PRIVATE FUNDS CRACK INTO DEFINED CONTRIBUTION PLANS

The United States Department of Labor (DOL) published an information letter (Letter) on June 3, 2020 that makes clear that defined contribution individual account ERISA retirement plans (DC Plans) could include investment products that themselves include private equity investments.

SUMMARY

The Letter confirms what many of us had believed, that private equity can be included, albeit indirectly, in funds that are offered to participants in DC Plans. As discussed below, the Letter marks a trail that can lead to broad DC Plan investment in private funds (potentially providing greater access to capital for private fund managers). Even if such investment is indirect, it can be significant: DC Plans make up a substantial portion of retirement pensions in the United States, and they will continue to grow in assets for a long time (they may be the fastest growing part of the US retirement system). The Letter also suggests that the current administration is not hostile to including private equity in DC Plans. The DOL uses the Letter to remind DC Plan fiduciaries of the process considerations necessary for including exposure to private equity in DC Plans' investment fund lineups. The Letter will encourage some managers and sponsors of private equity funds to develop products that may be offered to DC Plans.

The Letter responds to questions about including private equity investments in certain investment products, and the letter only addressed the inclusion of private equity investments. However, it would be reasonable to conclude that the advice of the Letter could apply to the inclusion of private funds generally and other alternative investments (including open-end funds and hedge funds) as well.

It is important to note that the DOL's Letter does not change any existing rules or eliminate any of the regulatory impediments that have inhibited the direct use of private equity in DC Plans. The Letter may not change the litigation risks associated with including private equity in DC Plans.

Investment managers need to remember that DC Plans are subject to the Employee Retirement Income Security Act of 1974 (ERISA), so managers will need to plan for how any private fund offered even indirectly to a DC Plan as described in this Alert will either be fully subject to ERISA or will satisfy the 25%

test exemption or the registered investment company exception, or will qualify as a venture capital operating company or a real estate operating company for ERISA.

BACKGROUND

ERISA governs and regulates private-sector pension plans in the United States. ERISA imposes fiduciary responsibilities on those who manage assets of such pension plans, including a heightened standard of care, restrictions on compensation and a prohibition of self-dealing. ERISA also limits transactions between the pension plans and their service providers and other related parties.

ERISA generally covers most private-sector employer pension benefit plans in the United States, such as corporate pension plans, plans maintained by other private-sector employers and multiemployer plans maintained by unions.

A DC Plan is a pension plan under which the participants bear the investment risk of plan participation. Under a DC Plan, an employer makes contributions to a plan's trust on behalf of participants. The plan's assets are held by its trustee, and accounts are used to track each participant's share of contributions, forfeitures and investment gains and losses.

With limited exceptions, all amounts held in a DC Plan are ultimately allocated to the individual accounts of participants and beneficiaries.

An employer is not exposed to market or interest rate risks with respect to the DC Plan that it sponsors, because its employee participants bear those risks. This makes DC Plans attractive to employers, but it creates more pressure to offer investment fund choices that will allow DC Plan accounts to grow enough to fund pensions in retirement.

DC Plans in the United States generally offer a menu of investment options, and most allow participants to decide how their accounts are allocated among the offered investment choices. Most of these private-sector, for-profit employer sponsored DC Plans offer a menu of mutual funds, ETFs and collective investment trusts, which generally invest in publicly traded equity and fixed income securities. Historically, DC Plans have not included investments in closed ended private equity funds.

THE LETTER

Certain private fund sponsors requested the Letter through their representative to seek a written confirmation from the DOL that DC Plan fiduciaries could satisfy their duties when including a product on DC Plan investment fund lineups that would give exposure to private equity. These parties have most likely developed professionally managed asset allocation funds that are structured as collective investment trusts, which in turn, invest in private equity and liquid assets so that participants may invest and withdraw from the professionally managed asset allocation fund as needed or desired.

The Letter offers additional insights for sponsors and general partners of private equity funds, which are highlighted below:

Investing Directly in Private Equity

The Letter does not address or endorse having a DC Plan invest directly in one or more private equity funds. A number of regulatory, practical and commercial issues still prevent most DC Plans, which include 401(k) plans, from letting participants invest their accounts directly in individual private equity funds. The historic headwinds remain.

Managed Asset Allocation Funds

The Letter confirms that private equity investments could be included in certain investment products that are offered to participants in DC Plans.

The Letter means that investment managers can now establish vehicles for offer to DC Plans, which would be collective vehicles with different assets and a reserved asset allocation to private equity investments.

The DOL advises fiduciaries through the Letter of what steps they need to take to include private equity investments inside of a larger "professionally managed asset allocation fund."

