PRIVATE EQUITY IN 401(K) PLANS – A TRILLION DOLLAR OPPORTUNITY?

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By: William P. Wade, Ruth E. Delaney

Private equity sponsors and other managers of private market investments, including private real estate, infrastructure, and credit (together, Private Market Investments), have long cast their eyes upon the 401(k) plan market. As of 31 December 2019, employer-sponsored defined contribution retirement plans held approximately US$8.9 trillion, of which US$6.2 trillion was held in 401(k) plans and US$1.1 trillion in 403(b) plans.[1] Because of liability concerns and distinct legal and operational issues, defined contribution plans that are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) have been reluctant to include Private Market Investments as investment options for plan participants.[2] On 3 June 2020, the Department of Labor (DOL) published an information letter that should help managers of Private Market Investments access this significant, growing market.[3] While the DOL's letter does not open the door to direct access to Private Market Investments by 401(k) plan participants, it does provide a framework for the expanded use of private equity and, we believe, other types of Private Market Investments in managed asset allocation funds such as target date funds.[4]

THE ROLE OF TARGET DATE FUNDS IN 401(K) PLANS

Typically, 401(k) plans offer plan participants a menu of investment options, and plan participants can select the portfolio of funds or other investments that best suit their needs. To encourage greater retirement savings, many plans automatically enroll eligible workers in the plan, unless the workers affirmatively opt out. Automatic enrollment diverts funds into a default investment (i.e., an investment into which contributions are invested absent a specific choice by a plan participant). The DOL has designated three types of “qualified default investment alternatives” (QDIAs), which, if used by the plan, provide the responsible plan fiduciary with limited protection from fiduciary liability: (i) target dated funds, (ii) balanced funds, and (iii) professionally managed accounts.[5] Target date funds—investment funds that invest in a mix of assets that shift from higher-risk to lower-risk investments over a pre-established glidepath—quickly became the most popular QDIA and, by some estimates, 401(k) plans now hold over US$2.0 trillion in retirement assets across mutual fund, collective investment trust, and separate account structures.[6]

In the United States, target date funds are typically established as mutual funds or bank-sponsored collective investment trusts operated in a fund of funds structure. Assets classes are often exclusively comprised of public securities (bonds and equities). Target date fund sponsors offer a series of funds designed for plan participants that expect to retire in different years (e.g., 2030, 2035, 2040). 401(k) plan participants may allocate some or all of their balance to target date funds, and automatically enrolled plan participants are directed by default into a particular series based on their anticipated retirement date.

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THE DOL'S GUIDANCE

401(k) plan fiduciaries have been reluctant to include Private Market Investments in a plan's investment lineup due to legal and operational concerns. But on 3 June 2020, the DOL, which is responsible for enforcing ERISA's fiduciary responsibility provisions, published an information letter confirming that a 401(k) plan fiduciary may offer managed asset allocation funds, including target date funds, that include an allocation to private equity while meeting their fiduciary responsibilities.

The DOL acknowledged that, as compared to the investments typically available in 401(k) plans, private equity investments tend to involve more complex organizational structures and investment strategies, longer time horizons, and higher fees. In addition, valuation of private equity investments is more complex because private equity investments often have no easily observed market value and there is often an element of judgment involved in valuing each of the portfolio companies prior to their sale by the investment fund or other liquidity event. These factors have complicated the evaluation of private equity investments by 401(k) plan fiduciaries under ERISA's fiduciary duty provisions, which require, among other things, that plan fiduciaries evaluate 401(k) plan investment options prudently and solely in the interest of plan participants.

