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# Alternative Investments in Participant Directed Individual Account Plans: The Treatment of Private Equity Sleeves

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Investment in private equity funds has long been a concern of practitioners, but generally with respect to the issue of whether it was holding plan assets,[1] or could avoid that status as a venture capital operating company[2] or a fund in which equity participation in the entity by benefit plan investors[3] is not significant.[4] While the plan asset issue continues to be a significant one with respect to investments in private equity funds, recently the focus has been upon offering private equity funds as a component part of an asset allocation fund, an issue that had been addressed both by the Department of Labor (DOL) and a California federal district court on multiple occasions, as discussed below.

## COMPTROLLER OF CURRENCY INFORMATION LETTER

An important background document with respect to investment by defined contribution plans in funds with a private equity component is the 1996 Information Letter[5] provided by the DOL to the Comptroller of Currency[6] with respect to investments in derivatives.[7] The DOL explained that investments in derivatives are subject to the same fiduciary rules as any other plan investments. Therefore, in determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any investment decision. These

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[1] ERISA §3(42); 29 C.F.R. §2510.3-101.

[2] 29 C.F.R. §2510.3-101(d)(1).

[3] 29 C.F.R. §2510.3-101(f)(2).

[4] 29 C.F.R. §2510.3-101(f)(1).

[5] An information letter issued by the DOL is informational only and not binding on the DOL in respect to any particular situation. ERISA Proc. 76-1, §11.

[6] March 21, 1996, Information Letter from Olena Berg to the Honorable Eugene A. Ludwig, Comptroller of the Currency. In its discussion of pecuniary factors in the November 13 2020, preamble to the DOL's final regulations on Financial Factors in Selecting Plan Investments, the DOL referenced the 1996 Information Letter in the context of risks that a prudent fiduciary should take into account. 85 Fed. Reg. 72,846 (Nov. 13, 2020). Those regulations were subsequently replaced by proposed regulations of the Biden Administration. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57,272 (Oct. 14, 2021).

[7] For purposes of the 1996 Information Letter, derivatives were defined as financial instruments whose performance is derived in whole or in part from the performance of an underlying asset, such as a security or index of securities. The DOL listed as examples of derivatives futures, options, options on futures, forward contracts, swaps, structured notes, and collateralized mortgage obligations.


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procedures and analysis would include, among other factors, a consideration of how the investment would fit within the plan's investment policy,[8] what role the particular derivative plays in the plan's investment portfolio, and the plan's potential exposure to losses.

The DOL further indicated that investments in certain derivatives, such as structured notes and collateralized mortgage obligations,[9] may require a higher degree of sophistication and understanding on the part of plan fiduciaries, than other investments. The 1996 Information Letter further states that the plan fiduciaries with ultimate authority for investing in derivatives are responsible for securing sufficient information to understand the investment prior to making the investment. In this regard, if the relevant plan fiduciary is being advised by an ERISA §3(21) fiduciary, it is important that the advisor understand his or her audience in explaining the strategy. A description of the strategy for another analyst will, in most instances, not be an appropriate form of communication to plan fiduciaries familiar with investments in stocks, bonds, and mutual funds.

In the DOL's view, plan fiduciaries have a duty to determine the appropriate methodology used to evaluate market risk and the information which must be collected. It indicated that, where appropriate, this would include stress simulation models to show the projected performance of the investment under various market conditions. If the plan is investing in a pooled fund, which will generally be the case with respect to private equity investments in defined contribution plans, then the plan fiduciary who has selected the pooled fund should obtain information to determine the pooled fund's strategy with respect to the use of derivatives in its portfolio, the extent of the investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.

The relevant plan fiduciary must analyze the operational and legal risks[10] associated with the investment. The relevant plan fiduciary must determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and the potential returns involved in a particular derivative investment. In this regard, the DOL stated in the 1996 Information Letter that "the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size, and complexity of the plan's derivative activity, and whether the plan fiduciary has personnel who are competent to manage these systems. If these investments are made by outside investment managers hired by the plan fiduciary, that fiduciary should consider whether the investment managers have such personnel and controls and whether the plan fiduciary has personnel who are competent to monitor the derivative activities of the investment managers."

