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A New Framework for Consideration of Private Equity in Defined Contribution Plans

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Alternative investments such as private equity can commonly be found in the investment portfolios of

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defined benefit plans. However, despite their potential strengths, there has not been wide adoption of private equity strategies in defined contribution (DC) plans to date. To support the consideration of private equity by fiduciaries of DC plans subject to the Employee Retirement Income Security Act of 1974¹ (ERISA), the Department of Labor (DOL) issued an information letter² on June 3, 2020, to Groom Law Group on behalf of two private equity managers (the "Information Letter"). The Information Letter provides a framework for a prudent process for fiduciaries who believe a private equity allocation to a diversified plan investment option, including a target date fund, may be appropriate.

In this article, we first explain the general ERISA fiduciary principles attendant to the selection of DC plan investment options. We then identify the source of interest in private equity investments as well as the litigation challenges that have prevented wide adoption within DC plans. Finally, we describe the guidance the Information Letter provides, including the considerations the DOL identified as important in analyzing whether to incorporate a private equity allocation within a diversified investment option.

FIDUCIARY DUTY OF PRUDENCE

ERISA imposes on fiduciaries duties of prudence, loyalty, prudent diversification, and a responsibility to follow the terms of the documents governing the plan.³ ERISA's duty of prudence requires that a fiduciary "discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like

¹ Pub. L. No. 93-406.

² DOL Info Ltr. to Jon Breyfogle (June 3, 2020), available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

³ ERISA §404(a).

character and with like aims.”⁴ With respect to the duty of prudence, courts and the DOL often focus on the requirement to engage in a prudent process prior to making a decision.⁵

The DOL issued a regulation in 1979 describing a fiduciary’s duty to engage in a prudent process in the investment context, which states that a fiduciary will satisfy its duty if it “(A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or course of action involved . . . and (B) has acted accordingly.”⁶ Applying modern portfolio theory, the regulation provides that a fiduciary should consider the role each investment plays in the context of the plan’s portfolio as a whole with respect to risk, return, diversification, and liquidity, and should take into account the unique factors of each plan.⁷

404(c) AND DEFAULT INVESTMENT SAFE HARBORS

Section 404(c) of ERISA provides a safe harbor from fiduciary liability for any losses to a plan resulting from a participant or beneficiary’s exercise of control over the assets in his or her individual account, provided certain conditions are met. The DOL regulation under §404(c) of ERISA contains detailed requirements plans must meet to obtain relief under that section.⁸ Among other things, plan participants and beneficiaries must be given sufficient information to make informed investment decisions, including information required under the DOL’s participant-level disclosure regulation.⁹ Additionally, plan participants and beneficiaries must be permitted to give investments instructions with a frequency that is appropriate in light of market volatility.¹⁰ Due to the potential liability protection, many ERISA-covered DC plans are designed to take advantage of the §404(c) safe harbor under ERISA.

Section 404(c)(5) of ERISA extends §404(c) safe harbor protection to fiduciaries who invest the account balances of participants and beneficiaries who have not provided investment instructions in qualified de-

fault investment alternatives (QDIA).¹¹ QDIAs include target date and target risk funds, balanced funds, and managed account services.¹² In addition to other conditions, participants and beneficiaries must be provided notice that their account will be invested in a QDIA if they do not provide investment instructions and information concerning the specific QDIA used by the plan.¹³

THE PRIVATE EQUITY ASSET CLASS

Private equity is a form of investment in privately-held companies. As part of the strategy, private equity managers attempt to use their skills to identify opportunities and improve the portfolio companies in which they invest. After the private equity managers have initiated desired changes in the portfolio companies, the investments are typically sold. Because of the time required to identify opportunities and initiate changes in portfolio companies, private equity is typically a long-term investment. In this respect, a private equity fund often has an eight to 10-year lifespan.¹⁴ In addition to pooled private equity funds, private equity investments may take other forms, including fund-of-funds designed to invest in other private equity funds and direct purchases by investors in the equity of portfolio companies.

Proponents of private equity point to two related strengths of the asset class. First, there is evidence that private equity may outperform public equity investments.¹⁵ Second, proponents believe that private equity may provide diversification benefits by providing access to investment in privately-held companies that experience their growth stages before their initial public offering, or that remain privately held perpetually.¹⁶ This access may be important because the number of public companies have declined over the past 20 years, and some believe the public markets may not provide as wide an array of investment opportunities as they once did.¹⁷

¹¹ See 29 C.F.R. §2550.404c-5.

¹² 29 C.F.R. §2550.404c-5(e).

¹³ 29 C.F.R. §2550.404c-5(d).

¹⁴ Edmund Lee, *401(k) Plans Move a Step Closer to Pooling with Private Equity*, N.Y. Times (June 3, 2020), available at <https://www.nytimes.com/2020/06/03/business/retirement/private-equity-regular-investors.html>.

¹⁵ DOL Info Ltr. to Jon Breyfogle (June 3, 2020) (citing *The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Outcomes*, Georgetown University Center for Retirement Initiatives, Policy Report 18-01 (June 2018)).

