

June 8, 2020

## The Department of Labor Provides a Road Map for Offering Private Equity and Other Alternative Investments in 401(k) Plans

### Executive Summary

On June 3, 2020, the U.S. Department of Labor issued guidance stating its view that plan sponsors of 401(k) and other defined contribution plans may offer participants access to alternative assets (including private equity funds) through broadly diversified investment options such as target date funds. Although this guidance does not change the law, it may encourage plan sponsors who have been hesitant to offer such products to incorporate alternative assets into their plans.

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As the various stakeholders choose to prepare for this opportunity, the following initial steps should be considered:

- Target date fund managers will need to decide whether and how they will incorporate alternative investments into their product offerings and how they plan to address the valuation and liquidity needs of plan sponsors and their participants.
- Alternative asset allocators (such as fund of funds managers) should consider how to construct durable asset allocation products that include a good pipeline for future opportunities as 401(k) plan participants' needs change over time and that can scale up or down in size. Additionally, they should consider how they will comply with their fiduciary duties under ERISA.
- Alternative fund managers should begin to explore whether and how they can tailor products and investments to better suit the needs of defined contribution plan investors.
- Plan fiduciaries should follow an objective, thorough and analytical process, which considers all relevant facts and circumstances, when evaluating investment products such as alternative assets.

### Introduction

On June 3, 2020, the U.S. Department of Labor (DOL) issued long-awaited guidance clarifying its views on defined contribution plans, including private equity investments as part of a broader diversified investment option. The guidance, which comes in the form of an information letter,<sup>1</sup> has the potential to accelerate the existing trend toward including a measured level of alternative asset exposure in these types of plans.

The letter demonstrates the DOL's recognition of the role that private equity and other alternative asset classes can play for participants by enhancing diversification of investment risk, facilitating potentially greater investment returns, and providing investment options whose performance may be less correlated to the traditional options available to plan participants. Participants in traditional pension plans have benefitted from exposure to these types of investments for years, and the letter may help level the retirement plan playing field.

The letter does not change the legal standards under ERISA, but it offers important guidelines for plan sponsors and asset managers. It will also have important implications for target date fund managers, alternative asset allocators (e.g., fund of funds managers) and private equity and other alternatives managers who seek to work with these types of plans. The letter may also help to curb the risk of class action lawsuits against plan sponsors who take appropriate steps in evaluating and adopting investment options incorporating private alternatives exposure. The wave of 401(k) fiduciary breach and fee litigation class actions over the last decade has had a chilling effect on efforts by plan sponsors and asset managers to offer

<sup>1</sup> An information letter is a piece of official DOL guidance that states a well-established interpretation or principle of ERISA without being binding on the DOL with respect to any particular factual situation.

these types of investment options, due in part to their higher fees and greater level of complexity versus a typical mutual fund or ETF. To date no court has weighed in on this question, but the DOL’s recognition of the ability for a plan sponsor to offer a product with alternatives exposure could give confidence to plan sponsors that they are acting in a manner consistent with their fiduciary duties in offering these products.

The remainder of this alert describes and analyzes the guidance provided in the letter and sets out some further factors that plan sponsors, target date fund managers, asset allocators, and alternatives managers should consider as they evaluate how to proceed following this guidance.

## Common Investment Structures the DOL Addressed

The letter addresses managed multi-asset class asset allocation funds (“Allocation Funds”) that include alternatives investments along with publicly traded securities and other liquid investments.<sup>2</sup> It describes each Allocation Fund as having a large enough pool of assets to provide sufficient exposure to a diverse mix of private equity and other investments that have varying risk and return characteristics and investment horizons. In addition, the fund’s overall exposure to alternative assets would have a target allocation that would not exceed a specified portion of the fund’s total assets, with the remainder of the fund’s portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values.<sup>3</sup> This means that the Allocation Fund will need to provide sufficient liquidity to participants to take distributions and to direct exchanges among the plan’s investment line-up in accordance with the plan’s terms, but it will not impose additional liquidity restrictions on the underlying alternatives funds.