## 2020 INFORMATION LETTER ON PRIVATE EQUITY IN DEFINED CONTRIBUTION PLANS

In a June 3, 2020, DOL Information Letter to Jon Breyfogle (2020 Information Letter),[11] the DOL concluded that a plan fiduciary would not violate its fiduciary duties under ERISA §403 and ERISA §404 because it offered a professionally managed asset allocation fund with a private equity component[12] as a designated investment alternative[13] for an ERISA covered individual account plan, in accordance with

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[8] Although generally regarded as a best practice, there is no requirement under ERISA that an investment policy be adopted.

[9] A collateralized mortgage obligation refers to a type of mortgage-backed security that contains a pool of mortgages bound together and sold as one investment. *Cf.* The National Credit Union Administration defines a collateralized mortgage obligation as a multi-class mortgage related security.

[10] The relevant fiduciary will frequently need assistance in reviewing subscription agreements and private placement memoranda in assessing legal risks associated with a private placement memorandum, because these documents often contain boilerplate disclaimers and boilerplate risk factor disclosures, i.e., disclosures that are lengthy, non-specific and standardized, and may be difficult to understand by a non-expert. For a more detailed disclosure of boilerplate language, see Richard A. Cazier, Jeff L. McMullen, and John S. Treu, *Are Lengthy and Boilerplate Risk Factors Inadequate: Judicial and Regulatory Assessment of Risk Factor Language* (Dec. 2019); and Jeremy McClane, *Boilerplate and the Impact of Disclosure in Securities Dealmaking*, 72 Vand. L. Rev. 191 (2019). *Cf. Allianz Global Investors U.S., LLC Alpha Securities Litig.*, No. 20 Civ. 5615 (KPF), 2021 BL 373037, n. 30 (S.D.N.Y. Sept. 30, 2021).

[11] The 2020 Information Letter was issued to Mr. Breyfogle as the representative of Pantheon Ventures (U.S.), LP and Partners Group (USA), Inc.

[12] The 2020 Information Letter does not address any fiduciary or other ERISA issues that would be involved in a defined contribution plan allowing individual participants to invest their accounts directly in private equity investments. The 2020 Information Letter also does not address any potential prohibited transaction issues under ERISA §406 or the application of any statutory or administrative prohibited transaction exemption that might be required in connection with the private equity investment, or any issues that might arise under federal securities or banking law, the Internal Revenue Code, or any other applicable federal or state law.

[13] 29 C.F.R. §2550.404(a)-5(h)(4) defines a designated investment alternative as any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. That regulation further provides that the term "designated investment alternative" does not include "brokerage windows," "self-directed brokerage accounts" or similar plan arrangements that enable participants and beneficiaries to select investments be-


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the terms of the letter, discussed below. It cautioned however, that private equity investments in defined contribution plans present additional considerations than private equity investments in defined benefit plans. The 2020 Information Letter provided that the plan fiduciaries making the decision to include an asset allocation fund with a private equity component must engage in ''an objective, thorough, and analytical process that compares the asset allocation fund with appropriate alternate funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component.''

The DOL indicated in the 2020 Information Letter that in evaluating whether to include a particular investment vehicle with an allocation of private equity as a designated investment alternative, a plan fiduciary should consider: (i) 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 with an appropriate range of expected returns and diversification of risk over a multi-year period; (ii) whether the asset allocation fund is overseen by plan fiduciaries (using third-party investment experts as necessary) or managed by investment professionals that have the capabilities, experience, and stability to manage an asset allocation fund that includes private equity investments effectively given the nature, size, and complexity of the private equity activity; and (iii) 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 associated with such an investment and has adopted features related to liquidity and valuation[14] designed to permit the asset allocation fund to provide liquidity for participants to take investments and direct exchanges among the plan's investment line-up.

The DOL also indicated that it would be important for the responsible fiduciary to consider the asset allocation fund with the private equity component in light of the plan's features and participant profile, including factors such as participant ages, normal retirement ages, anticipated employee turnover, and contribution and withdrawal patterns, to determine whether the characteristics of the investment alternative align with the plan's characteristics and needs of plan participants.

