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## INSIGHT: DOL's Private Equity Investment Information Letter—What It Means for 401(k) Plans



BY DANIEL L. MORGAN

On June 3, 2020, the Department of Labor (DOL) issued an information letter, which discusses the inclusion of private equity as part of an investment fund held by a 401(k) plan.

The information letter acknowledges that many defined benefit pension plans use private equity investments to diversify investment risk. Defined benefit plans are retirement plans that provide plan participants with a monthly annuity that does not vary based upon the plan's investment experience. A tax code [Section 401\(k\)](#) plan participant's benefit, on the other hand, is very much influenced by investment return; it is this characteristic that prompted the DOL's guidance in the information letter.

### **Target Date and Balanced Funds**

The information letter discusses adding a private equity investment to a managed asset allocation fund, which includes target date funds and balanced funds. The letter does not address allowing 401(k) plan participants to invest their plan accounts directly in private equity investments, which the letter notes "present distinct legal and operational issues."

The letter suggests that having a private equity investment in a managed asset allocation fund might have the advantage of diversifying the fund's investment risk by providing a vehicle that would respond differently in a market downturn than investments traded in the public securities markets. The letter also references the trend favoring businesses remaining private for prolonged periods and therefore out of reach of Main Street investors, but potentially accessible via private equity funds.

### **The Legal Landscape—ERISA**

The Employee Retirement Income Security Act of 1974 (ERISA) requires a party with decision-making authority over a 401(k) plan's investments to, among other things, exercise that authority "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA Section 404(a)(1)(B). This is often referred to as the "prudence standard." The party with the decision-making authority who must satisfy this standard is referred to by ERISA as a "fiduciary."

### **A Roadmap for Including Private Equity in 401(k) Plan Managed Asset Allocation Funds**

The information letter outlines the steps and considerations that a 401(k) plan's investment fiduciary must take in order to satisfy the prudence standard. The DOL reminds fiduciaries that:

"In evaluating a particular investment alternative for consideration as a designated investment alternative, the fiduciary must engage in an objective, thorough, and analytical process that considers all relevant facts and circumstances and then act accordingly."

To that end, the letter lists specific risks applicable to private equity that must be carefully considered, including complex structures, illiquidity, difficulty of valuation, and typically higher fees. Private equity investments are also regulated in a very different manner than public market securities.

The DOL advises the fiduciary to consider:

“(i) whether adding the particular asset allocation fund with a private equity component 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 (including management fees, performance compensation, or other fees or costs that would impact the returns received) and diversification of risks over a multi-year period;

(ii) whether the asset allocation fund is overseen by plan fiduciaries (using third-party investment experts as necessary) or managed by investment professionals that have the capabilities, experience, and stability to manage an asset allocation fund that includes private equity investments effectively given the nature, size, and complexity of the private equity activity; and

(iii) whether the asset allocation fund has limited the allocation of investments to private equity in a way that is designed to address the unique characteristics associated with such an investment, including cost, complexity, disclosures, and liquidity, and has adopted features related to liquidity and valuation designed to permit the asset allocation fund to provide liquidity for participants to take benefits and direct exchanges among the plan’s investment line-up consistent with the plan’s terms.”

The DOL further cautions that, in evaluating the appropriateness of having a private equity investment component, a 401(k) plan fiduciary should look at the

plan’s “participant profile,” which encompasses such things as the participants’ ages, anticipated employee turnover, and contribution and withdrawal patterns. The fiduciary will also need to assess how the illiquid nature of a private equity investment will interact with plan features such as participant loans and the ability of participants to change investments.

The DOL suggests that it might be advisable for a fund’s private equity component to be limited to a specified percentage of the fund.

## **Conclusion**

By recognizing private equity as a potential alternative to publicly traded securities, the information letter will be viewed by many as a welcome development. To comply with the duties imposed by ERISA, however, a 401(k) plan fiduciary who desires to make private equity part of a managed asset allocation fund will need to exercise careful due diligence before doing so and will also need to maintain ongoing oversight of that investment decision.

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