DOL Refines Its Position Regarding Private Equity in 401(k) Plans | Fiduciary Focus Series

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On December 21, 2021, the Department of Labor (DOL) issued a Supplemental Statement clarifying earlier guidance it issued under the prior administration in a 2020 Information Letter (the "2020 Letter"), which provided that private equity could be included as a component part of designated investment alternatives in 401(k) and other defined contribution plans. See more in our article, " Department of Labor Guidance Opens New Opportunities for Participant-Directed Investment in Private Equity." The Supplemental Statement narrows the scope of the 2020 Letter in a manner reminiscent of DOL clarifications that have repeatedly been issued by successive administrations regarding ESG and proxy voting. See more in our article, "The Long and Winding Road: The DOL's Proposed Rule on ESG Factors and the Exercise of Shareholder Rights." In other words, the Supplemental Statement shifts the direction of the guidance while ostensibly only clarifying it.

Bottom Line

The door is not closed to plan fiduciaries who are considering adding designated investment alternatives with private equity exposure to their 401(k) or other defined contribution plans, but it is less open than it was before issuance of the Supplemental Statement. Only plan fiduciaries of large 401(k) or other defined contributions plans who also have experience evaluating private equity in a defined benefit context should conclude that they have the necessary expertise to consider such option. Even then, they would be well-advised to use a qualified investment adviser in making such determination. Any decision to offer such a fund should be made through a rigorous and prudent process that should be fully documented.

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Thus, the Supplemental Statement may be a disappointment to those in the private equity industry who viewed the 2020 Letter as potentially expanding sources of capital for private equity funds that become a component of professionally managed asset allocation funds.

Supplemental Statement

The 2020 Letter had concluded that under certain circumstances, fiduciaries of such plans could include designated investment alternatives with a private equity component as a part of their respective plans' investment line-up without violating their fiduciary duties under Title I of the Employee Retirement Income Security Act (ERISA), provided the investment options are selected through a prudent process which, in the case of these investments, specifically considers certain factors set forth in the 2020 Letter. The 2020 Letter contemplated that such designated investment alternatives would be professionally managed asset allocation funds, such as target date funds or balanced funds with limited exposure to private equity and with sufficient liquidity.

As noted in the Supplemental Statement, the DOL viewed clarification as necessary following comments and questions from a range of stakeholders regarding the 2020 Letter and the issuance of a "Risk Alert" by the Securities and Exchange Commission (SEC) highlighting "compliance issues in examinations of registered investment advisors that manage [private equity] or hedge funds." The DOL, after carefully considering the stakeholder input and the implications of the SEC's Risk Alert, concluded that clarification was required to prevent a "misreading" of the 2020 Letter to say that a designated investment alternative, which includes a private equity component, is generally appropriate for a typical 401(k) plan.

The Supplemental Statement notes that the 2020 Letter did not endorse or recommend designated investment alternatives with private equity exposure. The Supplemental Statement also reiterates and emphasizes certain statements made in the 2020 Letter regarding private equity that the DOL continues to agree with—including the fact that private equity investments tend to be more complicated with longer time horizons, higher fees and

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valuations that are complex—before addressing those aspects of the 2020 Letter that it believes need clarification.

First, the DOL notes in the Supplemental Statement that it agrees with some stakeholders who suggested the 2020 Letter reflected the perspective of the private equity industry by reciting the representations of the information letter requestors (private equity firms) regarding the "claimed benefits" of private equity, without including counter-arguments or independent research challenging those "claimed benefits." The Supplemental Statement then discusses, as an example, certain stakeholder concerns about the 2020 Letter's unchallenged assumption that designated investment alternatives with private equity exposure may offer investors with longer investment horizons an equity-based option with "enhance[d] retirement outcomes" relative to publicly traded equities. The Supplemental Statement focuses on stakeholder concerns that making such return comparisons would be difficult given that private equity return information is neither standardized nor regulated and related investment disclosures may not be adequate to the task of assisting the average participant.

Second, in considering whether a plan fiduciary has the necessary expertise to assess and monitor a designated investment alternative, which includes a private equity component, the DOL believes that it needs to emphasize certain parts of the 2020 Letter. For example, the Supplemental Statement notes that the 2020 Letter stated that "a responsible plan fiduciary should be able to determine, either alone or with the assistance of a qualified advisor, whether the particular investment arrangement complies with the applicable requirements under securities, banking, or other relevant laws and regulations." It is true that this statement—a tall order—was made in the 2020 Letter, but it was made in a footnote. The footnote's elevation to the main text of the Supplemental Statement illustrates a shift in the scope of the guidance.

Finally, the Supplemental Statement clarifies that only a plan fiduciary with experience evaluating private equity in a defined benefit plan context may have the requisite expertise to consider designated investment alternatives with a private equity component for a 401(k) or other defined contribution plan's

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investment line-up. Even then, the DOL suggests the assistance of a qualified investment advisor would be helpful.

If you have questions about the implications of the DOL's guidance, please contact Sarah Lowe of Frost Brown Todd's Employee Benefits & ERISA practice and Private Equity industry team.

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