The letter identifies two common varieties of Allocation Funds that could have the design features just described:

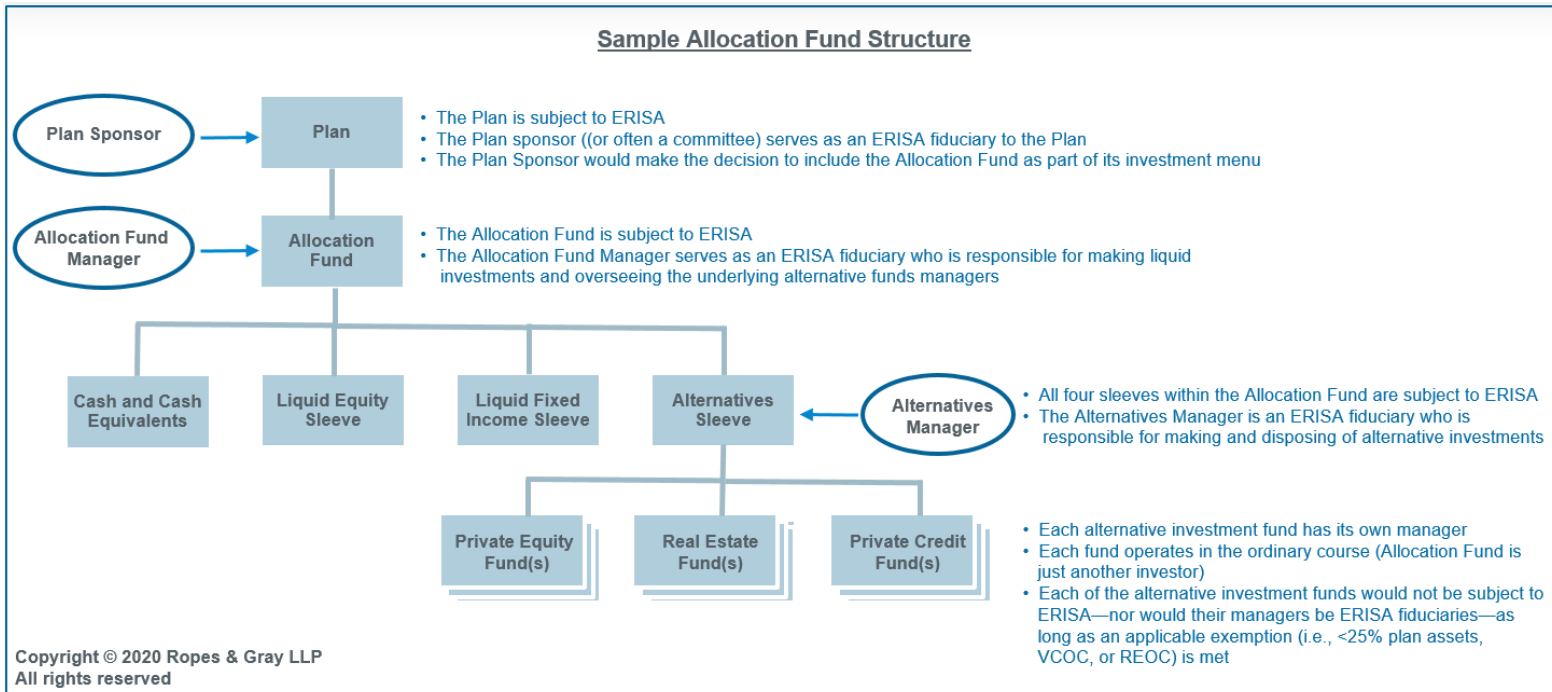
Structure Type	Details
<b>A custom-designed target date fund that includes private equity investments</b>	This type of fund would be structured by a plan investment committee as a separately managed account where the committee either retains direct discretionary responsibility for management of the account with the assistance of an independent investment adviser or delegates these responsibilities to an ERISA section 3(38) investment manager who has full discretion and authority over the private fund investments. <sup>4</sup>
<b>A fund of funds product that is offered by a financial institution to plans</b>	This type of fund would be a prepackaged investment option offered by a financial institution to individual account plans as a “fund of funds” (structured as, e.g., a collective trust fund or other pooled vehicle) that invests in other funds, with one of the underlying funds being a fund that invests primarily in alternatives.

The following chart describes the roles that the different parties will play in either of these structures.

<sup>2</sup> One example of an Allocation Fund would be a collective investment trust (CIT) that is a target date fund, target risk, or balanced fund. As a CIT, the vehicle would have to be maintained by a bank or trust company and it would be subject to regulation by the U.S. Office of the Comptroller of the Currency, but it would not be subject to the Investment Company Act of 1940. Moreover, as a CIT, it would be open only to certain limited categories of investors, including 401(k) and other retirement plans, but not IRAs or individual investors.

<sup>3</sup> In a footnote, the DOL referenced the SEC’s 15% limitation on illiquid investments applicable to registered open-end investment companies (i.e., mutual funds and exchange-traded funds). As the products addressed by the letter are not subject to SEC regulation, the 15% limit would not apply. This example may or may not guide market behavior.

