PROCEED WITH CAUTION:

Private Equity for Participant-Directed DC Plans

by | **Paul O. Catenacci**

In June, the Department of Labor issued an information letter on private equity offerings in participant-directed defined contribution plans. Is private equity right for your plan participants?

benefits MAGAZINE

On the topic of risk, Warren Buffet is credited with advising against testing the depth of the waters with both feet. That sage advice should be heeded by plan sponsors when considering private equity offerings in their participant-directed defined contribution (DC) plans.

Private equity is an alternative asset class that has garnered a great deal of attention in the investing world over the years. *Private equity* consists of debt and equity in companies that are not publicly traded or, in some instances, public companies that are being taken private. These investments come with high risk in the hope of a high reward.

Those diving in (with one or both feet) must have a tolerance for risk and the ability to withstand losses. In addition, the "private" nature of private equity not only comes with limited liquidity but also makes the investments notoriously difficult to value. As a result, private equity investors have historically been limited to high-net-worth individuals (with professional investment and tax advisors at their disposal) or large institutional investors, such as defined benefit (DB) pension funds (which are similarly equipped with professional investment and tax advisors).

At the request of a private equity firm, the Department of Labor recently released an information letter[1] on the offering of private equity to individual investors in the context of participant-directed individual account plans, which include commonly offered benefits such as 401(k) plans. Certainly, given that the level of assets in participant-directed DC plans in the United States is in the trillions of dollars, the market represents a substantial opportunity for alternative asset managers. It is important to note that an information letter does not carry the weight of an advisory opinion or federal regulation. Rather, it is best characterized as DOL considering a hypothetical question. In this instance, one might sum up DOL's thoughts on private equity in participant-directed plans like this: "We are not saying you can't do this, but we are not saying you should either. And, if you do, here a few things to think about that we may look at if we audit you."

With that in mind, this article will offer a more detailed look at the information letter as well as considerations for plan sponsors and trustees within the general context of the Employee Retirement Income Security Act (ERISA).

Is Private Equity Right for Plan Participants?

That is the question plan sponsors should ask before incorporating private equity into their plan's investment lineup. Private equity is a complex and high-risk investment, and those who deploy it do so on the advice and with the guidance of sophisticated professionals. The professional investment and tax advisors that high-net-worth individuals and DB plans use will not be available to the average plan participant. Even plans that offer their participants access to educational advisors must keep in mind that those advisors are not ERISA fiduciaries (even under the most recent proposed DOL fiduciary rule)[2] and are not certain to have substantial experience with private equity investments.

As a result, plan sponsors looking to introduce a private equity offering should consider how to educate plan participants about the role of private equity in their investment strategy. In so doing, plan sponsors should lean heavily on their investment consultant. No board of trustees should consider adding private equity without a written recommendation from the plan's fiduciary investment consultant that itself is the product of a robust (and well-documented) due diligence. This will be a time-consuming and perhaps costly endeavor, but a necessary one in order to make a prudent decision that tracks DOL guidance.

Trustees also must evaluate the risk of litigation, which has increased in recent years involving DC plans. The primary allegations made by plaintiff lawyers filing class action lawsuits relate to recordkeeping and investment manager fees. Introducing a high-cost and high-risk investment into a plan's investment mix may invite additional litigation. At least at this time, however, the opposite does not appear to be true. Trustees are not often subject to litigation for being conservative with respect to investment choices and associated fees. Moreover, private equity was not a component of participant-directed plans prior to the information letter, and nothing within suggests that DOL would view the exclusion of private equity as a failure to ensure a properly diversified mix of investment options are available to plan participants. However, specific requests directed to trustees to include private equity should not be categorically dismissed, and the plan investment consultant should review such requests and offer their opinions.

Because private equity is unlikely to become ubiquitous amongst participant-directed plans in the near term, the first plans to include such investments may

stand out in the crowd and become the first targets for litigation over the prudence of including private equity in their investment lineup. They may also be the first to garner attention from regulatory authorities, who will no doubt observe these initial forays into private equity and use their experiences to craft additional guidance or rules.

Offering a Private Equity Option

The information letter does not create a safe harbor, but it does leave a trail of breadcrumbs for plan sponsors to follow when setting up a private equity option. DOL provided a list of factors that plan sponsors should consider. These factors are not exhaustive and represent only a few items that DOL offered up for consideration. Like every other action trustees contemplate with regard to plan assets, a decision to add private equity must be viewed through the lens of each trustee's ERISA fiduciary duties of loyalty, prudence and diversification, as well as the ongoing duty to monitor those to whom duties are delegated.

Diversification and Fees

DOL says that plan sponsors should consider whether the private equity offering will enhance opportunities for diversification and whether this will generate the expected returns for the asset class net of fees on a long-term basis. If one reads between the lines, DOL appears to be saying that because private equity is high-cost and high-risk, ERISA demands a prudent selection of private equity vehicles that, over the long term, will meet or exceed established performance benchmarks within a portfolio as a whole. Trustees (along with their fiduciary investment consultant) need to analyze the entire plan investment lineup in order to consider how a private equity offering is anticipated to affect the risk, diversification, cost and performance of a typical participant's portfolio over time.

Who Is Driving the Bus?

Another factor to consider according to DOL is "whether the asset allocation fund is overseen by plan fiduciaries (using third-party investment experts as necessary) or managed by investment professionals that have the capabilities, experience, and stability to manage an asset allocation fund that includes private equity investments."