To assist 401(k) plan fiduciaries in navigating these matters, the DOL provided a “road map” or analytical framework for the assessment of private equity exposure in target date funds and other managed asset allocation funds. According to the DOL, in assessing the prudence of a fund that includes private equity investments, a fiduciary should consider the following matters:

- Whether the fund offers plan participants the opportunity to invest their accounts among more diversified investment options within an appropriate range of expected returns net of fees, including management fees, performance fees, and other fees or costs that impact returns;
- Whether the 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 effectively manage an asset allocation fund that includes private equity investments given the nature, size, and complexity of the private equity activity;
- Whether the fund has limited the allocation of investments to private equity in a way that is designed to address the unique characteristics associated with such a fund, including cost, complexity, disclosures, and liquidity and has adopted features related to liquidity and valuation designed to permit the fund to provide liquidity for participants to take benefits and direct exchanges among the plan's investment line-up consistent with the plan's terms (in the letter, the DOL referenced the Investment Company Liquidity Risk Management Programs rule, which was adopted by the Securities and Exchange Commission (SEC) in 2016, and codified the SEC's longstanding guideline limiting investments in illiquid assets for registered open-end investment companies to 15 percent);[7]
- Whether the characteristics of the fund align with the plan's characteristics and needs of the plan participants, taking into account, among other things, the fund's investment allocation and strategy, fees and other expenses, and the nature and duration of any liquidity restrictions, a participant's ability to access funds (e.g., loans) and ability to change investment selections on a potentially frequent basis;

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- Whether plan participants will be furnished adequate information regarding the character and risks of the fund to be able to make an informed assessment regarding making or continuing an investment in the fund; and
- Whether the fiduciary has the skill, knowledge, and experience to make these determinations.

The DOL's letter does not address whether or how a plan can offer direct investments into private equity. While this practice is not *per se* prohibited, it would raise additional legal and operational issues that plan fiduciaries would find difficult to reconcile absent additional guidance. Also, the letter does not address the complex ERISA considerations for sponsoring and operating a target date fund that includes an allocation to private equity when the target date fund is itself subject to ERISA, which is the case for target date funds established as collective investment trusts.

CONSIDERATIONS FOR PRIVATE FUND SPONSORS

Managers of Private Market Investments seeking to receive an allocation of assets from target date funds should consider what structures and operational features of private funds will best meet the challenges inherent in managing 401(k) plan assets. In addition to the valuation, liquidity, and fee constraints described below under “Considerations for Target Date Fund Sponsors”, a private fund sponsor's experience and expertise overseeing the activities of a range of Private Market investment funds as well as a fund's “ERISA capacity” (i.e., whether a fund can have additional ERISA investors without causing the fund itself to be subject to ERISA) are important considerations.

Private Markets Investments: Private Market Investments include private equity, real estate, infrastructure, commodities, and other asset classes. While the DOL's letter specifically references allocations to private equity, because Private Market Investments pose similar legal and operational challenges for 401(k) plans, we believe the guidance set forth in the DOL's letter should apply more broadly to additional types of Private Market Investments.

Managers With Oversight Experience: The DOL's letter suggests that when evaluating investment options a fiduciary should consider (i) whether plan participants will have the opportunity to invest their accounts among more diversified investment options and (ii) whether third-party investment experts and investment professionals with the capabilities, experience, and stability are involved in the management of the option. In light of this guidance, 401(k) fiduciaries may derive comfort from target date funds that obtain exposure to Private Market Investments through the oversight of seasoned fund of fund managers with expertise performing diligence on, entering into transaction with, and overseeing the activities of a range of Private Market Investment funds. These managers, whose experience and expertise would supplement the proficiencies of traditional date fund managers, could establish private funds specifically designed to complement a generic liquid portfolio, or could be engaged directly by target date funds as sub-advisers to manage a Private Market Investment sleeve of the target date fund.

Structuring and Marketing Private Market Investments: Managers of Private Market Investments seeking to develop products for the target date fund market will need to consider not only the structure of these allocation vehicles, but also the nature and scope of permissible marketing activities. Registered closed-end funds (interval funds and tender offer funds) can accommodate Private Market Investments and provide a viable path for private

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fund managers to access 401(k) assets. However, these funds introduce operational expenses and impediments that are not present in private funds. On the other hand, structuring allocation vehicles as traditional private funds can impair a private fund manager's ability to highlight the services and benefits it can provide to target date fund sponsors. Private fund managers may consider as an alternative relying on Rule 506(c) of the Securities Act of 1933, as amended, which permits issuers to engage in general advertising without giving up the benefits of operating a private fund. The primary drawback of Rule 506(c)—enhanced due diligence to ensure that purchasers are accredited investors—would not be an impediment for funds designed to provide a Private Market Investment allocation to target date funds organized as registered investment companies, which are accredited investors by definition.

