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New Developments Pave Way For PE In Retirement Investment

By **Jake Downing and Jennifer Neilsson** (February 4, 2022, 12:50 PM EST)

Recent guidance from the U.S. Department of Labor and a recent court decision have brought new attention to potential retirement plan investments in private equity and other alternative assets classes.

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Historically, defined contribution plan fiduciaries have been hesitant to include private equity investments within the investment menu of options where participants are responsible for directing investments. Under Section 404(c) of the Employee Retirement Income Security Act, defined contribution plan fiduciaries who prudently select investment options will not be held liable for the decision of plan participants in participant-directed plans if the investments otherwise meet certain requirements, including liquidity and disclosure requirements.

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However, private equity, by its nature, is illiquid and not subject to public disclosure obligations. Additionally, private equity investments are perceived to be more complicated and may have a higher risk of loss than traditional asset classes. Private equity investment managers tend to receive higher management fees and performance compensation than investment managers of traditional asset classes.[1]

These factors, along with aggressive plaintiffs attorneys who regularly sue defined contribution plan fiduciaries and sponsors, have significantly limited private equity as investments within defined contribution plans.

Notwithstanding the foregoing, defined contribution plan fiduciaries, in accordance with their fiduciary duties, are aiming to prepare participants for retirement in a world where fewer employees have guaranteed retirement income from participation in a defined benefit plan.[2]

The potential higher returns and increased diversification that private equity can provide plan participants is enticing and difficult to ignore — particularly by the largest defined contribution plan fiduciaries who would have access to the best private equity investment managers who regularly garner top returns.[3] These are the same reasons that large defined benefit plan fiduciaries regularly cause defined benefit plans to invest in private equity. [4]

Within this context, the DOL has provided guidance on including private equity as a component of an investment option, and the U.S. District Court for the Northern District of California has ruled on

fiduciary issues related specifically to including alternative investments as a component of a large defined contribution plan's investment options. These recent legal developments could assuage some of the concerns of defined contribution plan fiduciaries.

Regulatory Guidance

On June 3, 2020, the DOL issued an information letter addressing whether private equity investments could be included as a component of a managed fund in a defined contribution plan. A managed fund is an actively managed pool of assets and can be structured as a separate account or a collective investment trust.

Some managed funds are white label funds. A white label fund is an investment structure that uses various underlying asset managers to accomplish the goals of the asset class or multi-asset classes. White label funds are generally created for a specific plan and tend to have generic names like "Company ABC Fixed Income Fund" or "Company ABC Target Date Fund." An allocation to private equity could be included as a component of a managed fund.

The information letter explained that many plan fiduciaries have not included private equity as an investment option in defined contribution plans because of the uncertainty regarding fiduciary responsibilities and potential liability. The DOL confirmed that the inclusion of private equity as a component of a managed fund is not a per sé violation of ERISA fiduciary duties.

The DOL further provided that ERISA sets forth standards for fiduciary conduct, and whether a plan fiduciary satisfies those standards is a factual inquiry.

The DOL listed items that a fiduciary should consider when including private equity as a component in a managed fund, including:

- ***Diversification***

  A fiduciary should determine whether the private equity allocation provides appropriate diversification considering the expected net returns to participants. The DOL posited that fiduciaries should review the participant population, including age, normal retirement age, anticipated employee turnover and withdrawal patterns to determine the appropriateness of including private equity.

  The DOL suggested that a long-term investment like private equity may not be appropriate for a population where there is high employee turnover and employees who terminate employment request distributions of their account balances.

- ***Fees and Costs***

  A fiduciary should review the fees and expenses, including management fees and performance compensation — e.g., carried interest. A fiduciary should ensure that the fees and expenses are reasonable for the asset class.

  Further, a fiduciary should examine the expected returns net of fees to determine whether the asset class should be included in a managed fund. Because plaintiffs attorneys have focused on

the fees and expenses of investments in defined contribution plans, fiduciaries should demonstrate a prudent process for evaluating these costs.

- ***Expertise of Fiduciary***

  As with any investment decision, a fiduciary must determine whether it has the requisite skills, knowledge and experience to make a prudent investment decision. If not, the fiduciary should seek assistance from a knowledgeable expert.

  Increasingly, defined contribution plan fiduciaries are seeking assistance from either investment consultants or investment managers to determine investment menus. Specifically, plans with white label funds generally have sophisticated advisers providing fiduciary advice.

- ***Liquidity***

  A fiduciary needs to consider that the private equity is an illiquid investment and would want to avoid causing the managed fund to not be able to meet liquidity requirements.

  The DOL indicated that a fiduciary may want to follow the U.S. Securities and Exchange Commission rule that limits illiquid investments in registered open-end investment companies to no more than 15% of investments.[5] The DOL recognized that the liquid investments contained within a managed fund could provide day-to-day liquidity.

- ***Valuation***

  A fiduciary needs to consider how to value private equity assets, which do not have easily determinable values. The DOL suggested that fiduciaries may want to have an independent valuation in accordance with Financial Accounting Standards Board Account Standards Codification 820, Fair Value Measurements and Disclosures.

  Given that defined contribution plan participants regularly invest through plan contributions and can change investment selections as often as daily, it is important that the underlying assets of a managed fund are valued appropriately and consistently.

- ***Disclosure***

  A fiduciary needs to provide disclosure to defined contribution plan participants to describe the managed fund, including any private equity components. This is particularly important if the fiduciary wants to receive the benefit of the protection offered by Section 404(c) of ERISA.

  Fiduciaries have long been concerned about how to describe risks related to complicated investments, including private equity investments.

On Dec. 21, 2021, the DOL issued a supplemental letter to the information letter clarifying that the information letter was not an endorsement or recommendation of including private equity as a component in a managed account.