¹⁶ DOL Info Ltr. to Jon Breyfogle (June 3, 2020).

¹⁷ DOL Info Ltr. to Jon Breyfogle (June 3, 2020) (citing U.S. Department of Treasury, Capital Markets, A Financial System that Creates Opportunities (Oct. 2017), p. 21, available

⁴ ERISA §404(a)(1)(B).

⁵ *Pfeil v. State St. Bank and Tr. Co.*, 806 F.3d 377, 381 (6th Cir. 2015); DOL Info Ltr. to Eugene A. Ludwig (Mar. 21, 1996).

⁶ 29 C.F.R. §2550.404a-1(b)(1)(i)–§2550.404a-1(b)(1)(ii).

⁷ 29 C.F.R. §2550.404a-1(b)(2).

⁸ See 29 C.F.R. §2550.404c-1.

⁹ 29 C.F.R. §2550.404c-1(b)(2)(i)(B).

¹⁰ 29 C.F.R. §2550.404c-1(b)(2)(ii)

Private equity is well established among institutional investors, with more than \$4 trillion under private equity management.¹⁸ Accordingly, defined benefit plans commonly invest in private equity.¹⁹ Defined benefit plans often invest in private equity as part of a larger portfolio of other alternative assets.²⁰

Despite the potential benefits of private equity, the asset class has not seen wide adoption in DC plans. As noted in the Information Letter, one of the potential concerns preventing wide adoption is a concern that fiduciaries may be subject to litigation and resulting liability even where they believe it would be in the best interest of plan participants and beneficiaries incorporate private equity investments.²¹

The DOL's Guidance

Since the passage of ERISA, the DOL has provided guidance on the application of a fiduciary's duty of prudence in connection with a variety of investments and investment strategies, including derivatives, liability-driven investments, and annuities.²² In 2011, the Advisory Council on Employee Welfare and Pension Benefit Plans issued a report concerning ERISA plan investment in hedge funds and private equity funds. The report included a tip sheet on issues fiduciaries might consider when making investments in such funds, and one career DOL official testified to the council that the same prudence rules apply to private equity as with any other investment.²³ However, the council's tip sheet is not considered guidance issued by the DOL. Moreover, while the report included considerations for DC plans, its overall focus was on investments made within defined benefit plans. Therefore, calls were made for the DOL to issue guidance specific to DC plans.

[atwww.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf](http://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf))).

¹⁸ 2020 Prequin Global Private Equity & Venture Capital Report, 10, available at <https://docs.prequin.com/samples/2020-Prequin-Global-Private-Equity-Venture-Capital-Report-Sample-Pages.pdf>.

¹⁹ DOL Info Ltr. to Jon Breyfogle (June 3, 2020) (citing Center for Retirement Research at Boston College, Public Plans Database (2018), available at <https://publicplansdata.org/quick-facts/national>).

²⁰ Arleen Jacobius, *Private equity, real assets make gains with funds wanting safety*, Pension & Investments (Feb. 4, 2019), available at <https://www.pionline.com/article/20190204/PRINT/190209966/private-equity-real-assets-make-gains-with-funds-wanting-safety>.

²¹ DOL Info Ltr. to Jon Breyfogle (June 3, 2020).

²² DOL Info Ltr. to Eugene A. Ludwig (Mar. 21, 1996); DOL Advisory Opinion 2006-08 (Oct. 3, 2006); DOL Info Ltr. to Christopher Spence (Dec. 22, 2016).

²³ Testimony of Louis Campagna, Chief of the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, EBSA, before the 2011 Advisory Council on Employee Welfare and Pension Benefit Plans at 27 (Nov. 2011).

In response, the DOL issued the Information Letter, which contains clear statements confirming that a fiduciary “may offer” a private equity allocation as part of a diversified fund, provided a prudent process is used leading to the decision, and that there may be “many reasons” to do so. These statements were likely included to address fiduciaries’ concerns that they may be subject to liability even if they apply a prudent process, as noted above. However, the Information Letter does not require fiduciaries to offer or consider private equity investments.

The Information Letter does not analyze a stand-alone private equity fund offered as an investment option to DC plan participants that would, in theory, permit participants to allocate up to 100% of their account balance to private equity investments. The Information Letter states that such a fund would raise distinct legal and operational questions, but it does not state such a fund would be prohibited by ERISA *per se*. Instead, the Information Letter addresses the inclusion of a private equity component within a diversified investment option such as a target date fund, target risk fund, or balanced fund. The Information Letter describes that such a fund might be custom designed for a specific plan and composed of allocations to various separately managed accounts. Alternatively, the fund might be a pre-packaged pooled investment vehicle with allocations to various asset classes, including private equity. The identification of both custom, or white-label funds, and pre-packaged funds appears to be included to accommodate a variety of potential structures, to include products that may be appropriate for different types of DC plans. The statements also confirm that the DOL believes that a private equity allocation may be included within an investment option that is intended to serve as the plan's QDIA.

