more of aggregate third-party-fund commitments to the private equity fund). If benefit plan investment is significant, a private equity fund can avoid "plan asset" status by operating as a "venture capital operating company" (a category where the fund obtains certain "management rights" in respect of a majority of its portfolio investments, which are required to be investments in "operating companies"). Otherwise the sponsor will need to manage the fund as an ERISA plan asset fund, with appropriate procedures for satisfying ERISA fiduciary, plan asset, and prohibited transaction rules.

Considerations for ERISA Fiduciaries

The guidance offered in the DOL Letter creates opportunities for plan fiduciaries (including investment advisors and ERISA plan asset managers) to offer participants an investment option with exposure to private equity investments. This option may be particularly attractive in the current low-interest-rate environment, which may continue for some time. Plan participants may benefit through professional management and the possibility of higher net returns.

In order for plan fiduciaries to meet their fiduciary obligations in selecting plan investments, the DOL Letter suggests that they ask the following questions when evaluating the risks and benefits associated with adding and selecting an asset allocation fund that contains a private equity component:

- Will the asset allocation fund offer plan participants a more diversified investment alternative within an appropriate range of expected returns, net of fees (including management fees, performance compensation, or other fees or costs that would impact the returns received) by comparison to funds that do not include a private equity component?

- How will the asset allocation fund be managed? Will it be overseen by plan fiduciaries (using third-party experts) or will it be managed by investment professionals? Do these managers have the appropriate capabilities, experience, and stability to manage the asset allocation fund effectively given the nature, size, and complexity of the private equity activity?

- Does the asset allocation fund limit the allocation of private equity investments in a way that appropriately addresses any issues related to cost, complexity, disclosures, and liquidity? For example, does the fund have features that enable participants to both take distributions and direct exchanges among the plan's investment lineup? Without mandating a diversification limit for private equity, the DOL Letter states that a fiduciary could consider whether to follow the 15% limitation on illiquid investments applicable to open-end investment companies (*i.e.*, mutual funds and exchange-traded funds).

- Does the asset allocation fund align with the plan's characteristics and meet the needs of plan participants in light of the plan's features and participant profile, such as participant ages, normal retirement age, anticipated employee turnover, and contribution and withdrawal patterns?
- How will participants be furnished with adequate information about the character and risks of the investment alternatives, so that they may make informed decisions regarding their investments in the fund?

These questions should guide ERISA fiduciaries when considering participant investment choices that include private equity and other similar private investment funds.

Some Limitations

While the DOL Letter offers welcome guidance, it does not expressly authorize and does not require ERISA fiduciaries to make private equity investments available as defined contribution plan investments. Further, if plan fiduciaries do make private equity investments available to participants, the private equity investment option cannot be the only asset class; rather it must be part of a multi-asset class offering. Finally, the DOL Letter does not offer a safe harbor to plan fiduciaries. When selecting plan investments, plan fiduciaries still need to meet their ERISA obligations.

Conclusion

The DOL Letter provides meaningful guidance as to how plan fiduciaries may satisfy their ERISA obligations when offering plan participants access to an asset class that had typically been unavailable. The guidance potentially helps to unlock a significant source of investor capital for private equity fund sponsors. It could also open up opportunities for plan investors to further diversify the investment of their retirement assets and participate in an equity class that may have attractive diversification and return benefits to individual investors. The authors expect investment banks and financial advisory firms to be active in designing investment products that comply with the guidance set forth in the DOL Letter. Private equity funds and investment advisors seeking to tap defined contribution retirement plans as a source of investor capital should consider consulting counsel regarding the scope of the DOL Letter and understanding the ERISA obligations imposed on plan fiduciaries when creating and selecting plan investments.

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Endnotes

1 US Department of Labor Information Letter dated June 3, 2020, addressed to Jon W Breyfogle of Groom Law Group, Chartered, *available at* https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020.

2 Source: Investment Company Institute "The US Retirement Market, Fourth Quarter 2019," dated as of March 19, 2020, *available at* https://www.ici.org/research/stats/retirement/ret_19_q4.