Hodgson Russ LLP ATTORNEYS

DEPARTMENT OF LABOR ISSUES GUIDANCE ON INCLUSION OF PRIVATE EQUITY INVESTMENTS IN DEFINED CONTRIBUTION RETIREMENT PLANS

Hodgson Russ Employee Benefits Newsletter
July 20, 2020

In an effort to more broadly diversify their investments and potentially achieve higher rates of return than could be achieved solely through investing in the public markets, defined benefit plans have long made investments in private equity. However, largely due to concerns related to fiduciary liability, sponsors of defined contribution plans have avoided including exposure to private equity investments among a plan's designated investment alternatives ("DIAs"). A recent information letter from the Department of Labor provides guidance to sponsors of defined contribution plans on the inclusion of private equity investments among a plan's DIAs. The information letter provides ERISA's fiduciary requirements are not violated solely due to the inclusion of private equity as a component of a defined contribution plan's DIAs, but that inclusion of private equity implicates special fiduciary considerations.

The information letter does not address including an investment vehicle that allows participants to cause their plan account to be directly invested in private equity. Instead, the information letter concerns the inclusion of private equity investments as a component of a target date fund, target risk fund, or balanced fund. The information letter notes that, compared to public market investments, private equity investments (i) tend to involve more complex organizational structures and investment strategies, longer time horizons, and more complex, and typically, higher fees, (ii) be subject to different regulatory disclosure requirements, oversight, and controls, and (iii) involve more complex valuations due to there being no easily observed market value. Accordingly, in evaluating the risks and benefits associated with including private equity as a component of a DIA, the information letter provides that a fiduciary should consider the following:

- Whether adding a target date fund, target risk fund, balanced fund or other asset allocation fund with a private equity component would offer plan participants the opportunity to invest their accounts among more diversified investment options over a long-term period and within an appropriate range of expected returns net of fees;
- Whether any target date fund, target risk fund, balanced fund or other asset allocation fund is overseen by plan fiduciaries (using third-party investment

Attorneys

Peter Bradley

Michael Flanagan

Richard Kaiser

Ryan Murphy

Amy Walters

Practices & Industries

Employee Benefits

experts as necessary) or managed by investment professionals that have the capabilities, experience, and stability to manage an asset allocation fund that includes complex private equity investments;

- Whether any target date fund, target risk fund, balanced fund or other 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 designed to permit the asset allocation fund to provide liquidity for participants to receive distributions and direct exchanges among the plan's investment line-up consistent with the plan's terms;
- The plan's features and participant profile (e.g., participant ages, normal retirement age, anticipated employee turnover, and contribution and withdrawal patterns) and make a considered decision about whether the characteristics of a target date fund, target risk fund, balanced fund or other asset allocation fund align with the plan's characteristics and needs of plan participants; and
- Providing plan participants with adequate information regarding the character and risks of a target date fund, target risk fund, balanced fund or other asset allocation fund that includes a private equity component to enable them to make an informed assessment regarding making or continuing an investment in the DIA, especially in the context of a plan designed to comply with ERISA 404(c) or in which the DIA serves as a qualified default investment alternative for participants who fail to provide affirmative investment instructions for their plan account.

Regarding the valuation and liquidity factors in the third bullet point, the information letter observes that a plan fiduciary could require that private equity investments within a DIA not exceed a specified percentage. On this point, the Department noted that Securities and Exchange Commission rules applicable to registered open-end investment companies include a 15% limitation on illiquid investments. The information letter further suggests that a plan fiduciary ensure that private equity investments be independently valued and contractually require that additional disclosures be provided to meet ERISA's disclosure obligations concerning the value of a plan's investments.

Importantly, the information letter does not address any prohibited transaction issues that may arise as a result of the inclusion of a private equity component of a DIA. Plan fiduciaries should give careful consideration to any prohibited transaction implications associated with the inclusion of a private equity investment component in a DIA. Further, in light of the ongoing focus and litigation relating to fees being borne by defined contribution plan participants, plan fiduciaries should carefully weigh the potential benefits associated with a private equity investment against the commonly higher fees.