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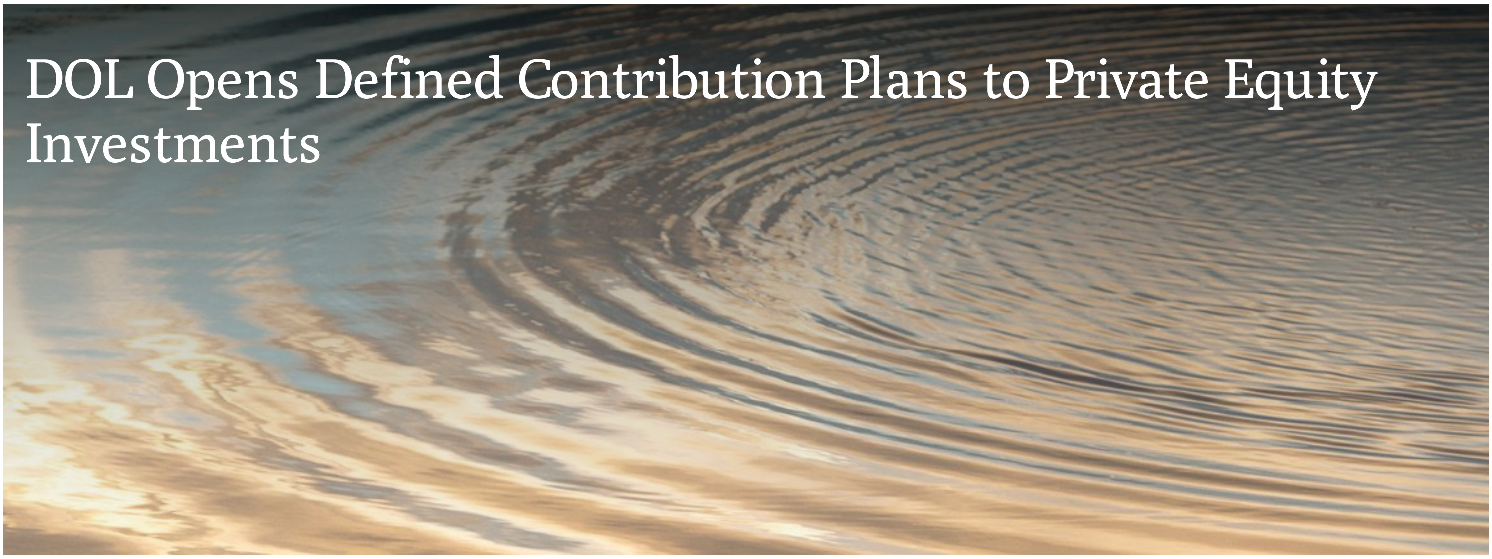

DOL Opens Defined Contribution Plans to Private Equity Investments

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With the growth of private equity in the investment marketplace, clients frequently ask whether it is legally permissible for individuals to use their balances in a 401(k) or profit sharing plan (a defined contribution plan), or individual retirement account (IRA), to invest in a private equity fund. In an information letter (Letter) issued to Groom Law Group on behalf of its clients Pantheon Ventures and Partners Group, the Department of Labor (the DOL) opened the window slightly for defined contribution plans to offer indirect investment in private equity funds.

Many defined benefit plans invest in private equity and other private market assets, such as debt and real estate, to diversify investment risk and enhance returns. Because defined benefit plans do not specifically allocate investments to participants, and generally have a longer investment horizon, direct investment in private equity is more feasible for these plans. In the context of defined contribution plans, which are individual account plans, private equity investments are more difficult to utilize and raise more fiduciary liability risks for plans governed by the Employee Retirement Income Security Act (ERISA). These risks arise because the investment fees are relatively higher, the investments are illiquid, valuation is more difficult, and such investments are harder to understand by the average plan participant. Nonetheless, in some cases, private equity investments offer investors the possibility of investing in privately held companies during their earlier, more-lucrative growth stages, whereas there are fewer financial opportunities to invest in public companies in that same growth stage. Such investments also offer investors valuable opportunities to diversify their investment portfolios.

In the Letter, the DOL did not review all types of private equity investments. It reviewed a specific type of private equity investment that would be a component of a professionally managed asset allocation fund. The investment would be offered as part of a multi-asset class vehicle structured as a custom target date, target risk, or balanced fund. To provide diversification and liquidity, each asset allocation fund with a private equity component 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. To minimize risk, the asset allocation fund’s overall exposure to private equity investments would have a target allocation that limits the investment in private equity investments to a certain prescribed limit, with the remainder of the fund’s portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values.

