

Using Private Equity in Defined Contribution Plans

Understanding the U.S. Department of Labor's recent guidance and its impact on retirement plans and participants

Guidance from the U.S. Department of Labor

On June 3, 2020, the U.S. Department of Labor (DOL) issued an information letter providing guidance around the use of private equity investments in defined contribution (DC) plans (e.g., 401(k)) as a component of a more diversified investment option, such as an asset allocation fund, a separately managed account, or a Collective Investment Trust.

Employer-sponsored defined benefit (DB) plans, such as pension plans, have long leveraged these types of investments in portfolios, and the DOL's guidance is focused on addressing use of these investments in DC plans. The letter identifies several factors plan fiduciaries should consider when evaluating the risks and benefits of choosing an investment fund with a private equity investment allocation. These factors are outlined to the right of this document.

Private equity investments present both opportunities and risks, and the plan fiduciary is responsible for understanding those considerations when selecting a fund as a designated investment alternative for a plan. The DOL suggests, as it does for selection of any investment option in an ERISA plan, engaging in an objective, thorough, and analytical process that compares the asset allocation strategy for investing options with and without a private equity investment allocation.

Information letters generally are not binding law, but rather, provide the DOL's "well-established interpretation or principle of" ERISA, without addressing a specific factual situation. It bears noting that the DOL's letter does not address investment vehicles that would allow a participant to invest directly in private equity investments, as these options present distinct legal and operational issues, e.g., valuations, for fiduciaries of ERISA-covered individual account plans. The letter also does not address any prohibited transaction issues arising from private equity investments.

While there was a fair amount of press around it, this information letter did not present new analysis or insight into the DOL's general views on fiduciary plan investment selection or monitoring. Rather, the DOL acknowledged the use of PE as a component of a larger asset allocation investment option.

Factors plan fiduciaries should evaluate and consider:

- **Diversification and return.** How would the private equity allocation impact the plan investment option in terms of diversification and expected return?
- **Skill to evaluate and monitor.** Is the plan fiduciary able to skillfully evaluate and monitor private equity investments? Or should they hire a consultant or delegate authority to an investment manager?
- **Proportion of allocation.** What percentage of the diversified investment option is to be invested in the private equity component? The DOL noted the SEC's 15% limitation on investment in illiquid assets for registered open-end investment companies.
- **Benefit responsiveness and exchange.** Does the diversified investment option include liquidity and valuation features that allow participants to take benefit distributions and exchange into other plan investment options in a manner consistent with plan terms? The DOL suggests fiduciaries confirm that private equity investments will be valued according to accounting standards and be subject to an annual audit.
- **Appropriateness for participant population.** Does the long-term nature of private equity investments and any potential liquidity restrictions align with the plan participant population's age, employee turnover, and contribution and withdrawal patterns?
- **Adequacy of disclosure.** Will participants be able to make an informed decision about investing in the plan investment option that includes a private equity component, based on participant investment disclosures and education provided?

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