Department of Labor Guidance Opens New Opportunities for Participant-Directed Investment in Private Equity | Fiduciary Focus Series

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In a recent Information Letter (the "Letter"), the Department of Labor (DOL) clarified that defined contribution retirement plan fiduciaries can offer participants and beneficiaries plan investment options that include a private equity component without violating their fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), provided the investment options are selected through a prudent process.

The DOL acknowledged that there may be many reasons why the fiduciary of an individual account-based defined contribution plan might choose to offer an investment option with a private equity component as a part of the plan's investment line-up but noted private equity investments present unique challenges. For example, private equity investments tend to maximize investor returns over a multi-year period during which investors' ability to redeem, sell or obtain a return of capital may be limited.

Whether a particular fund or investment alternative satisfies ERISA's fiduciary requirements is an inherently factual question that the DOL declined to answer. However, the investment options contemplated by the Letter include professionally managed asset allocation funds with exposure to private equity that are designed as custom target date, target risk or balanced funds. Such custom funds would typically be structured by a plan's investment committee as separately managed accounts for which the committee would either retain management responsibility or delegate responsibility to an ERISA section 3(38) investment manager.

In addition, the funds would provide plan participants limited exposure to private equity in the context of a diverse fund with

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investments from a range of asset classes with differing risk/return characteristics and investment horizons. The funds would have a limit on private equity to ensure the overall exposure does not exceed a specified portion of a fund's assets. The remaining allocations would be in publicly traded securities or other liquid investments with readily ascertainable market values to support private equity capital calls at the fund level and investment exchanges and participant withdrawals at the plan level. The DOL acknowledged that such funds could be structured as "pre-packaged investment option[s]" offered by financial institutions as funds of funds (structured as, e.g., collective trust funds or other pooled vehicles), with one of the underlying funds being a fund that invests primarily in private equity.

Notably, the Letter does not address any ERISA fiduciary issues or other concerns presented by direct participant investment in private equity. In fact, the DOL emphasizes such direct investments in private equity involve specific legal and operational issues for fiduciaries of defined contribution plans.

As with all investment products, plan fiduciaries must engage in an objective, thorough and analytical process that considers all relevant facts and circumstances with respect to a fund. Pursuant to that process, the Letter outlines key considerations for fiduciaries to evaluate the risks and benefits associated with asset allocation funds that contain a private equity component. Those considerations include, in relevant part:

- Does the allocation fund offer participants the opportunity to invest in more diversified investment options than is appropriate in light of expected returns net of fees (management fees, performance compensation, etc.) and diversification of risks over a multi-year period?
- Is the allocation fund overseen by plan fiduciaries (using third-party investment experts as necessary), or is the fund managed by investment professionals that have the necessary management skills, given the nature, size and complexity of the private equity activity?

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- Has the allocation fund limited the allocation of investments to private equity in a way that is designed to address its unique characteristics, including cost, complexity, disclosures and liquidity, such as limiting the private equity investments to a stated percentage?
- Do the characteristics of the allocation fund (e.g., fees, liquidity restrictions and investment allocation and strategy) align with the plan's features and characteristics, including participant profiles (e.g., participant ages, normal retirement age, anticipated turnover and contribution and withdrawal patterns), and participants' ability to access funds in their accounts and change their investment choices on a potentially frequent basis?
- How does the fund compare with appropriate alternative funds that do not have a private equity component?

The Letter emphasizes that plan fiduciaries must consider whether they have the required knowledge, skill and experience to monitor the fund or whether a qualified investment advisor or other investment professional should be engaged. The duty to monitor is ongoing, and fiduciaries must periodically confirm that the fund remains a prudent investment and in the best interests of plan participants.

Plan fiduciaries are also responsible for ensuring that participants are furnished with sufficient information about the character and risks of the investment alternative to enable them to make informed decisions. The DOL points out that this is especially important if the fiduciary intends to claim protection under ERISA section 404(c) for participants that exercise control over their individual accounts or if the fund will be offered as a qualified default investment alternative.

Finally, the DOL makes clear that the Letter does not address any potential prohibited transaction concerns under ERISA or the application of any applicable exemptions that may need to be considered in light of the structure, investments or fees related to a private equity investment. Such considerations are complex and should involve experienced ERISA counsel.

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If you have questions about the DOL's guidance or the fiduciary process of prudent fund selection, please contact Sarah Lowe or Kellie Money of Frost Brown Todd's Employee Benefits and ERISA group.

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