



Defined Contribution
Institutional Investment Association

10 YEARS
2010-2020

Considerations for Offering Private Equity in Defined Contribution Plans

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EXECUTIVE SUMMARY

With the recent issuance of an Information Letter from the US Department of Labor (DOL) on private equity in defined contribution (DC) plans, alternative investments are once again in the spotlight for DC plan sponsors and industry service providers. The Defined Contribution Institutional Investment Association (DCIIA) has been discussing this topic since our founding 10 years ago. In light of the potential benefits that alternative investments can offer DC plan participants in terms of diversification and performance—and in spite of the numerous related factors that must be considered—we maintain that plan sponsors may be well served by opening the door to discussing these options as part of broader investment fund design conversations. This paper provides a brief overview of the Information Letter and some initial takeaway considerations.

INTRODUCTION

On June 3, 2020, the DOL issued an Information Letter that provides its view on using private equity (PE) investments within 401(k) and other DC plans. The letter sets forth a framework to consider in order to demonstrate the prudence of such investments and can be accessed [here](#). Its objective is to provide guidance to plan fiduciaries as they select and monitor the use of PE investments within professionally managed asset allocation funds that are designated investment alternatives for participant-directed individual account plans. The following DCIIA guide supplements the DOL's Information Letter, offering additional information on the opportunities of PE investments in DC plans.

The DOL's letter confirms the long-understood notion that the Employee Retirement Income Security Act (ERISA) does not prohibit plan fiduciaries from making available an allocation to PE as part of a DC plan investment option. Moreover, in doing so, the DOL provides a framework for a prudent process if plan fiduciaries choose to explore PE as a component of a larger, diversified managed fund. This fund might be a custom target date fund (cTDF), a target risk fund, or a balanced fund that would provide participants with exposure to a range of asset classes. Additionally, the DOL acknowledges this fund type could be structured in multiple ways, including as a separately managed account managed by a plan investment committee or overseen by an investment manager exercising delegated investment responsibility, or as a pre-packaged fund-of-funds structured as a collective investment trust (CIT) or other pooled vehicle. The DOL clarified, however, that its guidance does not address vehicles that would allow a participant to invest in PE directly and on a standalone basis. These investments present distinct legal and operational issues that require separate analysis. Nonetheless, this guidance creates an opportunity for DC fiduciaries to provide their plan participants with access and diversification, while retaining confidence that they are fulfilling their fiduciary obligations.

POTENTIAL BENEFITS OF INCLUDING PE FUNDS

Including PE investments as a component of professionally managed asset allocation funds in a Qualified Default Investment Alternative (QDIA) for an ERISA-covered individual account plan could provide the following benefits, all of which are explored more fully in DCIIA's white paper *Is it Time to Diversify DC Risk With Alternative Investments?* and its presentation deck on *Capturing the Benefits of Illiquidity*:

- a. **Optimized Outcomes:** The inclusion of PE in a QDIA can offer plan participants with longer investment horizons and less need for liquidity, an equities-based investment choice that may enhance their retirement outcomes when compared to investment choices containing only publicly traded securities.
- b. **Increased Access:** Asset allocation funds with a PE component can give individual participants access to the type of asset allocation used by many actively managed defined benefit (DB) plans.
- c. **Increased Diversification:** Certain PE investments may present the opportunity for enhanced diversification and greater returns on participant investments than ones that could be achieved through investing only in public equities. PE investments may also contribute to diversification and provide a hedge against market downturns by offering investment opportunities that are less correlated than public equities. With more companies staying private for longer, utilizing PE may present an opportunity for plan participants to benefit from exposure to an increased range of companies.

IMPORTANT CONSIDERATIONS FOR FIDUCIARIES CONSIDERING PE

While there are extensive benefits potentially available from the use of PE in asset allocation funds, there are also potential risks that should be evaluated (e.g. valuation, liquidity, complexity, fees, etc.) and the DOL has set forth a series of considerations to help a fiduciary to exercise their duties in this domain. While PE presents many opportunities for DC plan sponsors to provide more diverse options to their plan participants, PE investments also have unique fiduciary considerations. The June 3rd Information Letter provides an analytical framework fiduciaries can use when considering a fund that includes PE investments as a component of it. The DOL identifies the following considerations as being particularly important for fiduciary review:

1. **Long-Term Impact:** The impact of the PE allocation on the plan investment option in terms of diversification and expected return net of management and performance fees, on a long-term basis;
2. **Expertise:** Whether the plan fiduciaries overseeing the asset

allocation fund have the requisite skills to evaluate and monitor PE investments, or should use an investment consultant or delegate investment selection authority to an investment manager;

3. **Allocation:** The percentage of the investment option to be invested in the PE component. The DOL notes that the US Securities and Exchange Commission (SEC) has adopted a regulation that sets forth a 15% limitation on investment in illiquid assets for registered open-end investment companies;
4. **Consistency with Plan Terms:** Whether the investment option will include features regarding liquidity and valuation that allow participants to take distributions and exchange into other plan investment options in a manner consistent with plan terms. The DOL also suggests that fiduciaries confirm that PE investments will be valued according to the Financial Accounting Standards Board's accounting standards and be subject to an annual audit.
5. **Liquidity:** Whether the long-term nature of PE investments and any potential liquidity restrictions align with the plan participant population, in terms of age, employee turnover, and contribution and withdrawal patterns that may affect the ability of participants to take distributions or change investment options; and
6. **Informed Decision-Making:** The adequacy of disclosures provided to participants regarding the risks of the plan investment option that includes a PE component, so as to allow participants to make an informed decision.

Plan sponsors should take the six preceding considerations into account, in addition to conducting their ordinarily prudent investment review process before adding a DC investment option with an embedded PE component. Plan sponsors should also periodically review the prudence of retaining the investment.

CONCLUSION

In its June 3rd Information Letter, the DOL clarifies that the inclusion of PE components in a DC plan investment option is not a per se violation of ERISA. This guidance creates an opportunity for DC fiduciaries to provide their plan participants with access, diversification and a potential for optimized outcomes by including PE as a component of their DC plan investment options, while retaining confidence that they are fulfilling their fiduciary obligations.

DCIIA plans to continue facilitating this important dialogue by bringing the key stakeholders together to develop thought leadership that explores the opportunities and challenges associated with adding other types of alternative investments to DC plans.

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, record keepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants. For more information, visit: www.dciia.org.

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