Additionally, the Information Letter does not address whether private equity investments may raise issues under the prohibited transaction rules of §406 of ERISA. Specific prohibited transaction issues would need to be reviewed by ERISA counsel, but key aspects underlying the analysis may include the manner in which the private equity investments are structured and the potential for conflicts of interest.

Having confirmed that private equity may be prudently offered within a diversified plan investment option, the Information Letter sets forth a prudent process framework that a fiduciary could follow when deciding whether to make private equity investments available. The framework consists of a number of considerations the DOL believes are important, described below.

Expected Returns and Diversification

The Information Letter states the fiduciaries considering private equity should consider whether a diver-

sified investment option with a private equity allocation would offer participants the opportunity to allocate their individual accounts to investments with appropriate returns, net of fees, and with appropriate diversification of risks over a long-term period. This analysis appears to draw from the DOL's prudence regulation, which provides that investments should not be viewed in isolation but instead in the context of a plan portfolio as a whole.²⁴ Thus, the Information Letter instructs fiduciaries to consider the role a private equity allocation would play within a diversified investment option as a whole. Additionally, while the Information Letter states that fiduciaries considering private equity should understand the fees private equity investments will bear, including management fees, performance compensation, or other fees or costs, it suggests that the fees should not be viewed in isolation but in the context of the potential for private equity to hedge risk or generate investment returns after deducting fees.

Governance

The Information Letter states that fiduciaries considering private equity should consider whether they have the internal expertise and resources to analyze private equity investments, both in the context of the decision to offer a private equity allocation initially and in terms of ongoing periodic monitoring of the investment. If the fiduciaries do not have such expertise or resources, the Information Letter explains they may seek advice from an investment consultant or delegate investment selection authority to an investment manager. This discussion appears designed to accommodate a variety of different types of plans. In this respect, some plan sponsors may have dedicated staff with the time and experience to analyze private equity investments, while for others an outsourced model with delegation to an investment manager may be more appropriate.

Liquidity and Valuation

Private equity investments are generally considered long term in nature and investors' ability to redeem or sell the investment may be limited during the term of the investment.²⁵ However, the Information Letter explains that fiduciaries considering private equity should ensure that a diversified investment option with a private equity allocation provides sufficient liquidity to permit participants to seek a distribution of their benefits and exchange investment options in a manner consistent with the terms of the plan. The de-

mographics of the plan, including participant ages, normal retirement age, anticipated employee turnover and contribution, and withdrawal patterns, may inform the need for participants to liquidate their investment in the diversified investment option. Therefore, the Information Letter notes that fiduciaries considering private equity should consider these demographics in analyzing whether to make the diversified investment option with a private equity allocation available.

The Information Letter states that the valuation practices of the diversified investment option should also be designed to meet participants' liquidity needs. Additionally, the Information Letter suggests that fiduciaries confirm that private equity investments be valued according to accounting standards, and that private equity funds be subject to an annual audit. The Information Letter also notes that fiduciaries considering private equity should obtain sufficient valuation information to report the value of the private equity investments on the plan's annual Form 5500.

Percentage of Investment Option Allocated to Private Equity

The Information Letter states that fiduciaries must prudently analyze the percentage of the diversified investment option that will be invested in the private equity component, noting that the percentage will affect the costs, liquidity, potential complexity, and disclosures to be made regarding the diversified investment option. In a footnote, the Information Letter references a Securities and Exchange Commission regulation providing for a 15% limitation on registered investment companies' allocation to illiquid investments and suggests fiduciaries may consider adopting this limitation for the diversified investment option.²⁶ However, this reference does not appear intended to provide a safe harbor for fiduciaries who decide to adopt it or prohibit allocations above 15%.

Participant Disclosures

Finally, the Information Letter explains that fiduciaries should ensure that participants will be provided disclosures regarding the character and risks of the diversified investment option to enable them to make an informed assessment regarding making or continuing an investment. The Information Letter states that providing the disclosures is important for fiduciaries to demonstrate their reliance on ERISA

²⁴ 29 C.F.R. §2550.404a-1.

²⁵ DOL Info Ltr. to Jon Breyfogle (June 3, 2020).

²⁶ DOL Info Ltr. to Jon Breyfogle (June 3, 2020) (citing Investment Company Liquidity Risk Management Programs, Release No. 33-10233, IC-32315 (Oct. 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10233.pdf>).

§404(c) and QDIA safe harbors described above. It should also be noted that a separate DOL regulation also requires the administrator of a plan to provide disclosures regarding plan investment options to participants.²⁷

CONCLUSION

The Information Letter includes certain limitations, qualifications, and affirms that fiduciaries would need

to engage in a prudent process centered on the considerations listed above. However, it contains clear statements confirming that private equity may be offered as part of a diversified investment option and acknowledges that there may be a variety of ways to structure such an investment option to flexibly accommodate different types of DC plans. Thus, while the ultimate impact of the Information Letter remains to be seen, there is potential for significant adoption of private equity in DC plans by plan sponsors and for the DC plan market to adapt with a variety of new products and services relating to private equity.

²⁷ See 29 C.F.R. §2550.404a-5.