Additionally, the DOL stated that the fiduciary must 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 decision regarding making or continuing an investment in the fund. In light of the complexity of many private equity investments, it is not clear as a practical matter how this fiduciary responsibility would be satisfied. However, the DOL indicated that this factor would be especially important for a plan fiduciary seeking to limit liability under ERISA §404(c) or deciding that a particular investment alternative would be appropriate to add as a qualified default investment alternative.

## SUPPLEMENTAL STATEMENT ON PRIVATE EQUITY IN DEFINED CONTRIBUTION PLANS

On December 21, 2021, the DOL issued a Supplemental Statement on private equity in defined contribution plan designated investment alternatives. It began by stating that the letter did not endorse or recommend such investments. While that statement is an accurate one, it is difficult to see how an objective reading of the 2020 Information Letter could be viewed as either a recommendation or an endorsement, and the DOL then underscored all of the statements in the 2020 Information Letter that established that point. The 2020 Information Letter noted that private equity investments are more complicated, with longer time horizons, are typically less liquid, and are subject to different regulatory requirements than traditional defined contribution plan investments. The valuation of private equity investments is more complex, and fees are typically higher. The 2020 Information Letter stated that fiduciaries considering such an investment must engage in an objective, thorough, and analytic process that evaluates anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with private equity investments. The 2020 Information Letter also stated that the plan fiduciaries should compare the fund to funds that did not offer a private equity component. It had stated that the relevant plan fiduciaries were responsible for obtaining sufficient information to make an informed decision. The 2020 Information Letter also identified a series of factors that plan fiduciaries should consider in evaluating whether or not to include an investment vehicle with a private equity component as a designated investment alternative.

The DOL indicated that it was issuing the Supplemental Statement to ensure that plan fiduciaries do not

yond those designated by the plan. 29 C.F.R. §2550.404(c)-1(e)(4) defines the term somewhat differently as ''a specific investment identified by a plan fiduciary as an available investment alternative under the plan.''

[14] With respect to valuation and liquidity, a plan fiduciary could require that private equity investments in the investment alternative not be higher than a specified percentage, such as 15%, and require investments be independently valued according to agreed upon valuation procedures. Financial Accounting Standings Board (FASB), ASC-820, Fair Value Measurement.


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expose plan participants to unwarranted risk by misreading the letter as saying that a private equity fund is generally appropriate for a typical 401(k) plan. The Supplemental Statement then made the unusual comment that recitations of representations in the 2020 Information Letter regarding the claimed benefits of private equity investments reflected the perspective of the private equity interests and were not balanced with counter-arguments and research from other sources. Then, the DOL shared shareholder concerns about the ability of plan sponsors and other plan level fiduciaries in a typical 401(k) plan to satisfy the conditions set forth in the 2020 Information Letter.

In the concluding substantive paragraph of the Supplemental Statement, the DOL indicated that a plan level fiduciary who has experience in evaluating investments in a defined benefit pension plan may be suited to analyze these investments in a participant directed individual account plan, particularly with the assistance of a qualified fiduciary investment advisor. However, the DOL in the Supplemental Statement provides that except in those limited circumstances, ''plan-level fiduciaries of small individual account plans are not likely suited to evaluate the use of private equity investments in designated investment alternatives in individual account plans.'' The DOL did not clearly state why such plan fiduciaries cannot compensate for their lack of expertise by hiring a qualified fiduciary investment advisor or an ERISA §3(38) investment manager. While the Supplemental Statement does not modify any of the legal positions set forth in the 2020 Information Letter, it is likely to have a chilling effect upon a plan sponsor's inclination to include an investment asset with a private equity component in its investment platform.[15]

The Supplemental Statement took into consideration the deficiencies noted by the SEC in its June 23, 2020, Risk Alert[16] concerning compliance issues for registered investment advisors that manage private equity and hedge funds. The DOL clearly considered the implications of the SEC findings as it calibrated and walked back its ''endorsement'' for private equity. However, when all is said and done, the Supplemental Statement, like the 2020 Information Letter, stands for the proposition that there are no specific investment strategies or products that are either disallowed or endorsed under ERISA. Rather, it is the obligation of the plan fiduciary experienced in such matters, with the assistance of advisors where necessary, to make prudent and loyal decisions on behalf of the plan to monitor and evaluate alternative forms of investment.