Importance of Letter; Shortcomings

The Letter signals that in litigation, plaintiffs may no longer argue that fiduciaries who include private equity in DC Plans automatically fail ERISA's fiduciary duties. However, as litigations over whether or not DC Plan accounts pay inappropriately high investment fees have become common, the fee structures of private equity investments could become litigation targets, and private equity fee structures will face increased scrutiny. Fiduciaries who include private equity exposure in DC Plans will need to document an analysis that shows that the extra fees are appropriate, given the potential returns relative to risk that such exposure can provide. More importantly, the DOL makes explicit that under the fiduciary's duties to a DC Plan, ***"the fiduciary must engage in an objective, thorough, and analytical process that compares the asset allocation fund with appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component."***

New Product Specifications

The DOL based the Letter on the following product specifications that came from those who requested the Letter:

- Each professionally managed asset allocation fund would be a custom target date, target risk or balanced fund. Target date funds, which are often fund of funds products that manage retirement assets in broad allocations of equity, fixed income securities and cash, and whose allocations get adjusted over time as the pre-set target date approaches, have become extremely popular in defined contribution plans, because they allow participants to get broad market exposure with a dynamic level of risk that is adjusted for the participants over the life of the product. Because target date funds are professionally managed and already invest in many different assets, and because target date funds by their nature have multi-decade investment horizons, private equity may be a good fit.

- Each fund would include private equity investments and "would have a sufficient pool of assets to diversify the exposure of plan participants to the private equity investments with other investments in a range of asset classes with different risk and return characteristics and investment horizons. The asset allocation fund's overall exposure to private equity investments would have a target allocation that does not exceed a specified portion of the fund's assets, with the remainder of the fund's portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values."
- The professionally managed asset allocation fund would have a mix of assets that would include enough publicly marketable securities and other forms of liquidity to enable (A) a DC Plan to make distributions from participants' accounts in the plan to DC Plan participants in the ordinary course, (B) participant-directed exchanges inside of participants' accounts among DC Plan investment funds and (C) the professionally managed asset allocation fund to respond to capital calls made in respect of private equity investments held by the professionally managed asset allocation fund.
- The professionally managed asset allocation fund might include "fund of funds" options.
- The professionally managed asset allocation fund would not include a means for DC Plan participants to directly invest their accounts in private equity investments.

Other Considerations for New Products

The DOL used the Letter to remind ERISA fiduciaries what they need to consider when evaluating a professionally managed asset allocation fund that includes private equity exposure:

❖ Plan fiduciaries must adhere to ERISA prudence standards of conduct when selecting and monitoring any investment choice being offered under the plan.

❖ Fiduciaries must have an "***objective, thorough, and analytical process that considers all relevant facts and circumstances***" when considering an investment fund choice for the fund lineup.

❖ The fiduciary needs to consider how adding a professionally managed asset allocation fund offers more diversification of investment opportunities and more diversification of risk.

❖ The fiduciary should consider the range of expected investment returns a professionally managed asset allocation fund could offer net of fees, taking into account any management fees, performance compensation, and other fees and expenses that could affect returns, and how the range of expected returns of a professionally managed asset allocation fund would help to diversify the DC Plan's investment mix.

- The DC Plan's fiduciaries or their relevant investment professionals need to have the "***capabilities, experience, and stability***" to manage a professionally managed asset allocation fund that includes private equity allocations and any necessary liquidity.
- A professionally managed asset allocation fund must include sufficient liquidity to allow participants to take distributions from the fund and reallocate investments among other fund choices within the DC Plan in a manner that is consistent with the plan's terms.
- The professionally managed asset allocation fund needs to include a means for regular valuation to allow participant distributions and reallocations among other DC Plan investment choices.
- Any professionally managed asset allocation fund will need to consider a limit to private equity investments, such as the 15% limit on illiquid investments that the United States Securities and Exchange Commission imposes on mutual funds and ETFs.
- The component private equity investment fund interests held by the professionally managed asset allocation fund should be independently valued according to procedures that satisfy Accounting Standards Codification Topic 820, and the requisite ERISA disclosures about the current value of the DC Plan's investments should be produced.
- The DC Plan's fiduciary should confirm to itself that a professionally managed asset allocation fund with private equity would be right for the DC Plan's demographic and its participants' needs and expectations.
- The DC Plan fiduciary will need to be sophisticated enough, or it will need the right professional help, to review and monitor a professionally managed asset allocation fund.
- Participants would need to receive enough information about the professionally managed asset allocation fund so that fiduciaries would have limited fiduciary liability, as often occurs when DC Plan participants have sufficient information about and control over their investment accounts.

If you would like to discuss this Alert or any other ERISA-related questions, please contact Paul Koppel, paul.koppel@cliffordchance.com, +1-212-878-8269, or your regular Clifford Chance Funds & Investment Management Group contact.

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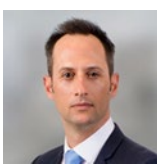

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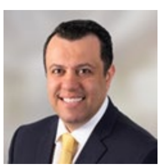

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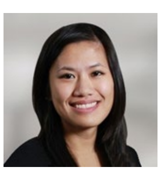

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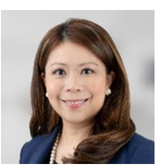

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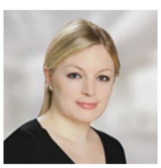

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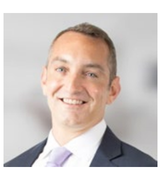

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