Legislative and regulatory bulletin

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Private equity investments in target date funds: The DOL weighs in

On June 3, the Department of Labor (DOL) published an information letter confirming that the Employee Retirement Income Security Act (ERISA) does not prohibit defined contribution (DC) plan fiduciaries from offering asset allocation funds (e.g., target date funds) that include a private equity (PE) component.[1] However, the DOL letter highlights some of the important differences between PE and typical public market investments—differences that fiduciaries should understand. In addition, the DOL describes issues fiduciaries should consider when determining whether to include PE in an asset allocation fund offered to DC plan participants.

Background

Including private equity in asset allocation funds is not new. For several years, a small number of 401(k) plan sponsors have been offering custom target date funds with an allocation to PE. But after two lawsuits were filed against one large plan sponsor, claiming that the inclusion of PE in its target date funds was imprudent, other sponsors were concerned about potential fiduciary liability if they added PE to their target date funds.

The DOL information letter was requested by two firms that have developed collective investment trusts that invest in private equity, but other groups also have asked the DOL to issue guidance on the issue. In addition, there is a COVID-19 angle to the timing of this guidance. As the DOL noted in its news release about the information letter, the president had issued an executive order directing federal agencies "to remove barriers to the greatest engine of economic prosperity the world has ever known: the innovation, initiative and drive of the American people" to "overcome the effects the virus has had on our economy."

PE vs. public market investments

The DOL notes that there are differences between a fiduciary's decision to include private equity in a professionally managed defined benefit plan and including it as a component

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[1] U.S. Department of Labor Information Letter 06-03-2020, available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020

of an asset allocation fund offered to participants in DC plans. Compared with public market investments included on a DC plan menu, PE investments tend to be more complex, with longer time horizons; they are typically less liquid and are subject to different regulatory disclosure rules. In addition, the valuation of PE investments is more complex, and their fees are typically higher.

What DC fiduciaries should consider

When ERISA fiduciaries consider any investment for a DC plan menu, they must engage in an objective, thorough and analytical process. But the DOL highlights additional considerations for fiduciaries who are evaluating whether to include a fund that has an allocation to private equity. Fiduciaries should compare the fund with funds that do not include PE, keeping in mind the complexities associated with the PE component. In addition, fiduciaries should consider a number of questions, including:

- Do fiduciaries have the skills, knowledge and experience to evaluate the fund, or should they seek assistance from a qualified investment professional?
- Is the fund overseen by capable, experienced fiduciaries or investment professionals?
- How does the inclusion of PE impact the fund's expected return net of fees?
- What are the limits on the portion of the fund that can be allocated to PE? The DOL notes that SEC rules impose a 15% limit on illiquid investments in mutual funds.
- How does the fund handle valuation issues?
- Does the fund provide liquidity to permit participants to take distributions and make exchanges among other plan investments?
- Does the fund align with participant characteristics and needs? On this point, the DOL refers to its fact sheet "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries."[2]
- Will participants be given adequate information about the fund, especially if the fund will be a component of the plan's qualified default investment alternative?

Choosing an appropriate private equity manager is also important, given the wide variability of manager performance net of fees. And fiduciaries must periodically review the fund to determine whether it continues to be prudent and in the best interests of participants.

A road map for fiduciaries considering PE or other private investments

In its PE information letter, the DOL lays out the issues prudent fiduciaries should consider and the questions they should ask when thinking about incorporating PE into an asset allocation fund—essentially, providing a road map for a process for fiduciaries to follow. But the process the DOL describes could also be helpful for DC fiduciaries considering target date funds that incorporate other private investments, such as direct real estate.

Although an information letter from the DOL does not carry the same weight as a regulation, courts generally give deference to a regulatory agency's views on matters within its authority and expertise. So following the due diligence path the DOL outlines in the information letter may also help convince a court that the fiduciaries lived up to ERISA's standards in the event participants bring a lawsuit claiming fiduciaries were imprudent.

Now that the DOL has publicly confirmed that PE can be a component of an asset allocation fund, some DC plan sponsors who were leery of the fiduciary risk of including private equity in their plans' target date funds may decide to reconsider the idea. But whether many plan sponsors go forward with incorporating PE into their target date or other asset allocation funds remains to be seen.

[2] U.S. Department of Labor, February 2013, available at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf

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