## THE INTEL CASE — *ANDERSON v. INTEL CORPORATION INVESTMENT POLICY COMMITTEE*

*Anderson v. Intel Corp. Inv. Policy Comm.*[17] involved a substantive challenge to a plan's investment strategy of substantially increasing the percentage of the plan's Global Diversified Fund (GDF) as a risk mitigation strategy. Plaintiffs' class action alleging six causes of action under ERISA: (i) breaches of duty under ERISA §404(a) by the Investment Committee in selecting and monitoring the investments in the Intel plans; (ii) breaches of duty by the Investment Committee in managing the assets of the Intel plans, including the failure to monitor and evaluate the asset allocation in the Intel funds; (iii) breaches of duty by the Administrative Committee for failing to provide material and accurate disclosures to plan participants; (iv) breaches of duty under ERISA §404(a) by the Finance Committee and Chief Financial Officer for failure to monitor the Investment Committee; (v) violations of ERISA §102(a) by the Administrative Committee for issuing summary plan descriptions that failed properly to disclose and explain risks associated with the asset allocation in the Intel funds; and (vi) co-fiduciary liability against all of the defendants. The district court dismissed all of these claims,[18] but permitted plaintiffs to amend their complaint.

With respect to its claim that the duty of prudence had been breached, plaintiffs alleged that the Investment Committee had breached its duty of prudence by adopting an asset allocation model that excessively allocated assets to non-traditional funds, such as private equity and hedge funds, despite the higher fees and risks associated with these investments. The plaintiffs

[15] While the Supplemental Statement was limited to private equity investments, the same legal analysis would also apply to other types of complex investments, such as bitcoin or other cryptocurrency investments.

[16] While the DOL was responding to the SEC Risk Alert, footnote 1 to the 2020 Information Letter indicated that the DOL has also been coordinating its response to the 2020 request for an Advisory Opinion with the Chairman of the SEC, who urged the DOL ''to address uncertainties regarding ERISA that might be impeding plan fiduciaries from considering private equity investment opportunities as a way to enhance retirement savings and investment security for American workers.''

[17] No. 19-CV-04618-LHK, 2021 BL 22172 (N.D. Cal. Jan. 21, 2021). In a similar case, the district court had initially dismissed this case on statute of limitations grounds, but the Court of Appeals for the Ninth Circuit reversed and the Supreme Court affirmed the decision of the Ninth Circuit and remanded the case. *Sulyma v. Intel Corp. Inv. Policy Comm.*, No. 15-cv-04977 NC, 2017 BL 106910 (N.D. Cal. Mar. 31, 2017), *rev'd and rem'd,* 909 F.3d 1069 (9th Cir. 2018), *aff'd,* 140 S. Ct. 768 (2020).

[18] Plaintiff Anderson also alleged a seventh cause of action for himself only, alleging a violation of ERISA §104(b)(4) by the Administrative Committee for improper delay in the provision of certain documents. Defendants denied liability but did not move to dismiss this claim.


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further alleged that the Investment Committee breached its duty of prudence by failing to properly monitor and regularly evaluate the asset allocation to non-traditional investments, and remove any imprudent investments. Plaintiffs did not attempt to support their claim with allegations regarding the knowledge, methods or investigations made by the Investment Committee at the time that the Investment Committee made the challenged investments. Also, while plaintiffs did not challenge any specific private equity or hedge fund investment as imprudent, its position was that the level of an asset class within a plan could give rise to a claim for breach of fiduciary duty. However, plaintiffs were still required to allege specific facts to support a cognizable claim that the Investment Committee's decision to allocate a particular percentage of the Intel plan assets to hedge fund and private equity investments was imprudent at the time that the decision was made. Plaintiffs were unable to make this showing. With respect to the poor performance of the funds and the alleged excessive fees, plaintiffs could not establish meaningful benchmarks. With respect to the allegation that the Investment Committee's allocation models drastically departed from prevailing industry standards, the court held that ERISA does not require that fiduciaries mimic industry standards when making investments.[19] With respect to plaintiffs' allegation that there was contemporary evidence in 2011 of risk associated with non-traditional investments, the court concluded that while there was some evidence available in 2011 when the Investment Committee implemented the strategy that hedge funds and private equity funds carried risk and that a prudent fiduciary could have found that evidence, that small body of evidence was insufficient on its own to support a claim for breach of the duty of prudence by the Investment Committee. With respect to allegations of self-dealing, the district court found that the mere fact that Intel Capital invested in a tiny percentage of the same companies that also received investments from private equity funds that the Intel plans invested in was insufficient to plausibly allege a real conflict of interest. This finding allowed the court to dismiss both the breach of duty of prudence and loyalty against the Investment Committee.

