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New DOL Guidance Provides Road Map for 401(k) Plans to Invest into PE Funds

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On June 3, the Department of Labor (the “DOL”) issued new guidance (the “Information Letter”) that confirms that plan fiduciaries can prudently offer private equity (“PE”) as part of a diversified investment option, such as a target date fund, under 401(k) and other defined contribution retirement plans. This guidance is a significant and positive step toward allowing 401(k) plans to invest in PE funds, which 401(k) plan fiduciaries have historically shied away from due to concerns of potential liability under the Employee Retirement Income Security Act of 1974 (“ERISA”). The 401(k) market represents a potentially large source of capital that PE fund managers have long aspired to tap into, and the Information Letter has generated significant industry interest and media coverage. While the Information Letter does not address allowing plan participants/beneficiaries to invest directly in PE funds under a 401(k) plan, the DOL provided a road map for how a plan fiduciary may offer an asset allocation that includes PE in a manner that is consistent with the requirements of ERISA.

Background

The Information Letter was several years in the making, and the DOL issued this guidance at the urging of the Securities and Exchange Commission (the “SEC”) in an effort to address the uncertainties that may be “impeding plan fiduciaries from considering private equity opportunities as a way to enhance retirement savings and investment security for American workers.”

Under ERISA, plan fiduciaries have a duty to prudently select and monitor investment options that are available to plan participants under a 401(k) plan. Historically, plan fiduciaries have generally not included investment options that have exposure to PE in the 401(k) plan context because of concerns relating to liability under ERISA (e.g., lawsuits alleging imprudent investment selection) even where the plan fiduciaries

believed that providing exposure to PE funds was prudent and in the best interest of their plan participants.

The Information Letter

The Information Letter concludes that a plan fiduciary may offer a multi-asset class vehicle structured as a custom target date, target risk or balanced fund that includes a PE component and sufficient assets to diversify participant exposure to PE and other asset classes with a range of investment horizons and risk/return characteristics. The investment option could be either a custom investment option designed by plan fiduciaries or a “prepackaged” investment option offered by a financial institution as a “fund of funds” (e.g., a collective trust fund) each of which would have a PE component.

The DOL provided plan fiduciaries with a variety of factors to consider in evaluating whether to include an investment option with a PE component in their 401(k) plans. These factors may be instructive to PE fund sponsors as they consider potential opportunities within these multi-asset class vehicles. Many of the considerations highlighted by the Information Letter may also be helpful to plan fiduciaries when evaluating whether to include investment options with exposure to illiquid asset classes other than PE, such as real estate.

When selecting an investment option for a 401(k) plan, a plan fiduciary must engage in an objective, thorough and analytical process to evaluate the risks and benefits associated with the investment option, including comparing an asset allocation fund with a PE component against alternative funds that do not include a PE component. The Information Letter sets forth factors that a plan fiduciary would likely want to consider when evaluating an investment option with a PE component, including:

- whether the investment option would offer plan participants diversification of risks over a multi-year period while also providing an appropriate range of expected returns net of management fees, performance compensation and other fees or costs that would impact the returns received;
- whether the investment option would be overseen by plan fiduciaries or managed by investment professionals with the appropriate capabilities, experience and stability to manage an asset allocation fund, taking into account the nature, size and complexity of the PE investment; and
- whether the investment option has limited the allocation of PE exposure in a way that addresses the cost, complexity, disclosures and liquidity features that are

unique to PE investments, such that plan participants would retain the ability to take distributions of their benefits and make direct exchanges among the plan's investment line-up as provided by the plan's terms.

What PE managers can glean from this DOL guidance is that when considering an investment option with a PE component, plan fiduciaries will be working through the foregoing and asking questions relating to fees, expenses, diversification of risk, the nature and duration of any liquidity restrictions, valuation and the ability to make the requisite plan disclosures as required by ERISA. For example, the Information Letter states that, with respect to liquidity and valuation considerations, a plan fiduciary may wish to specify that PE investments may not be higher than a specified percentage and suggested that a plan fiduciary may consider tracking the 15% limit on illiquid investments under certain SEC rules relating to open-end mutual and exchange traded funds. Liquidity solutions will be an important element for PE fund sponsors to consider when evaluating potential products in this space. In addition, plan fiduciaries will need to ensure that plan participants are provided with adequate information about the character and risks of an investment alternative so the participants can make an informed decision about whether to invest in the fund. Accordingly, plan fiduciaries will look for PE fund sponsors to be ready to provide information and disclosures that are sufficient to address these requirements.

SEC Considerations

Although the Information Letter is helpful because it gives plan fiduciaries some assurance on the ERISA front, there are additional SEC regulatory considerations. The SEC has taken the position that self-direction by 401(k) plan participants into a specific PE fund would cause the underlying PE fund to have to qualify the participant as a Qualified Purchaser for Investment Company Act ("ICA") Section 3(c)(7) funds or count the participant for ICA Section 3(c)(1) funds in the count to no more than 100 investors. There is some relief from these look-through rules when a plan fiduciary, and not the participant, selects the PE fund(s) and limits the amount invested in the fund(s) to no more than 50% of the assets of a generic option including private equity. Unless the SEC issues more expansive guidance, it will be necessary to both fit within the Information Letter and current securities law guidance to include PE funds in a 401(k) plan.

Conclusion

The Information Letter provides a number of considerations to help plan fiduciaries make a prudent determination as to whether to give participants access to PE exposure through their 401(k) plans. This guidance may give some plan fiduciaries the confidence to take a closer look at including in their 401(k) plans an investment option with a PE component, and accordingly may present an important new source of capital for PE fund sponsors.

Authors

[Elizabeth Dyer](#)

Partner / [Chicago](#)

[Melissa R. Grim](#)

Partner / [Chicago](#)

[David Lenzi](#)

Partner / [New York](#)

[Scott A. Moehrke, P.C.](#)

Partner / [Chicago](#)

[Erica Rozow](#)

Associate / [Chicago](#)

[Jaime Doninger Schechter](#)

Partner / [New York](#)

[Nicole Washington, P.C.](#)

Partner / [New York](#)

[Andrew Wright, P.C.](#)

Partner / [New York](#)

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