The DOL's Letter provides a road map for ERISA plan fiduciaries to follow when determining whether an investment alternative with an allocation of private equity is a prudent investment offering for a defined contribution plan. The DOL specifically states that an individual account plan may offer such a fund in a manner consistent with ERISA. To do so, the fiduciary of a plan must evaluate the risks and benefits associated with the investment alternative in a manner consistent with ERISA, including evaluating the following:

- the fees, liquidity, and valuation of the fund;
- whether the allocation would offer plan participants the opportunity to invest their accounts among more-diversified assets within an appropriate range of expected returns net of fees (including management fees, performance compensation, or other fees or costs);
- how the allocation fund is managed, including whether the allocation fund would be overseen by plan fiduciaries (using third-party experts) or managed by investment professionals, and whether such professionals have the capabilities, experience, and stability to manage the fund effectively given the nature, size, and complexity of the private equity activity in the fund;
- whether the fund has limited the allocation of investments to private equity in a way that addresses potential issues related to cost, complexity, disclosures, and liquidity (to enable participants to both take benefits and direct exchanges among the plan's investment line-up); and
- whether the asset allocation fund aligns with the plan's characteristics and meets the needs of participants in light of the plan's features and participant profile (including, e.g., participant ages, normal retirement age, anticipated employee turnover, and contribution and withdrawal patterns).

The DOL notes that fiduciaries must ensure that participants are furnished adequate information regarding the character and risks of the investment alternative to enable them to make an informed assessment regarding investments in the fund.

It is important to note that the DOL's Letter does not authorize making private equity investments available for direct investment by participants. Nonetheless, the DOL's Letter is one step forward in providing individuals investing through an individual account plan with the ability to access the enhanced returns and diversification available to institutional and accredited investors and provide a hedge against downturns by offering investments that are not tied to the public market.

The DOL's Letter also does not address whether it is prudent for an IRA to invest in private equity investments. The Internal Revenue Service (IRS), and not the DOL, regulates IRAs. Although there is no list of approved investments for an IRA, there are certain prohibited investments (e.g., IRAs cannot invest in collectibles, such as art, antiques, gems, coins, or alcoholic beverages, and they can invest in certain precious metals only if they meet specific requirements).

Often IRA owners, who are also employees or the general partner of a private equity investment fund, want to invest in their own private equity fund. Since these IRA owners can be considered disqualified persons under the Internal Revenue Code (Code), additional hurdles must be cleared for this to occur. For example, certain fees cannot be paid by the IRA. In addition, the IRS requires that the IRA owner prove that he/she has not directly or indirectly personally benefited by his/her IRA investment. If the IRA owner cannot prove that he/she did not receive any direct or indirect personal benefit from the IRA's investment in the private equity fund, then the IRS would likely argue that the investment triggered a prohibited transaction. The onus is on the IRA owner to disprove a claim of this nature made by the IRS.

***Winston takeaway*:** Although the DOL's guidance takes plan fiduciaries one step closer to considering a limited form of private equity investments in the investment lineups of defined contribution plans, it does not definitively state that such investments are prudent or without risk. Therefore, like any other investment alternative, plan fiduciaries will need to carefully evaluate, in a manner consistent with ERISA (including the factors noted in the Letter), any investment that includes a private equity component. At present, this type of investment may be best suited for a workforce that is well educated with respect to sophisticated investments. In addition, offering such investments though a brokerage window rather than through a plan's primary investment lineup may also be a lessrisky method of making these investments available to those individual account investors who seek such investments.

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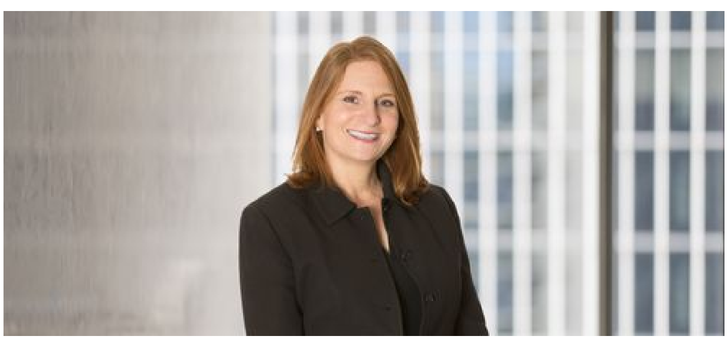

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