<sup>4</sup> An ERISA section 3(38) investment manager is a fiduciary who has the power to manage, acquire or dispose of plan assets and who is a registered investment adviser, bank or insurance company. When a plan fiduciary retains a 3(38) investment manager, the investment manager generally takes on primary responsibility and liability for its own investment decisions.



In either case, plan participants and beneficiaries would only be making indirect investments in alternatives and would not be able to control the level of investment in or designate a specific fund into which they invest. This means that the Allocation Fund will be viewed as the investor in the underlying fund for purposes of that fund’s securities exemptions (i.e., the Allocation Fund will not be a “look through” vehicle for securities purposes) and for determining the level of investment by ERISA “benefit plan investors.” The letter does not address the separate ERISA and other legal and operational issues that would be raised if a plan sought to offer a private equity fund (or fund of funds) directly.

## The DOL’s Road Map of Considerations for Plan Fiduciaries

ERISA’s cornerstone duties of care and loyalty for plan fiduciaries are generally understood to be the highest under U.S. law, and require them to discharge their responsibilities solely in the interest of participants and beneficiaries.<sup>5</sup> Plan fiduciaries are required to prudently select and monitor any designated investment alternative (i.e., as one of the options on the plan’s investment menu) under a plan. This requires the fiduciary to engage in an objective, thorough, and analytical process that considers all relevant facts and circumstances and then act accordingly.

The fiduciary’s consideration of any particular investment vehicle with an allocation to alternatives should reflect the fact that alternative investments often involve more complex organizational structures and investment strategies, have longer time horizons, and typically incur higher fees, as compared to publicly traded securities. The DOL identified various factors the fiduciary ought to consider, which will also be important guidelines for asset managers designing new investment products intended for the 401(k)/defined contribution plan market.

<sup>5</sup> Section 404(a) of ERISA requires plan fiduciaries to act (i) for the exclusive purpose of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of administering the plan; (ii) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct on an enterprise of a like character and like aims; (iii) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (iv) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with ERISA.

DOL's Factors for Consideration	Details	Potential Action Items
<p><b>Plan fiduciary's abilities to assess the prudence of the investment alternative</b></p>	<p>Whether the plan fiduciary has the requisite skills, knowledge, and experience to make the necessary determinations about the prudence and suitability of adding a private equity investment alternative to the plan lineup, or whether the fiduciary needs to seek assistance from a qualified investment adviser or other investment professional.</p>	<ul style="list-style-type: none"> <li>Plan sponsors should consider their own experience and expertise in dealing with alternative assets (i.e., whether they have experience evaluating alternative assets based on their responsibilities under a defined benefit plan).</li> <li>Fiduciaries may want to engage a consultant with expertise in alternative investments before adding exposure to a plan.</li> </ul>
<p><b>Competence and expertise of the asset allocation fund managers</b></p>	<p>Whether the Allocation Fund would be overseen by plan fiduciaries (using third-party investment experts as needed) or managed by investment professionals that have the capabilities and experience to manage an Allocation Fund that includes private equity investments effectively given the nature, size, and complexity of these investments.</p>	<ul style="list-style-type: none"> <li>Plan sponsors considering a custom fund should determine whether to manage the alternative asset allocation in house or whether to hire a professional asset allocator (such as an experienced fund of funds manager).</li> <li>Plan sponsors considering a commingled fund should evaluate the experience and track record of the target date fund manager or the asset allocator whom the target date fund has engaged to manage alternative investments.</li> </ul>
<p><b>Sufficient diversification</b></p>	<p>Whether the Allocation Fund would provide plan participants the opportunity to invest their accounts among more diversified investment options within an appropriate range of expected returns net of fees and diversification of risks over a multi-year period.</p>	<ul style="list-style-type: none"> <li>Plan sponsors should review the investment thesis and portfolio design guidelines for any potential fund to ensure they are appropriate for the plan and its participants.</li> </ul>
<p><b>Limits on exposure to alternative investments</b></p>	<p>Whether the Allocation Fund would limit the allocation of investments to private equity in a way that is designed to address their unique characteristics, including cost, complexity, disclosures, and liquidity.</p>	<ul style="list-style-type: none"> <li>Plan sponsors should confirm that the alternatives allocation in any fund option is clearly stated and that the rationale for that level is sound.</li> </ul>
<p><b>Appropriate liquidity and valuation features</b></p>	<p>Whether the Allocation Fund would adopt features related to liquidity and valuation designed to permit the 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.</p>	<ul style="list-style-type: none"> <li>Plan sponsors should ensure that they understand how a fund will address liquidity and valuation considerations on an ongoing basis, including the role of any third-party advisors in the valuation process and how much discretion the</li> </ul>

