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DOL Gives Private-Equity Guidance

401(k) plans may include the strategy as part of a diversified fund.

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ADVISER QUESTION: I'm a fiduciary adviser to ERISA [Employee Retirement Income Security Act] plans. I heard that the DOL [Department of Labor] just provided guidance on private equity investments in 401(k) plans. What did it say?

ANSWER: The DOL's recent information letter providing guidance on this topic describes the evaluation process for determining whether an investment fund having a private equity component is prudent under ERISA fiduciary standards. Here are the key takeaways.

Characteristics of the Investment

The type of investment being discussed was a professionally managed asset-allocation fund, structured as a custom target-date fund (TDF), target-risk fund or balanced fund. Included would be a pooled investment vehicle such as a collective trust fund or separately managed account. We'll refer to it here as simply "the fund." The fund's overall exposure to private equity investments was limited to a target allocation, with the remainder of its portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values.

Evaluating the Prudence of the Investment

The DOL observed that a fiduciary has a duty to evaluate such funds as it would any other designated investment alternative by engaging in an objective, thorough and analytical process that considers all relevant facts and circumstances. Further, the DOL pointed out that certain factors unique to investments of this type should be considered, including the following:

Diversification. Does the fund offer plan participants the opportunity of more diversification over a multi-year period within an appropriate range of expected returns net of fees?

Oversight. Is the fund managed by an experienced investment professional, or overseen by the plan fiduciary, using a third party investment expert as needed?

Liquidity. Is the fund's allocation to private equity limited so as to insure that the fund provides liquidity for participants and permits direct exchanges as between it and other investments of the plan's lineup? By way of example, the DOL indicated that these funds could limit their private equity investment to 15%—in a manner similar to the 15% limitation imposed by the Securities and Exchange Commission (SEC) on illiquid assets of a registered open-end fund. The DOL pointed out that the liquidity and valuation of funds with an equity component need to be appropriate given the practice of allowing 401(k) plan participants to change investment selections on a frequent—often daily—basis.

Valuation. Does the fund appropriately value the private equity investment—for example, according to independent valuation procedures such as the Financial Accounting Standards Board Accounting Standards Codification (ASC)?

Adequacy of fund information. Will adequate information regarding the fund's character and risks be provided to participants to help them make an informed assessment as to whether to invest their plan account in the fund? The DOL observed that, for those fiduciaries claiming limited fiduciary liability under the ERISA 404(c) safe harbor rule, the adequacy of such fund information is especially important in order to establish that participants had investment control over their plan accounts.

Alignment with the plan's characteristics. Evaluating the fund similarly to the way you evaluate target-date funds, do you find it aligns with the characteristics and needs of the participants? This means that the evaluation process should include consideration of the fund's investment allocation and strategy, fees and other expenses, the nature and duration of any liquidity restrictions, the participant's ability to access money in his account for a loan or distribution and the ability to change investment selections on a frequent basis.

Advisers should consider the DOL guidance when advising 401(k) plan clients that are considering offering managed asset-allocation funds with a private equity component. For such clients, an adviser could assist them in developing an investment policy statement (IPS) that reflects the factors set forth above, including restrictions on the percentage of private equity investment that their fund may hold. In advising such clients, advisers should also consider that the scope of the DOL guidance is limited. For instance, it does not address the selection of private equity investments offered directly as investment options to participants.

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