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Private Equity in ERISA DC Plans: DOL Issues Guidance

The U.S. Department of Labor (DOL) released new guidance yesterday that will likely facilitate the inclusion of private equity (PE) exposure in participant-directed defined contribution (DC) plans subject to the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA). The guidance concerns the viability of multi-asset target-date, target-risk and balanced funds made available on a plan lineup, including as a designated investment alternative under a Section 404(c) plan and/or as a qualified default investment alternative, with a PE component. This new guidance does *not* address participants investing *directly* in a standalone PE fund, which raises considerable securities laws issues. Here are the key takeaways:

- The guidance is relevant to ERISA plan sponsors, as well as plan advisers and private equity managers.
- DOL Secretary Eugene Scalia indicated that the DOL issued this guidance in response to President Donald Trump's May 19, 2020 Executive Order, in which the President directed 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" in order that we may "overcome the effects the virus

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has had on our economy." According to the DOL's news release, Jay Clayton, Chairman of the U.S. Securities and Exchange Commission, said the DOL's new guidance "will provide our long-term Main Street investors with a choice of professionally managed funds that more closely match the diversified public and private market asset allocation strategies pursued by many well-managed pension funds as well as the benefit of selection and monitoring by ERISA fiduciaries."

- Plan sponsors, consultants and fund managers have for years wrestled with how to enable participants in a DC plan to gain exposure to PE to increase diversification and returns without running afoul of ERISA. The illiquid nature of PE presents practical challenges for plan fiduciaries considering participants' needs for liquidity. The complexity and cost of PE have also been hindrances to DC plan adoption, particularly in light of the widespread fee litigation brought against plan fiduciaries. This new guidance provides a helpful roadmap for plan sponsors and other fiduciaries when considering the inclusion in the plan lineup of a fund with PE exposure.

- The selection and monitoring of an investment fund made available in a participant-directed plan is subject to ERISA's stringent fiduciary duties. This guidance explains how a fiduciary, in a manner consistent with its fiduciary duties, can select an investment option that has PE exposure. As a general matter, "the fiduciary must engage in an objective, thorough, and analytical process that compares the asset allocation fund with appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component."

- Fiduciaries will still have to deal with any prohibited transaction concerns under ERISA, as well as securities, banking and other laws, which the guidance does not address. The responsible fiduciary must also still comply with existing DOL regulations relating to participant-directed plans, as applicable, such as 29 C.F.R. § 2550.404a-5, 29 C.F.R. § 2550.404c-1 and 29 C.F.R. § 2550.404c-5.

- The types of funds the DOL has in mind under the new guidance are those with partial exposure to PE; the remainder of the fund's portfolio would need to have "a range of asset classes with different risk and return characteristics and investment horizons." The DOL specifically envisions the non-PE asset classes to be both liquid and have readily ascertainable market values, such as publicly-traded securities. The DOL is agnostic as to whether the investment fund itself invests in PE or if it operates as a fund-of-funds. The DOL implies that it may be advisable for the fiduciary to (i) seek funds that fix and designate their PE exposure and/or (ii) ensure that the private equity investments are independently valued according to agreed-upon valuation procedures that

For more information, please contact:

George Michael Gerstein
Co-Chair, Fiduciary Governance
202.507.5157
ggerstein@stradley.com

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satisfy the Financial Accounting Standards Board Accounting Standards Codification (ASC) 820, "Fair Value Measurements and Disclosures."

- As part of the decision-making process in evaluating a prospective fund with PE exposure for inclusion on the plan's lineup, the plan sponsor or other responsible fiduciary should consider whether:

    - it has the skills, knowledge and experience to actually determine that the fund is prudent for the plan (taking into account the plan's demographics, anticipated employee turnover, liquidity needs, etc.) or whether it should instead seek outside assistance in doing so;

    - the fund "would offer plan participants the opportunity to invest their accounts among more diversified investment options within an appropriate range of expected returns net of fees (including management fees, performance compensation, or other fees or costs that would impact the returns received) and diversification of risks over a multi-year period";

    - the fund is overseen by a plan fiduciary or managed by "investment professionals that have the capabilities, experience, and stability to manage an asset allocation fund that includes private equity investments effectively given the nature, size, and complexity of the private equity activity"; and,

    - the fund "has limited the allocation of investments to private equity in a way that is designed to address the unique characteristics associated with such an investment, including cost, complexity, disclosures, and liquidity, and has adopted features related to liquidity and valuation designed to permit the asset allocation fund to provide liquidity for participants to take benefits and direct exchanges among the plan's investment line-up consistent with the plan's terms.

In sum, the DOL guidance may facilitate the inclusion of PE within DC plan lineups and allay fiduciary duty concerns regarding the selection and monitoring of target-date, target-risk and balanced funds that have a PE component.

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