



DOL Offers Guidance to Fiduciaries Considering Private Equity Investments in Defined Contribution Plans

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One of the key tasks for fiduciaries of a participant-directed individual account plan is selecting appropriate investment options. Reminding readers that “plan fiduciaries have duties to prudently select and monitor any designated investment alternative under the plan, and liability for losses resulting from a failure to satisfy those duties,” the DOL’s June 3, 2020 Information Letter (the “Information Letter”) confirmed that ERISA does not prohibit plan fiduciaries from selecting investment vehicles that include private equity as a component.

While the guidance does not establish any new fiduciary rules or exemptions, it is nonetheless quite helpful in providing factors to be considered by fiduciaries in determining whether investment vehicles with private equity components belong in their plan investment menu. The Information Letter considers facts relevant to private equity investments, but the guidance can be applied more broadly to consideration of any alternative investment vehicle with similar characteristics. As explained in more detail below, the DOL’s road map for fiduciary review and selection of investment vehicles suggests a helpful standard for fiduciary action in selecting plan investment options that plan fiduciaries contemplating alternative investments would be wise to consider.

While the guidance may be more broadly applied, the DOL specifically excluded consideration of standalone private equity as an investment alternative. Rather, the advice and suggested analysis applies to evaluating multi-asset class vehicles such as target date, target risk, or balanced funds that include private equity as one of the asset classes in their investment portfolios. The fiduciary’s task is, therefore, not only to look at a potential vehicle’s overall strengths and weaknesses, but also to inquire about and evaluate factors related to a fund’s investment in this specific asset class.

Noting that a plan fiduciary must engage in an “objective, thorough, and analytical process that considers all facts and circumstances and then act accordingly,” the Information Letter articulates the following five factors for fiduciaries to consider in evaluating whether to select a designated investment alternative that includes private equity in its asset allocation:

- Evaluation of the risks and benefits;
- Requisite fiduciary expertise to evaluate the investment vehicle;
- Valuation and liquidity;
- Consideration of plan features and participant profile; and
- Plan participant disclosures.

Evaluation of Risks and Benefits

The DOL cautioned that there are important differences between evaluating a private equity investment for a professionally managed defined benefit pension plan and deciding whether to include an asset allocation fund with a private equity component in the investment lineup of a participant-directed individual account plan. The DOL noted that private equity investments tend to be more complex than public market investments, have longer time horizons, and typically have higher fees. Private equity investments tend to have multi-year investment objectives and may limit investors' ability to redeem or sell. Unlike public market investments, private equity investments do not have an easily observable market value, creating challenges for valuation, and they are not subject to the same disclosure requirements, oversight, or controls.

With these things in mind, the DOL indicated that the responsible plan fiduciary "must evaluate the risks and benefits associated with the investment alternative," including:

- 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 and diversification of risk over a multi-year period;
- whether the asset allocation fund is overseen by plan fiduciaries and their investment advisers, or managed by investment management professionals that have the ability to manage the asset allocation fund effectively; and
- 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 of such an investment, including issues of liquidity and valuation.

Plan Fiduciary Expertise

Recognizing that private equity investments are frequently complex, the Information Letter reminds plan fiduciaries that they must obtain sufficient information to understand a potential investment and its attendant risks prior to adding a fund with a private equity component to a plan's investment lineup. If the fiduciaries lack the requisite skills, knowledge, or experience to evaluate the investments, they need to seek out the assistance of a qualified investment advisor or other investment professional.

As with any other designated investment alternative, a prudent fiduciary needs to monitor a selected investment fund with a private equity component to ensure that it continues to be appropriate as an investment option under the plan.

Valuation and Liquidity

Valuation of a private equity interest within an investment option may make it difficult to properly value participants' interest in the investment vehicle, since there is typically no market. Private equity investments also typically have a longer time horizon and often have lockup periods when investors cannot sell their interests. Both of these factors tend to be inconsistent with needs for participant-directed individual account plans where participants are generally able to make investment changes on demand.

To address these factors, the DOL suggests that a plan fiduciary could require that private equity investments not exceed a specified percentage of the vehicle's portfolio (the analogous SEC rule on illiquid investments would impose a 15% cap), ensure that private equity investments be independently valued according to agreed upon valuation procedures that satisfy FASB requirements, or require additional disclosures necessary to satisfy ERISA's reporting obligations with respect to the current value of such investments.

Plan Features and Participant Profile

The responsible plan fiduciary must also determine whether an asset allocation fund with a private equity component is an appropriate fit for the plan. This analysis requires consideration of both the features of the plan and the demographic composition of plan participants, such as their ages, normal retirement age, anticipated employee turnover, and their contribution and withdrawal rates. The objective is to determine whether the characteristics of the investment alternative under consideration align with both the characteristics of the plan and the needs of plan participants.

Adequate Disclosures About Characteristics and Risks

The Information Letter emphasized that a fiduciary "must also determine whether plan participants will be furnished adequate information 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," recognizing that such information may be necessary if a plan is designed to give participants investment control in compliance with ERISA Section 404(c), or if an investment option with a private equity component is to be designated as a qualified default investment alternative (QDIA).

This particular recommendation raises a number of questions. The Information Letter does not explain what type of information a plan fiduciary would need to obtain, or from where. Given that private equity would likely be a small percentage of a vehicle's holdings, the Information Letter does not explain whether more information must be provided about a vehicle's private equity component than is provided about the vehicle's majority investments. Efforts can be made to simplify the risk disclosure, although that approach has the attendant concern of not fully disclosing the nature of the risk. In short, the DOL's acknowledgment that participants will be entitled to information about the nature of an alternative investment offers little specific guidance on how this is to be accomplished, while placing the issue directly on a fiduciary's plate. The plan fiduciary will need to carefully consider the application of the DOL regulations concerning participant-directed plans, such as the regulations under Sections 404a-5, 404c-1, and 404c-5.

Takeaway

The Information Letter gives detailed substantive guidance to fiduciaries of individual account plans that will help them decide whether private equity exposure is appropriate for their plans, either as a designated investment alternative or as a default investment fund. The inquiry and analysis needed to support such an investment has

now been illuminated somewhat by the Information Letter. Although it does not provide a formal safe harbor, the Information Letter sets forth guidelines. Clearly, plan fiduciaries will need to engage in thoughtful consideration of relevant factors. Fiduciaries who select investment vehicles with private equity components for participant-directed individual account plans will need to make many decisions based on relevant facts and circumstances and will want to document consideration of the many factors described in the Information Letter and perhaps work with legal counsel to obtain a legal opinion addressing procedural prudence in the selection of the private equity designated investment alternative.

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