DOL Warms Up to Private Equity in 401(k) Plans

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On June 3, 2020, the Department of Labor provided valuable insights via an information letter addressing private equity investment (PEI) within defined contribution retirement plans (such as 401(k) plans). The letter addressed a scenario in which PEI would be a part of a larger, diversified asset allocation fund (such as a balanced fund or target-date fund).

The DOL did not consider the use of PEI as a separate direct investment option, noting that "direct investments in private equity investments present distinct legal and operational issues for fiduciaries of ERISA-covered individual account plans." Such fiduciary concerns were raised by the SEC in a risk alert issued on June 23, 2020, and discussed in more detail in "OCIE Turns up Heat on Private Fund Adviser Compliance ."

Based on the letter and other guidance addressing issues not covered by the letter, the following is a checklist of considerations that are relevant when deciding whether to allow PEI in participant-directed 401(k) plans. Because of the complexity and breadth of issues, many plan sponsors and retirement plan committees will need expert professional assistance to answer all the questions in this checklist.

Effect of PEI on General Plan Operations

- Will the fund option with PEI have sufficient liquidity to handle cash outflows (including hardship distributions, loans, and required minimum distributions)?
- Will that fund option be able to accommodate investments of relatively small amounts over time via payroll deduction?
- In the event of a divorce or a death, will the PEI subject itself to the retirement plan's QDRO and beneficiary procedures (which might require the investment to be split with, respectively, a divorcing spouse or beneficiaries)?

Determination that the PEI is a Proper Plan Investment Option

- Are the PEI's goals consistent with the interests of the fund option that holds the PEI, the plan, and its participants and beneficiaries, considering such aspects as the likelihood of appropriate return with reasonable risk within a reasonable time horizon?
- Are the PEI fees and expenses reasonable?
- Do participants have a level of sophistication that makes it likely they will use the fund option containing PEI appropriately?
- Will the PEI provide information that will adequately inform participants of how it works, how it differs from other investments, the fees and risks involved, and what restrictions apply?
- Will the PEI add to the investment diversification already available to plan participants?

Impact of PEI on DOL Form 5500 Reporting Obligations

- Is the PEI being valued reasonably, and will the valuation be acceptable for annual audit purposes?
- Will the PEI provide adequate information for the plan administrator to satisfy its reporting obligations, including regular valuations of investments, annual and quarterly fee disclosures (the latter of which must state the fees and expenses that were actually incurred by each participant), and reports of commissions paid?
- Will the PEI affect the plan's annual audit process, the time or cost of conducting an audit, or audit waiver qualifications?

Evaluation of Potential Increase in the Risk of Conflicts of Interest or Self-dealing

- Do any fiduciaries stand to gain (financially or otherwise) by a plan option's investment in a particular PEI?
- Do any decision-makers or "influencers" have personal funds invested in the PEI or stand to earn a commission from the plan option's investment?

While all prohibited transactions must be avoided, the use of PEIs will probably increase the risk of certain types of "self-dealing" that might violate a plan sponsor's fiduciary obligations even if it does not constitute a prohibited transaction. For example, assume a CEO has personal funds invested in a PEI. To the CEO, it makes sense to allow 401(k) participants to invest in that PEI, too, since the CEO already vetted the PEI and determined it is a prudent investment. However, might the additional 401(k) investments reduce the risk of loss to the CEO's personal investment? Might the CEO be able to aggregate the personal investment with the plan's investment to exert additional influence on the underlying PEI companies?

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