Proskauer

DOL Provides Guidance Regarding 401(k) Plans Offering Limited Exposure to Private Equity Within a Diversified Investment Option

June 10, 2020

On June 3, 2020, the Department of Labor (the "DOL") published an Information Letter confirming that an investment option under a 401(k) plan (or other defined contribution plan) may include a limited allocation to private equity[1] but it did not establish any kind of "safe-harbor" for doing so. While this is not a novel concept (in fact, some defined contribution plans have had private equity and other alternative asset allocations within their plan investment options for years; and challenges to the prudence of those investments are actively being litigated), the Letter does confirm that including a small allocation to private equity within an investment option would not violate ERISA if ERISA's fiduciary and prohibited transaction requirements are satisfied.

Notably, the Letter does not discuss whether a 401(k) plan could have an investment fund investing all or substantially all of its assets in private equity as a direct investment option for plan participants. Rather, the Letter discusses including private equity as a small allocation (DOL suggests in a footnote to the Letter that fiduciaries should consider limiting to 15% or less[2]) within a diversified investment option such as a custom target date fund, target risk fund, or a balanced fund, while indicating that a direct investment in private equity would "present distinct legal and operational issues."

Recognizing that private equity-based investments may offer greater returns than could be achieved solely in the public market, 401(k) plan participants and fiduciaries have long sought access to such asset class that is often utilized in investing defined benefit plan assets. Given the complex fiduciary and regulatory issues, however, it has been a struggle for plan fiduciaries and private equity asset managers to determine out how best to accomplish that goal.

The Letter lists specific issues for 401(k) plan fiduciaries to consider and solve (again, without providing a "safe harbor") before authorizing (or maintaining) an investment option with a private equity allocation. In particular, the Letter notes that any such decision must be made in accordance with ERISA's strict duties of prudence and loyalty and in a manner that avoids prohibited transactions, which requires (among other things) that the fiduciary must evaluate whether the potential upside from the investment justifies the added risk, fees, complexity, and valuation and liquidity issues, arguably creating enhanced risk if such investments underperform their counterparts that do not include an allocation to private equity. Also, the Letter references, and does not resolve, additional issues that might arise under ERISA's prohibited transaction rules, as well as securities, banking, tax, and other laws.

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While this guidance purports to provide some comfort for private equity asset managers seeking to access the defined contribution plan space, the "comfort" is fairly limited in scope and the issues remain just as complex as ever. Proskauer's cross-disciplinary employee benefits and asset management teams are focused on supporting and addressing these considerations in a practical way.

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[1] The Letter does not address investments in illiquid asset classes that do not fit directly within the "private equity" heading (e.g., debt or real estate).

[2] As the Letter does not address other illiquid asset classes, it is unclear whether this limit would apply to all illiquid assets.

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