The supplemental letter emphasized concerns about fiduciary compliance with certain fiduciary considerations that were listed in the information letter — including whether private equity provides

appropriate diversification, whether fiduciaries have adequate expertise and whether disclosure fully informs participants of the risks of private equity investments.

Further, the supplemental letter states that including private equity as a component of an investment is likely only appropriate for large defined contribution plans except in rare circumstances.

The supplemental letter does not add much to the analysis in the original information letter. As previously explained, the type of managed funds that would include private equity are generally available only to large defined contribution plans. Large defined contribution plan fiduciaries often receive sophisticated fiduciary advice.

Further, for private equity investments to avoid registration requirements under SEC rules, investors generally must meet certain asset thresholds. For example, for an employee benefit plan trust to be a qualified purchaser, which is required under certain exemptions to registration, the trust must have $25 million in investments.[6]

Consequently, under current regulatory regimes, private equity investments are generally only available to large defined contribution plans. The other points only serve to reiterate fiduciary considerations already listed in the information letter.

Case Law

Weeks after the supplemental letter was issued, the Northern District of California dismissed multiple claims in Anderson v. Intel Corporation Investment Policy Committee, a case involving two defined contribution plans sponsored by Intel Corporation.[7] The Intel case has a long procedural history — including a visit to the U.S. Supreme Court.

The complaints focus on fiduciary breaches related to the inclusion of alternative investments in target date funds and a global diversified fund, each a managed fund — together, the Intel funds. More specifically, target date funds invested up to 32.7% of their assets in hedge funds and commodities, and global diversified funds invested up to 56.22% of its assets in hedge funds, private equity funds and commodities.

The plaintiffs alleged that defendants breached fiduciary duties of prudence by selecting these particular investment options. The court determined that the pleadings were insufficient. Specifically, the court found that plaintiffs failed to identify a meaningful comparison benchmark, which would demonstrate the imprudence of selecting a particular Intel fund.

The court found that it is not enough to provide merely common comparable funds. Rather, the plaintiffs needed to explain why an applicable comparable fund or benchmark has similar aims, risks and rewards to the applicable Intel fund. For example, target date funds can have different strategies, glide paths and fees, and not all target date funds are meaningful benchmarks for other target date funds.

The court's dismissal of the claims seemingly supports the DOL's position that inclusion of alternative investments within a defined contribution plan investment option is not a per sé violation of ERISA fiduciary duties. Further, future plaintiffs may have difficulty identifying appropriate benchmarks and

comparable funds for bespoke managed funds — like white label funds — with unique investment allocations.

Next Steps

In light of the DOL guidance and dismissal of the claims in the Intel case, fiduciaries of large defined contribution plans have a path forward for including private equity as a component of a managed fund.

Ultimately, if a fiduciary believes that inclusion of private equity as a component in a managed fund is in the best interest of participants, the fiduciary should take the steps to prudently add such a component. To undertake a prudent process and protect against litigation risk, a fiduciary would be best served to consider each of the items listed in the information letter and document the process undertaken to consider such items.

In most cases, defined contribution plan fiduciaries should rely heavily upon the advice of an expert in private equity in this process, particularly with respect to selection and valuation issues. Further, considerable attention should be given to the disclosures given to participants to ensure understanding of the risk and fees related to private equity investments.

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[1] Traditionally, the investment manager of a private equity fund receives a 2% management fee, and the general partner of a private equity fund receives 20% carried interest after investors have received a certain rate of return (e.g., 8%).

[2] In 2021, 68% of private sector employees had access to a qualified retirement plan, with 15% having access to a DB plan, 65% having access to a DC plan (e.g., a 401(k) plan) and some having access to both. Congressional Research Service, A Visual Depiction of the Shift from Defined Benefit (DB) to Defined Contribution (DC) Pension Plans in the Private Sector (Dec. 27, 2021) available at https://crsreports.congress.gov/product/pdf/IF/IF12007.

[3] Although private equity and public equity have been thought by some to have similar performance since the financial crisis, investments in private equity, particularly with highly rated managers, have continued to outperform public equity. See, e.g., Hugh MacArthur, Josh Lerner and State Street Global Markets & State Street Private Equity Index, Public vs. Private Equity Returns: Is PE Losings Its Advantage?, Bain's 2020 Global Private Equity Report (Feb. 24, 2020) available at https://www.bain.com/insights/public-vs-private-markets-global-private-equity-report-2020/; Julie Segal, Private Equity Still Outperforms Listed Stocks—But It's Losing Its Edge, Institutional Investor (Jul. 3, 2021) available at https://www.institutionalinvestor.com/article/b1sk0t9kg78dlv/Private-Equity-Still-Outperforms-Listed-Stocks-But-It-s-Losing-Its-Edge.

[4] See Department of Labor Information Letter 06-03-2020 (Jun. 3, 2020) (citing a study showing that DB plans frequent invest in private market assets available at https://publicplansdata.org/quick-facts/national/).

[5] See Investment Company Liquidity Risk Management Programs, Release No. 33-10233; IC-32315

(Oct. 13, 2016) available at https://www.sec.gov/rules/final/2016/33-10233.pdf.

[6] See Securities and Exchange Commission No-Action Letter under Investment Company Act of 1940-Section 3(c)(1), 3(c)(7) to H.E.B. Investment & Retirement Plan and H.E. Butt Grocery Company (May 18, 2001) (explaining how certain SEC rules apply to DC plans versus the underlying plan participants).

[7] Anderson v. Intel Corp. Inv. Pol'y Comm., No. 19-CV-04618-LHK, 2022 BL 6803 (N.D. Cal. Jan. 8, 2022).