

401 (K) PLANS: NEW MULTI-TRILLION DOLLAR SOURCE OF INVESTMENT CAPITAL FOR PRIVATE EQUITY FUNDS

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On June 3, 2020, the U.S. Department of Labor (“DOL”) issued an “information letter” (the “Letter”) offering a “well established interpretation” of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), respecting the use of private equity investments as investment alternatives in “individual account plans”, such as 401(k) plans (“DC Plans”).

The DOL concluded that DC Plans may offer “a professionally managed asset allocation fund with a private equity component as a designated investment alternative” in a manner described in the Letter.

A NEW DEAL

The Letter may have offered a “well established interpretation” of ERISA, but its conclusion was news to both private equity funds and DC Plans.

The Letter paves the way for over \$8 billion (in DC Plan assets) of new investment capital for private equity funds; and an “an opportunity for enhanced diversification of investment risk and for greater returns on (DC Plan) participant investments than could be achieved in the public market” where DC Plan investments currently reside.

DEFINED BENEFIT PLANS/DIRECT INVESTMENT IN DC PLANS

The Letter acknowledges the accepted practice of the use of private equity investments by ERISA “defined benefit” plans (“DB Plans”), but concludes that there are important differences between the decision to use private equity investments in DC Plans and DB Plans.

The Letter also makes clear that it does not address the issue of DC Plans allowing individual participants to invest their accounts directly in private equity investments, although it leaves open the possibility of such investments if the “distinct legal and operational issues” governing such investments could be addressed.

ASSET ALLOCATION FUND WITH PRIVATE EQUITY COMPONENT

Instead, the Letter describes the conditions that must be satisfied for a DC Plan to offer an asset allocation fund with a private equity component (such as a collective investment trust, or a multi-asset class vehicle structured as a custom target date, target risk, fund of funds or other balanced fund) in a manner consistent with the requirements of ERISA.

According to the Letter, each such asset allocation fund should:

- be sufficiently diversified with asset classes having different risk and return characteristics and investment horizons;
- contain private equity investments not to exceed a specified portion of the fund's overall assets;
- be developed and managed by experienced investment professionals;
- be designed to contain features that take into account cost, liquidity needs and other DC Plan characteristics, such as the need for valuations, participant exchanges among a DC Plan's investment line-up, participant turnover, withdrawal patterns and normal retirement ages, accessibility of accounts for loans and distributions, and required disclosures to plan participants enabling informed decisions regarding making /continuing investment in the fund;
- ensure fiduciary oversight respecting the prudence of continuing to offer the fund in the DC Plan;
- review compliance with applicable securities, banking and other legal requirements; and
- in general, engage in an objective, thorough and analytical process that considers all the facts and circumstances, and acts in the best interests of plan participants, in compliance with ERISA's requirements of prudence, and continuing maintenance of the DC Plan according to ERISA's fiduciary standards.

OFF TO MARKET

The Letter was requested on behalf of two global private equity firms, each of whom at the time the request to the DOL for the information letter was made had already developed private equity investments designed to be used by DC Plans as a component of a managed asset allocation fund. Both investments were collective investment trusts investing in private equity, having a liquidity component to manage withdrawals from the fund. Presumably, upon receipt of the Letter (if not before), these two firms began marketing their funds to the 401(k)/DC Plan investment community.

It remains to be seen whether other private equity funds will follow suit, and whether DC Plan fiduciaries will offer such funds as investment alternatives under their plans.

To learn more about the Employment Retirement Income Security Act of 1974 and how it may be of value to your private equity fund, we encourage you to reach out to our Employment Group partner Bill Duff or your regular RCCB contact.

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