

Department of Labor Guidance on Private Equity Adds Flexibility for Defined Contribution Plans

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On June 3, 2020, the Department of Labor (“Department”) issued an [Information Letter](#) that, for the first time, provides the Department’s views on the use of private equity investments within 401(k) and other defined contribution (“DC”) plans. The Information Letter was issued to Groom Law Group on behalf of two of its clients and makes clear that 401(k) fiduciaries can prudently include private equity as a component of an ERISA plan’s diversified investment option, such as a target date fund. The letter provides a framework of important factors for plan fiduciaries to consider to demonstrate the prudence of such investments.

The Information Letter acknowledges that while private equity has been available to defined benefit pension plans and other large institutional investors for decades, most plan fiduciaries have refrained from offering private equity within DC plans largely due to concerns about liability under the ERISA. To address this, the Information Letter first confirms that ERISA does not prohibit plan fiduciaries from making available an allocation to private equity as part of a DC plan investment option. The Department notes that the plan investment option might be a custom target date fund, target risk fund, or a balanced fund that would provide participants with exposure to a range of asset classes. Additionally, the Department acknowledges this type of fund could be structured in multiple ways, including as a separately managed account managed by a plan investment committee or managed by an investment manager exercising delegated investment responsibility, or as a pre-packaged fund-of-funds structured as a collective investment trust or other pooled vehicle. The Department clarified, however, that the guidance does not address vehicles that would allow a participant to investment in private equity directly, and that such investments present distinct legal and operations issues.

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Accordingly, the Information Letter states that a plan fiduciary “may offer an asset allocation fund with a private equity component . . . in a manner consistent with the requirements of Title I of ERISA.” It then provides an analytical framework fiduciaries can use when considering a fund that includes private equity investments. The Department identified the following considerations as important:

- The impact of the private equity allocation on the plan investment option in terms of diversification and expected return net of fees, including management and performance fees, on a long term basis;
- Whether the plan fiduciaries overseeing the asset allocation fund have the requisite skills to evaluate and monitor private equity investments or should use an investment consultant or delegate investment selection authority to an investment manager;
- The percentage of the investment option to be invested in the private equity component. In this respect, the Department noted that the Securities Exchange Commission had adopted a regulation that sets forth a 15% limitation on investment in illiquid assets for registered open-end investment companies;
- Whether the investment option will include features regarding liquidity and valuation that allow participants to take benefit distributions and exchange into other plan investment options in a manner consistent with plan terms. In this respect, the Department noted that Pantheon Ventures (US) L.P. (Pantheon) and Partners Group (USA), Inc. have developed private equity investment products containing a liquidity component to manage participant directed deposits and withdrawals. The Department also suggested that fiduciaries confirm that private equity investments will be valued according to accounting standards and that private equity fund investments be subject to an annual audit.
- Whether the long-term nature of private equity investments and any potential liquidity restrictions align with the plan participant population, in terms of how participant age, employee turnover, contribution and withdrawal patterns may affect the ability of participants to take distributions or change investment options with the frequency they would desire; and
- The adequacy of disclosures to be provided to participants regarding the character and risks of the plan investment option that includes a private equity component, so as to allow participants to make an informed assessment as to whether to invest in the investment option.

Finally, the Department clarifies that the Information Letter did not address whether the structure, investments, or fees involved in a private equity component could raise issues under the prohibited transaction rules of ERISA. With the foregoing in mind, the Department acknowledges that “[t]here may be many reasons why a fiduciary may properly select an asset allocation fund with a private equity component as a designated investment alternative for a participant directed individual account plan.”

The Information Letter does not require that DC plan fiduciaries use private equity in their plans, but it does provide a framework for a prudent process if they choose to explore it as a component of a larger diversified, managed fund. While the guidance is novel, the Department has taken similar action in the past, issuing guidance that has established guideposts for new types of investments such as derivatives, liability-driven investment strategies and annuities.