EMPLOYMENT & IMMIGRATION - USA

DOL creates path for 401(k) plans to offer private equity investment options

23 September 2020 | Contributed by McDermott Will & Emery

Introduction

In June 2020 the US Department of Labour (DOL) issued an information letter indicating that, in limited circumstances, it will allow defined contribution retirement plans (eg, 401(k) plans) to indirectly invest in private equity funds. Specifically, the information letter allows plans to offer their participants a professionally managed asset allocation fund with a private equity component as an investment option.

While information letters are not binding, the DOL uses these letters to call attention to well-established principles or interpretations, making them helpful guidance on which retirement plan fiduciaries and their advisers frequently rely.

Background

Defined benefit retirement plans (ie, pension plans), which typically hire investment managers to make investment decisions for their participants as a group, have long invested in private equity funds. However, 401(k) and other defined contribution plans, which allow each participant to choose where to invest their retirement savings from a menu of options, do not commonly offer private equity investment options. Even 401(k) plans with brokerage windows, which allow participants to choose unique investments not offered in the plan's menu of mutual fund investment options, typically do not allow participants to invest in private equity.

Indirect investment structure

The DOL's guidance is subject to several limitations that plan sponsors and firms should consider when evaluating and selecting investment options for 401(k) plans. The information letter does not allow 401(k) plan participants to directly invest in private equity funds on a stand-alone basis. Both of the investments reviewed and approved by the DOL's information letter were offered as collective investment trusts that invest in private equity and have a liquidity component to manage the participant-directed deposits and withdrawals from the fund. The information letter specifically describes investment options as part of a multi-asset class vehicle, structured as a custom target date, target risk or balanced fund. The DOL acknowledged that the purpose of such an investment option would be to provide participants with an opportunity for enhanced diversification of investment risk and greater returns on investments than could be achieved solely in the public market, particularly for participants who have longer investment horizons.

In addition, to limit risk, the asset allocation fund's overall exposure to private equity investments must have a target allocation that does not exceed a specified portion of the fund's assets, with the remainder of the fund's portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values. The DOL did not include a specific limit, but suggested that a fiduciary could consider whether to follow the US Securities and Exchange Commission rule which includes a 15% limitation on illiquid investments applicable to registered open-end investment companies (ie, mutual and exchange-traded funds). In this manner, the fund would be designed to provide sufficient liquidity to participants to take benefit distributions and direct exchanges among the plan's investment line-up in accordance with plan terms and to meet periodic capital calls on private equity investments.

The DOL noted that one typical structure of an asset allocation fund would be a custom target date fund

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structured by a plan investment committee as a separately managed account, with the committee retaining responsibility for management of the account with the assistance of an independent Employee Retirement Income Security Act (ERISA) Section 3(21) fiduciary investment adviser or, alternatively, the plan investment committee could delegate those investment responsibilities to an ERISA Section 3(38) investment manager. The DOL observed that, in some other cases, an asset allocation fund could be in the form of a pre-packaged investment option offered by a financial institution to individual account plans as a 'fund of funds' (structured as, for example, a collective trust fund or other pooled vehicle) that invests in other funds, with one of the underlying funds being a fund that invests primarily in private equity.

ERISA issues to consider

When evaluating investment options that include private equity funds, plan sponsors must consider how they will meet their obligations under ERISA with respect to private equity investments.

Fiduciary obligations

Plan sponsors, plan investment committees and any investment manager that they delegate investment responsibilities to are subject to fiduciary duties under ERISA which they must comply with when selecting investment options. In the information letter, the DOL warned that when selecting an asset allocation fund that includes private equity investments for a 401(k) plan, the fiduciary must engage in an objective, thorough and analytical process that compares the asset allocation fund with appropriate alternative funds that include no private equity. The fiduciary also must periodically review whether the investment vehicle continues to be prudent and in the best interests of plan participants. Fiduciaries must carefully evaluate the risks and fees associated with private equity investments to ensure that they are prudent investments to offer participants. They should also consider whether a private equity investment with a longer time horizon, liquidity restrictions and increased complexity meets the needs of plan participants, taking into account factors such as participants' age, the normal retirement age, anticipated employee turnover and contribution and withdrawal patterns.

Participant disclosures

Plan sponsors must also provide participants with sufficient information to make informed investment decisions with regard to investment options available under the plan, which may be more difficult to do for private equity investments. When compared with typical public market investments available in 401(k) plans, private equity investments tend to involve:

- more complex organisational structures and investment strategies;
- longer time horizons; and
- more complex, and typically higher, fees.

In addition, the valuation of private equity investments is more complex because they often have no easily observed market value, which may make it challenging to determine the value of a participant's account.

Comment

The new guidance creates a significant opportunity for plan sponsors to consider investment options that include private equity funds, but it will be important for both plan sponsors and funds to carefully evaluate potential investments for compliance with ERISA requirements.

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