DOL's Factors for Consideration	Details	Potential Action Items
		<p>manager of the fund will exercise in determining valuations.</p> <ul style="list-style-type: none"> <li>Specifically, the DOL suggests that plan sponsors consider requiring the fund to be independently valued according to agreed-upon valuation procedures that satisfy the Financial Accounting Standards Board Accounting Standards Codification (ASC) 820.</li> </ul>
<p><b>Alignment with the plan's features and the needs of the participant population</b></p>	<p>Whether the Allocation Fund aligns with the plan's features and participant needs as well as the participant profile (including, e.g., participant ages, normal retirement age, anticipated employee turnover, and contribution and withdrawal patterns), taking into account, among other things, the investment alternative's investment allocation and strategy, fees and other expenses, the nature and duration of any liquidity restrictions, the participants' ability to access funds in their accounts (e.g., loans and distributions when employees separate from service with the sponsoring employer), and their ability to change investment selections on a potentially frequent basis.</p>	<ul style="list-style-type: none"> <li>Plan sponsors should ensure they have a thorough understanding of the design of each fund option they are considering, including the glide path (if applicable) and how incorporating alternative assets will serve the needs of participants.</li> </ul>
<p><b>Participant communications and disclosures</b></p>	<p>Whether plan participants will be furnished adequate information regarding the character and risks of the investment alternative to enable them to make an informed assessment regarding making or continuing an investment in the fund, which would be especially important for individual account plans operated in accordance with the safe harbor from liability for participant investment decisions under ERISA section 404(c).</p>	<ul style="list-style-type: none"> <li>Plan sponsors should review the forms of disclosure that funds will provide to participants, including any enhanced disclosure designed to address the additional complexity of alternative investments.</li> <li>If the Allocation Fund will be the qualified default investment alternative ("QDIA") for the plan, or if the plan sponsor intends to rely on the 404(c) safe harbor, the plan sponsor should pay special attention to what disclosure will be needed to ensure the Allocation Fund meets the requirements for QDIA or 404(c) status.</li> </ul>

## Additional Findings to Be Made by Plan Sponsors

The DOL notes that the plan fiduciary must periodically review its use of an Allocation Fund, taking into account the considerations outlined above as well as “*any other factors*” (emphasis added) the plan fiduciary deems appropriate in light of its duties under ERISA. A thorough diligence process is critical for a fiduciary considering an investment product that offers alternative asset exposure, since there will be generally less information available regarding alternative investments compared to publicly traded assets, and comparing these investments to other available opportunities may be more difficult. A key focus for the plan fiduciary should be understanding the manager’s strategy and process for directing investments and gauging the manager’s ability to select investments and act on behalf of the ultimate investors (i.e., the plan and its participants).

The following is a list of additional considerations and factors that a plan fiduciary may consider in evaluating a potential investment product, which can serve as a supplement to the list of considerations described by the DOL in the letter.

- If the fiduciary is contemplating adding a custom-designed target date fund to the investment menu, it should consider whether the glide path is appropriate for the plan participant population, including how the investment mix may change along the glide path, and should examine how the target date fund is structured to achieve its proposed glide path with respect to the alternative asset allocation.
  - The fiduciary should also assess the fee structure, including asset-based and performance fees relating to the underlying investments as well as any incremental fees at the level of the product itself, to determine whether the fees are reasonable and appropriate for the plan and in the context of the broader market, including products that do not include allocations to alternative investments.
- If the plan fiduciary is looking to utilize a fund of funds manager that would offer a product providing alternatives exposure, it should assess the manager’s background and experience, and examine the manager’s track record (giving due consideration to any differences in asset type or investment strategy from what is being presently reviewed). Overall, the fiduciary should evaluate the manager’s position and ability to engage in primary and secondary investments in accordance with the product’s identified strategy.
  - The plan fiduciary should also evaluate the fund of funds product’s projected return and operational process. This will include understanding the manager’s method for formulating cash flow projections as well as its valuation methodology. The fiduciary should compare the projected return to market trends (the plan’s investment adviser could be a particularly useful resource for comparative analysis) as well as to other products that are or could be included on the plan’s investment menu.
  - The plan fiduciary should also inquire about the frequency with which the fund of funds manager will provide investment updates to the plan, including the nature and scope of financial data that will be reported to the plan, and how the product manager will benchmark performance. Depending on the type of product and the mix of alternative assets, comparisons may be difficult, but the fiduciary should seek to compare the projected return against market-based indices to the extent applicable, including indices based on similar or comparable investment strategies if available.
  - The plan fiduciary should have the fund of funds manager explain its approach to exercising limited partner rights in any underlying funds.
  - The plan fiduciary should ask about any recent or proposed changes to operations or key personnel.
- The plan fiduciary should also seek to understand the manager’s method for evaluating investments initially and monitoring on an ongoing basis. As the plan fiduciary will not be involved in selecting the underlying investments, it is essential that the fiduciary fully evaluate the manager’s due diligence process for the underlying alternative funds, including:
  - an evaluation of projected performance and analysis of valuation and financial reporting methods;



