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Department of Labor Update

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Private Equity in 401(k) Plans

On December 21, 2021, the Department of Labor (Department or DOL) issued its "Supplemental Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives" (Supplemental Statement). The Department issued the Supplemental Statement in order to reinforce and clarify the guidance included in its June 3, 2020 Information Letter (Information Letter) regarding the inclusion in a participant-directed individual account plan (Plan) covered by the Employee Retirement Income Security Act of 1974, as amended (ERISA) of designated investment alternatives in which a portion of the alternative's assets are invested in private equity (PE).

In the Information Letter, the Department stated "that a plan fiduciary would not, in the Department's view, violate the fiduciary's duties under Sections 403 and 404 of ERISA solely by reason of offering a professionally managed asset allocation fund with a PE component as a designated investment alternative subject to important conditions set forth in the letter." In issuing the Supplemental Statement, the Department neither changed this view nor the helpful guidance in the Information Letter regarding how a plan fiduciary should go about meeting its fiduciary duties when selecting a designated investment alternative that includes a PE component. Rather, the Department clarified its own position with regard to such investment alternatives and emphasized several important fiduciary principles discussed in the Information Letter.

In the Supplemental Statement, the Department clarified that in issuing the Information Letter it "did not endorse or recommend" the inclusion of PE in designated investment alternatives or the inclusion of such designated investment alternatives in a Plan's investment fund line up. This is likely no surprise to Plan fiduciaries. The Department historically has not taken a position on what investments an ERISA-covered Plan should or should not make or what investments should or should not be made available to participants. However, it has issued guidance regarding what factors a plan fiduciary should consider when deciding how to invest plan assets, including when the investments under consideration are more complex (for example, investments in derivatives). The Department in the Supplemental Statement reminds us, unsurprisingly, that similar principles apply when considering designated investment alternatives that invest a portion of their assets in PE.

The Department also explained to Plan fiduciaries that, while the Information Letter stated that there could be certain benefits to including PE investments in a Plan's designated investment alternative, Plan fiduciaries also should recognize that

ERISA requires that they review certain aspects of investment alternatives with a PE component. For example, Plan fiduciaries should carefully analyze performance figures related to such investment alternatives because the performance calculations related to the PE component are not standardized or regulated as they are for some other kinds of investments (for example, mutual funds). Additionally, participant disclosures should adequately describe the investment alternative to the participants in light of the fact that they may not have specialized education or experience with PE investments. Finally, the Department recognized that Plan participants' interests in designated investment alternatives should be sufficiently liquid in order to meet participant distribution and investment transfer requests.

Furthermore, the Department restated its position in the Information Letter that, similar to other Plan investment options, Plan fiduciaries who lack the expertise to select and monitor designated investment alternatives with a PE component should hire one or more experts with appropriate expertise to assist the fiduciary in the selection and monitoring of such investment alternatives. A registered investment adviser experienced in PE investing would be one potential example of such an appropriately qualified expert. In addition, such expert or experts should be in a position to advise the Plan fiduciary "whether a particular investment arrangement complies with applicable requirements under securities, banking, or other relevant laws and regulations." The Department recognized that the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) issued a "Risk Alert" after the Information Letter that highlighted compliance issues discovered by the OCIE during examinations of PE and hedge fund managers. The OCIE recognized noncompliance in three areas including (1) conflicts of interest, (2) fees and expenses, and (3) policies and procedures relating to material non-public information. Clearly, by referencing the Risk Alert, DOL expects that Plan fiduciaries with the help of appropriately qualified experts will conduct their due diligence of investment alternatives with an eye to assuring that the managers are in compliance with applicable law including those areas of non-compliance identified by the OCIE.

Finally, the Department clarified in the Supplemental Statement its remarks in the Information Letter regarding Plan fiduciaries who traditionally have worked with defined benefit plans that invest in PE funds. In the Information Letter, the Department noted that such fiduciaries may be in a position to evaluate the PE component of a designated investment alternative in a defined contribution plan due to their prior experience with the pension plan, particularly with the help of appropriately qualified experts. However, the Department noted that "…plan-level fiduciaries of small, individual account plans are not likely suited to evaluate the use of PE investments in designated investment alternatives in individual account plans." The Department also reminded Plan fiduciaries that the protections of the investment safe harbor under Section 404(c) of ERISA do not apply to Plan fiduciaries that make imprudent investment selections.

As discussed, while the Department clarified and emphasized some of the fiduciary principles it discussed in the Information Letter, the Supplemental Statement did not change these fundamental principles. Indeed, the Information Letter provides valuable guidance to Plan fiduciaries responsible for selecting and monitoring designated investment alternatives, including those with a PE component. As a threshold matter, the responsible Plan fiduciary must have the expertise to evaluate all aspects of the investment alternative including the PE component. Additionally, to the extent the Plan fiduciary does not have such expertise, he or she should engage appropriately qualified experts to help the fiduciary perform the evaluation. The Department emphasized this point in the Supplemental Statement.

In performing the evaluation, the DOL states in the Information Letter that the responsible plan fiduciary must evaluate the risks and benefits of the

investment alternative. This includes (1) considering whether the investment alternative provides greater diversification within an appropriate range of expected returns net of fees, (2) whether the investment fund is overseen or managed by investment professionals that understand PE investments and how they can be incorporated into an investment alternative's asset allocation strategy, and (3) whether the investment alternative's allocation to PE is sufficiently limited so as "…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 reiterates and emphasizes these points in the Supplemental Statement.

With regard to valuation and liquidity, the DOL particularly focused on the requirement that Plan fiduciaries consider limits on PE investment allocations, independent valuation of PE investments in accordance with Financial Accounting Standards Board Accounting Standards Codification (ASC) 820, and any necessary additional disclosures required to meet ERISA's market value reporting requirements. The Department also stated that the responsible plan fiduciary should consider whether the investment alternatives with PE components are appropriate in light of Plan participant demographics and needs.

Finally, in the Information Letter, the Department emphasized the need to provide adequate information to participants "regarding the character and risks of the investment alternative to enable them to make an informed assessment regarding making or continuing an investment in the fund." This is particularly the case when the Plan fiduciaries intend to rely on the safe harbor under Section 404(c) of ERISA, which provides plan fiduciaries will not be held liable for losses incurred by participants resulting from participant investment decisions so long as the requirements under Section 404(c) and DOL regulations promulgated thereunder are met. One such requirement is that the Plan fiduciary provide or make available to the participant "sufficient information to make informed investment decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments." The Department also reminded Plan fiduciaries that Section 404(c) does not provide a defense against a Plan fiduciary's imprudent selection and monitoring of designated investment alternatives made available under the Plan, just as the Department reminded Plan fiduciaries in its Supplemental Statement.

In conclusion, the Supplemental Statement issued by the Department does not change its position as originally expressed in the Information Letter. ERISA allows a Plan fiduciary to include in a participant-directed defined contribution plan one or more designated investment alternatives that include a PE investment component. Further, the Department in the Information Letter provides a road that Plan fiduciaries can follow in determining how to make the decision to make such investment alternatives available under a Plan. In the Supplemental Statement, the Department simply emphasizes or clarifies many of the points it made in its Information Letter. However, the Department has not blocked that proverbial road.

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