On January 8, 2022, plaintiffs' amended complaint was denied with prejudice on all six counts.[20] Plaintiffs were still unable to establish meaningful benchmarks, and the district court also rejected plaintiffs' new theory that defendants should never have pursued a risk mitigation strategy at all, and that defendants should have been looking for ways to change their risk mitigation strategy to a riskier strategy that could provide more returns for employees. The court stated that ERISA fiduciaries are not required to adopt a riskier strategy simply because that strategy may increase returns. With respect to the breach of the duty of loyalty, the revised complaint only alleged a potential conflict of interest that was insufficient to establish a breach of the duty of loyalty claim.[21]

## *HUGHES v. NORTHWESTERN*

The recent Supreme Court decision in *Hughes v. Northwestern Univ.*[22] was focused upon pleading issues in ERISA breach of fiduciary duty litigation, but its holding that the presence of prudently selected and monitored investment alternatives that are available to plan participants does not eliminate the fiduciary duty to remove imprudent funds from the plan's investment platform could have an effect upon offering private equity investments in some form in defined contribution plans. That is, if the relevant plan fiduciary's obligation extends to every plan offering, then the addition of new investment options to a plan may increase the plan's litigation exposure. One way of avoiding, or at a minimum substantially reducing potential increased exposure for breach of fiduciary duty, would be to establish a self-directed brokerage account, brokerage window, or similar program, and allow plan participants desiring to investment in funds that have a private equity component to do so.[23] Establishing a brokerage window only plan as a means of avoiding fiduciary liability exposure would be an aggressive tactic likely to be challenged by the DOL, but establishing a brokerage window as a feature of a plan's investment strategy may be a permissible means of reducing fiduciary exposure, while providing plan participants with a potentially valuable benefit.

## CONCLUSION

What investments are regarded as permissible for a trust is evolutionary. Historically, investments in equi-

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[19] *Anderson*, 2021 BL 22172 at *14-15.

[20] *Anderson v. Intel Corporation Investment Policy Comm. et al*, No. 19-cv-04618, 2022 BL 6803 (N.D. Cal. Jan. 8, 2022) (court order). As of the date this article was drafted, no decision had been made as to whether an appeal to the Ninth Circuit has been made.

[21] The amended complaint also sought to establish a breach of the duty of loyalty based upon a Minimum Pension Plan, but the discussion of that issue would have no general application to the issue of a fiduciary's decision to include in a plan's investment platform an investment option that included a private equity component.

[22] 142 S. Ct. 737 (2022).

[23] *See* Advisory Council on Employee Welfare and Pension Benefit Plans, Report to the Honorable Martin Walsh, United States Secretary of Labor: Understanding Brokerage Windows in Self-Directed Retirement Plans (Dec. 2021).


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ties were viewed with skepticism, and lengthy legal lists were commonplace at the state level in the 20th century. However, while permissible investments may evolve over time, the standards of fiduciary conduct under ERISA with respect to the decisions to include and or retain such investments has not. While the due diligence required with respect to private equity investments may be somewhat more rigorous than other investments, the same process should be used to evaluate investments in private equity as other investments. Fiduciaries of defined benefit plans who have had experience with alternative investments may be able more readily to evaluate such investments, but prior experience with private equity investments in a defined benefit context cannot be a condition of offering such investments in the defined contribution plan context. As with other investments, if the plan fiduciary with ultimate investment authority lacks the necessary knowledge, the plan fiduciary can hire the relevant investment professional to provide him or her with the necessary guidance.


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