- how the manager addresses portfolio company disputes and other issues that may give rise to litigation or requires the manager to vote its interest;
- a review of governing documents, compliance manuals and annual audits;
- an assessment of the organization and any third-party advisors; and
- an analysis of the applicability of ERISA (for example, where investing in a fund, analysis of whether the underlying alternative fund manager is an ERISA fiduciary on account of plan assets invested in the fund, and if so whether the fund documents properly reflect the manager’s fiduciary status and responsibilities).

The plan fiduciary should review and discuss the due diligence process with the product manager to ensure that it is at least as thorough as the process the plan fiduciary would undertake itself if investing directly, and to understand both how the manager’s due diligence is conducted prior to making investments and how the manager will monitor its investments on an ongoing basis.

## Implications and Next Steps for Target Date Fund Managers, Asset Allocators and Alternative Fund Managers

The letter provides the clearest evidence to date that the DOL sees alternative assets as a viable investment strategy for 401(k) plan participants. The letter also suggests that when such investment opportunities are structured appropriately and evaluated prudently by fiduciaries prior to being added to a plan investment lineup, they should not violate the ERISA standards of care and loyalty. While the guidance focuses on the considerations relevant to plan fiduciaries in reviewing alternative investment products, it also has important implications for other stakeholders such as target date fund managers, alternative asset allocators (i.e., fund of funds managers) and private equity fund managers.

Stakeholder	Implications and Next Steps
<p><b>Target date fund managers</b></p>	<ul style="list-style-type: none"> <li>• Target date fund managers will need to decide whether and how they will incorporate alternative investments into their product offerings.</li> <li>• A plan sponsor or fiduciary will likely look to the target date fund manager to thoroughly vet the investment professionals constructing the portfolio of private equity funds that are selected for the target date fund, so the target date fund manager must perform thorough diligence on any asset allocators it works with.</li> <li>• Target date fund managers will also need to determine how to address the valuation and liquidity needs of the plan sponsor and its participants (including under adverse circumstances such as disruptions in the markets or a sudden, large redemption request).</li> <li>• Target date fund managers will need to ensure that the alternative asset allocation appropriately aligns with the target date fund’s glide path and is feasible given how the glide path changes over time.</li> </ul>
<p><b>Alternative asset allocators</b></p>	<ul style="list-style-type: none"> <li>• For alternative asset allocators such as fund of funds managers, the plan fiduciary will expect the manager to bring the relevant expertise and relationships for sourcing private equity investments and underlying fund managers.</li> <li>• The fund of funds manager should also make sure it is well-positioned and able to engage in primary and secondary investments in accordance with the product’s identified strategy.</li> </ul>

Stakeholder	Implications and Next Steps
	<ul style="list-style-type: none"> <li>• Furthermore, the fund of funds manager will also want to make sure it constructs durable asset allocations that include a good pipeline for future opportunities as 401(k) plan participants' needs change over time and that can scale up or down in size.</li> </ul>
<p><b>Private equity and other alternative fund managers</b></p>	<ul style="list-style-type: none"> <li>• For private equity and other alternative fund managers, defined contribution plan money represents a substantial and largely untapped source of capital. Now armed with the guidance set forth in the letter, defined contribution plan sponsors will likely seek to take advantage of the opportunities that private equity strategies may offer.</li> <li>• Managers should explore whether and how they can tailor their products and investments to better suit the needs of defined contribution plan investors.</li> </ul>

If you would like to discuss the impact that the DOL's guidance may have on any aspect of your business, please feel free to reach out to the attorneys listed on the first page. For further information on the broader emerging landscape of retail investment in alternative asset classes, see our article "[Retail Investments in Private Funds: Regulatory Obstacles and Opportunities.](#)"