Easy There, Tiger. The DOL Slightly Clarifies Private Equity in 401(k)s

"If everything seems under control, you're just not going fast enough." – Mario Andretti, thankfully not a DOL employee

Back in June of 2020, the Department of Labor issued an information letter indicating that ERISA doesn't prohibit the use of private equity investments in qualified defined contribution plans. We noted then that media and industry reaction barbelled between "the wolves are at the door" and "the playing field has been leveled."

As one might have predicted, the letter motivated some strong "stakeholder" reactions. In a new supplemental statement, the DOL has clarified some of what they were trying to say.

SUMMARY

- In June 2020, the DOL released an information letter that confirmed that ERISA doesn't necessarily prohibit the offering of private equity investments in ERISA-qualified defined contribution plans, though only as components of diversified asset allocation funds.
- Stakeholders responded with several concerns, including that the letter reiterated private equity industry talking points without balancing statements and that the DOL hadn't been as clear as it could have been regarding expectations of fiduciaries.
- The new supplement admits that there are alternate views regarding the claimed benefits of PE investments, amplifies the complexity of PE evaluation, and reinforces the need for prudent processes carried out by qualified fiduciaries.

JUNE 2020 INFORMATION LETTER (READ HERE)

The DOL issued an information letter in June 2020 in response to a request from two private equity firms, both represented by Groom Law Group (as disclosure, we've worked with Groom). In the letter, the DOL confirmed that ERISA law does not prohibit the use of private equity (PE) in 401(k) and other ERISA-qualified defined contribution (DC) plans. The DOL stipulated certain conditions: 1. PE may only be an allocation within target date, risk-based, or balanced funds that offer exposure to a diversified range of asset classes; 2. it must be selected through a prudent investment process; 3. it must be professionally managed.

The Department explicitly noted that the letter's guidance did not address the offering of stand-alone private equity options to participants, given the legal and operational problems such vehicles would present. The letter also listed factors that fiduciaries should consider when determining if PE has a place in their plan. In addition, the DOL recommended that sponsors impose and adhere to limits on the PE allocation within a fund and that PE investments be independently valued and subject to an annual audit.

DECEMBER 2021 SUPPLEMENT STATEMENT (READ HERE)

In the 18 months since the June 2020 information letter was issued, the DOL received questions and comments from stakeholders, with many expressing concerns with the letter's contents and message. (We're just guessing who the concerned stakeholders might have been, but possibly consumer watchdog groups, state attorneys general, federal or state securities regulators, other industry groups, maybe some civic-minded consultants, perhaps even some internal DOL sources).

In response, the DOL issued a supplement statement in December of 2021. The supplement has addressed a few key issues that stakeholders raised:

- **Stakeholders were concerned that the format of the 2020 letter delivered a lopsided presentation of the benefits and characteristics of private equity investments.** Given the healthy debate regarding the actual advantages of private equity compared to public equity, we found how the 2020 letter dealt with the subject somewhat remarkable. Apparently, others did, too. Concerned stakeholders cited that the 2020 letter simply reiterated the requestors' version of the advantages of PE, effectively giving airtime to standard PE industry talking points without providing any balancing statements.

  The Department agreed and has listed common considerations in the 2021 supplement, including that PE performance calculations aren't standardized or regulated in the way that those of mutual funds, for example, are. Partly because of that, the evaluation of the potential advantages of PE and, therefore, the prudence of offering the asset class may require a more strenuous effort on the part of plan fiduciaries. We discussed the complexity of that evaluation in our February 2021 article, "A Look at Private Equity in 401(k)s".

- **Responders aired concerns that participants who "may not have specialized investment education and experience" may not be provided with adequate disclosures.** We agree that this is a legitimate concern, but we'll suggest that the challenge of sufficient disclosure isn't unique to PE. For decades, sponsors and providers have spent considerable time, energy, and money fulfilling their duty to provide participants with proper investment disclosures and education. However, the idea that most participants (and many plan sponsors and an unfortunate number of consultants, for that matter) thoroughly understand the composition, strategy, risks, and accounting of, say, a stable value fund, is wishful thinking. This basic fact was one driver behind the creation and offering of professionally managed asset allocation investments such as target dates (coincidentally, the only place PE would be allowed). Providing adequate participant disclosures regarding a pooled PE vehicle may be more challenging than doing so for a stock or bond fund. However, that incremental difference likely amounts to a whisper on an existing scream.

- **Stakeholders asserted that the investment horizons of individual plan participants might be much shorter than typical long-term retail or institutional PE investors.** While the 2020 letter addressed the general issue of PE liquidity, it didn't directly address individual investor time horizons. Again, we acknowledge the concern; however, we don't view this as a shortcoming in the 2020 letter. The circumstance isn't unique to PE (it applies, in some way, to every commonly accepted target date component beyond cash). The issue is currently addressed by participant education and disclosures and, perhaps more effectively, by target-date fund structure.

- **The DOL has amplified their expectation plan fiduciaries should possess the skills, knowledge, and experience necessary to satisfy their ERISA duty to prudently select and monitor PE as an investment component.** The 2021 supplement extends this to "whether the particular investment arrangement complies with applicable requirements under securities, banking, or other relevant laws and regulations" and reiterates that 404(c) doesn't absolve fiduciaries from these duties.

The DOL goes on to say that those plan sponsors who already have experience in evaluating and monitoring private equity, such as those who invest in PE in defined benefit plans, may be better equipped to assess PE in a DC plan setting, especially when assisted by a qualified investment adviser. On the flip side, the DOL opines that most plan-level fiduciaries of small DC plans are unlikely to be well-suited to evaluate the use of PE in those plans.

We agree with the DOL here as well. Beyond the fundamental merit and cost of PE, we see sponsor (and consultant) capability as one of the most significant challenges in the employment of PE in DC plans. As we said in our earlier article, "The most natural fits for private equity are likely mega-market defined contribution sponsors who incorporate it elsewhere in their benefit complex. An example may be a state or a large corporation, likely with sophisticated internal capability, which currently utilizes PE within a defined benefit program."

OUR PERSPECTIVE

We were pleased the DOL released their supplement. The statement provides context that the 2020 information letter lacked. It also amends shortcomings in the agency's original approach, which made the 2020 letter appear to endorse assertions that aren't settled facts (albeit perhaps unintentionally).

Repeating our 2021 assessment, we feel that private equity has legitimate investment applications. Still, we don't expect the widespread incorporation of pooled private equity funds into DC multi-asset investments anytime soon. Aside from the complexity involved in selecting and monitoring strategies, there are valid concerns regarding cost, performance, and operational liquidity (as detailed in our earlier article).

Beyond the specific subject, the letter may be a symptom of another issue about which fiduciaries should be concerned. While the 2021 supplement is more a clarification than a walk-back, it comes on the heels of the Biden administration's proposal to remove limits placed by the Trump administration on plan fiduciaries' ability to consider climate change and other environmental, social, and governance (ESG) issues when selecting retirement plan investments. It also follows the relatively torturous 11-year path of the DOL fiduciary rule, where a seesaw evolution resulted in a final product that looked quite unlike the initial proposal.

Together, these examples demonstrate the impact on benefits and financial regulation of the two ruling political parties' very different ideas regarding business regulation and worker/consumer protection questions. While opposing views aren't new, the current political environment suggests that compromises may be elusive, politics may reach deeper into regulatory agencies, and continuity and consistency may more frequently give way to back and forth changes.

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