This statement is getting at whether the plan offering the private equity investment has a 3(21) or 3(38) investment consultant or is using some other model where the trustees are making direct investments. The difference is that a 3(21) investment consultant (often referred to as an *advisory* relationship) makes recommendations that the plan trustees are free to accept or reject, while a 3(38) investment manager has discretionary authority over the investment lineup. The latter type of relationship may be described as an outsourced chief investment officer (OCIO) platform. Regardless of the name given to the platform, discretionary consultants are just not as common in plans with participant-directed accounts, making due diligence and the written recommendation all the more important for plans without a discretionary relationship.

The takeaway is that while the plan's trustees can prudently inquire about adding private equity, the decision to do so should come only upon a written recommendation from the plan's fiduciary investment consultant. That consultant should also be the party recommending the specific private equity vehicles and managers to add to the plan's portfolio. In keeping with their statutory duty to monitor the operations of the plan, plan trustees should ask their investment consultant about the proposed private equity manager's experience and history as well as whether the specific vehicle has been well-tailored to participant-directed plans. The consultant's conclusions and recommendations should also be made in writing and recorded in the minutes of the plan's meetings. Some investment consultants, however, will not

takeaways

- The Department of Labor (DOL) issued an information letter on the offering of private equity investments within participant-directed individual account plans, such as 401(k) plans.
- Private equity is an alternative asset class consisting of investments in the debt and equity of companies that are not publicly traded.
- Plan sponsors and trustees considering adding a private equity offering to their defined contribution plans should have a written recommendation from the plan's fiduciary investment consultant.
- Additional considerations when evaluating whether to offer private equity investments include how to educate plan participants and the risk of litigation.
- When setting up a private equity investment offering, factors that plan sponsors should consider include diversification, fees, who will recommend the investments, liquidity and valuation.

make recommendations on alternative investments. In that case, it would be unwise for a plan to proceed without bringing in a fiduciary investment professional who is able and willing to make such recommendations.

Liquidity

Private equity is an illiquid investment, and DOL is cognizant of the challenges that its illiquidity could create. As a result, the information letter states that plan sponsors should consider establishing a cap on how much of a participant's account can be invested in private equity. One suggestion DOL makes is to adopt a limit of 15% of net assets, a cap borrowed from an existing Securities and Exchange Commission (SEC) rule applicable to mutual and exchange-traded funds (ETFs).[3]

In addition, trustees must consider whether the new plan design that incorporates private equity will allow participants to move in and out of investments in a manner consistent with plan terms and how the inclusion of private equity will affect distributions of all types (e.g., upon retirement, separation, death and disability as well as for hardships and loans if the plan offers them). This will require an understanding of withdrawal patterns borne out of a historical analysis of participant behavior (something akin to a "disruption report" typically performed for welfare plans when changes in pharmacy benefit managers or preferred provider organizations (PPOs) are being considered).

Plans offering loans or hardship distributions will also need to adopt what are commonly referred to *holdback percentages* and *periods* in order to protect both the plan and the participants from overpayments or underpayments. These tools operate just like they sound—They "hold back" a portion of the participant's distribution in order to allow time to properly value the portion of the participant's account that is illiquid or cannot be daily valued. Plan trustees should also ask about any so-called "gate" provisions that may exist. These provisions operate to restrict outflows from a private equity fund. If a fund is underperforming or a large number of investors try to pull capital out in a short period of time, the investment manager can put up the "gate," which blocks redemptions for a predetermined period of time. Importantly, triggering a gate provision is most often a decision left within discretion of the private equity manager, and the trigger normally is pulled to avoid a run on the fund during times of market turbulence. While the existence of gate provisions is disclosed in offering documents, trustees should consider that individual plan participants may not fully grasp their impact even when informed about them ahead of time in educational materials.

Valuation

With no public market or exchange available, private equity investments require specialized valuations that must be performed in accordance with standards set by the Financial Accounting Standards Board (FASB). Trustees will need to verify that this is occurring, a process that will require assistance from the plan's auditor and legal counsel. While feasible, this is a process that will necessarily increase the plan's operating costs.

If a plan decides to offer a private equity option, its investment policy statement (IPS) should be amended to reflect the change. Performance metrics customized for private equity should be established within the IPS so that there is a clear method for measuring performance. Plans can look to similar language in the IPS of sister DB plans as a starting point but should remember that the withdrawal patterns for a DC plan are very different, requiring a customized set of guidelines. Special attention should be also paid to target-date funds (TDFs) if they are to include private equity to ensure that a drawdown of risk over time is accounted for.

Plan trustees should further work closely with the investment consultant to develop educational materials for plan participants. While they need not be designed to scare off plan participants, these materials should not hide the com-

plexity, risk and cost associated with private equity investments. The educational materials should include a description of the various factors (e.g., risk, liquidity, cost), in the simplest terms possible, to allow plan participants to make an informed decision on whether private equity is an appropriate investment choice.

Conclusion

The universe of participant-directed DC plans represents a sizable pool of assets that private equity managers will certainly have interest in accessing. The sheer size of the assets invested in DC plans will incentivize these private equity managers to develop specialized investment offerings tailored to meet the needs these plans, so one can expect that over time, the type of investments offered will evolve as new considerations and challenges arise.

In addition, the information letter is not likely to be the last word from DOL on this topic. More guidance should be expected as plans start to open up to private equity. Overall, the key takeaway is that when it comes to private equity in participant-directed plans, plan sponsors should think of the Department's information letter as a blinking yellow light rather than a green "go." In other words, slow down, look both ways and proceed with caution.

bio

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Endnotes

1. See www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020#footnotes.
2. The proposed rule can be found at /www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/investment-advice-fiduciaries/improving-investment-advice-for-workers-and-retirees.pdf. It would allow certain investment advisors to engage in otherwise prohibited transactions when certain guidelines are met with respect to impartial conduct.
3. See Investment Company Liquidity Risk Management Programs, Release No. 33-10233; IC-32315 (October 13, 2016).