Memorandum

Department of Labor Provides Guidance on Private Equity Investments in Individual Account Plans

June 4, 2020

On June 3, 2020, the Department of Labor ("**DOL**") issued a letter ("**Information Letter**") clarifying that fiduciaries of individual account plans (such as 401(k) plans) could include, as an investment option, a managed asset allocation fund (e.g., a target date fund, target risk fund, or balanced fund) (a "**Managed Asset Allocation Fund**") that includes a private equity component. This is a significant first step toward giving 401(k) plan participants access to potentially higher return investment opportunities not typically available in these plans.

To date, most plan fiduciaries have not offered private equity as an investment option in the available investments offered to participants in individual account plans because of uncertainty regarding fiduciary responsibilities and liability under the Employee Retirement Income Security Act ("**ERISA**") given the perceived illiquidity, risk of loss, fee structures, and lack of publicly available information regarding these types investments. To reduce this uncertainty for plan fiduciaries, the DOL confirmed that ERISA does not intrinsically prohibit plan fiduciaries from including an allocation to private equity as a part of a larger Managed Asset Allocation Fund and provides a framework for plan fiduciaries to consider when evaluating the prudence of such investments. The Information Letter does not address the possibility of offering 401(k) participants the ability to directly invest in private equity investments (e.g., a private equity fund or private equity fund-of-funds), but does create a potential roadmap for greater access for these participants.

The Information Letter specifically describes different ways that a Managed Asset Allocation Fund with a private equity component could be structured. For example, a Managed Asset Allocation Fund that is designed as a target date fund could be structured as a separate account with an allocation to private equity funds where either the plan's investment committee or an outside investment manager is responsible for selecting the various private equity investments to be included in the target date fund. Or, in other cases, the private equity component of a Managed Asset Allocation Fund could simply be an investment by the Managed Asset Allocation Fund in a private equity fund-of-funds.

In order to determine whether these types of investment options are prudent, the Information Letter describes some of the factors a plan fiduciary would likely need to consider in determining to offer such an investment option in a Managed Asset Allocation Fund, including:

- ***Expenses***. A plan fiduciary should consider whether the inclusion of a private equity component of an Managed Asset Allocation Fund provides appropriate diversification in light of the range of expected returns net of fees (including, but not limited to, management fees and performance compensation) over a multi-year period. There has been significant litigation relating to 401(k) plan expenses, and as a result, plan fiduciaries should demonstrate procedural prudence by documenting this analysis. Significantly higher return profiles in the private equity class could justify the increased fees.
- ***Diversification***. A plan fiduciary would need to consider its specific plan population, and whether adding private equity diversification to the investment option makes sense in connection with the plan population. Specifically, a plan fiduciary would likely want to take into account the age of its participants, employee turnover rate, and contribution and withdrawal patterns. Private equity's longer return horizons may be more appropriate for some participant populations than others, which makes target date funds a particularly attractive candidate to test the waters.
- ***Liquidity***. Participants in a 401(k) plan can change investment options and/or withdraw from the plan upon the occurrence of certain events. Therefore, a plan fiduciary would need to consider the illiquid nature of private equity investments and issues that illiquidity could cause with respect to a Managed Asset Allocation Fund. The DOL provides that a fiduciary may limit private equity investments in an investment alternative to a specified percentage to ensure that a Managed Asset Allocation Fund can divest other assets to satisfy redemptions or fund capital contributions to a private equity fund. The DOL suggested that a fiduciary may consider whether to follow the Securities and Exchange Commission rule that limits illiquid investments to 15% of a registered open end fund.
- ***Valuation***. Because of the illiquid nature of private equity investments, valuation issues can arise, which are more acute in 401(k) plans (versus a traditional pension plan) because of the regular contributions and withdrawals. The DOL notes that the plan fiduciary could require that the private equity components that are included in the Managed Asset Allocation Fund are independently valued according to agreed-upon valuation procedures that satisfy the Financial Accounting Standards Board Accounting Standard Codification (ASC) 820, "Fair Value Measurements and Disclosures."
- ***Sophistication of Fiduciary***. The plan fiduciary would need to be sufficiently sophisticated with the prerequisite skills, knowledge, and experience to select, evaluate, and monitor Managed Asset Allocation Funds with private equity components. Alternatively, the plan fiduciary could delegate such responsibility to a sophisticated ERISA investment manager that acts as a fiduciary in selecting investments.
- ***Adequacy of Participant Disclosure***. Private equity investments are often complex and have a certain level of inherent risk. The plan fiduciary must provide robust disclosure to plan participants such that they can understand the character and risks of private equity investments. This is particularly important if the plan fiduciary is claiming limited liability under ERISA section 404(c) for participants exercising control over their accounts and/or deciding whether an investment option is prudent to use as a qualified default investment alternative.

The DOL recognizes that some plan fiduciaries may want to provide individual account plan participants access to the private equity investments to allow these participants to diversify investment risk and achieve greater returns, as has been done in the traditional defined benefit pension plan space. As a result, the Information Letter gives a helpful analytical framework for plan fiduciaries in considering investments with a private equity component.

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