ERISA Capacity: Target date funds structured as collective investment trusts or separate accounts can cause an underlying private fund to become subject to ERISA (known as "plan asset" funds).[8] If a private fund is subject to ERISA, the manager is subject to ERISA's fiduciary responsibility standards and prohibited transaction restrictions when managing and operating the fund. Because of the complexity in operating certain private funds—particularly funds that invest in Private Markets Investments—as "plan asset" funds, many funds seek to avoid "plan asset" status. This can be achieved by limiting ERISA and similar investors to less than 25 percent of each class of equity interest in the fund (known as the 25% test); complying with requirements to be a "venture capital operating company" (VCOC); or, for real estate funds, complying with the requirements to be a "real estate operating company" (REOC).[9] Therefore, managers of private funds seeking to receive an allocation of assets from a target date fund structured as a collective investment trust or separate account will need to consider whether their investment strategy can be operated within an ERISA "plan asset" fund. If not, managers of underlying private funds will likely need to limit ERISA investors to comply with the 25% test, unless the underlying private fund can be structured and operated to meet the VCOC or REOC requirements. In the alternative, Private Market Investment managers can avoid these issues entirely, if the investment vehicle can be structured as a registered closed-end fund, which is not considered to be an ERISA "plan asset" fund regardless of the type of strategy or investors in the fund.

CONSIDERATIONS FOR TARGET DATE FUND SPONSORS

Target date fund sponsors will also need to consider several legal and operational matters when designing investment products for the 401(k) market that include an allocation to Private Market Investments. The primary challenges include providing sufficient liquidity for investors and valuing investments on a daily basis.

Liquidity: As is the case for substantially all mutual funds, investment options available in 401(k) plans need to allow plans to support daily contributions and withdrawals at the plan participant level.[10] For example, a plan participant may want to (i) rollover his or her assets to an IRA, (ii) take a loan from the plan, or (iii) switch his or her investment to a different target date fund series. When a target-date fund experiences net outflows (or inflows) on a given day, the fund may need to raise (or invest) cash and rebalance in accordance with the target date fund's pre-established glidepath. Potential solutions to these liquidity needs include:

- Maintaining a cash buffer in the target date fund or in the fund's allocation to Private Market Investments;
- Including assets with a higher liquidity profile, such as listed private equity, in the Private Market Investments allocation;

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- Batch processing transactions (i.e., treating multiple buy and sell orders across different target date fund series as one transaction);
- Drawing on a credit facility to facilitate redemptions; or
- Raising cash by selling the target fund's publicly traded assets.

Valuation: 401(k) plans also require daily valuation of plan investments. Private Market Investments, however, are often valued on a monthly, quarterly, or even yearly basis. To address this discrepancy, target date fund sponsors seeking to access the 401(k) market will need to establish procedures to gather relevant information to re-evaluate quarterly or monthly valuations from the underlying funds, and determine current fair valuation on a daily basis.[11]

Fee Structure: ERISA generally provides that a service provider's fees can be no more than reasonable. In the last several years, a number of class action lawsuits have targeted 401(k) plan sponsors alleging the plan hired service providers or offered investment options that charged plan participants excessive fees. The total fees charged by a target date fund are largely based on the fees paid to managers of the underlying funds in the target date fund's portfolio. Therefore, for legal (and commercial) reasons, sponsors of target date funds used in 401(k) plans must consider whether the underlying funds cause the overall target date fund fees and expenses to be excessive. Since the fees and expenses associated with managing Private Market Investments are typically higher than fees for more traditional and liquid asset classes, target date fund sponsors will likely want to consider setting allocations to Private Market Investments that, when blended with traditional investment products, achieve a total expense ratio that is appropriate for ERISA plans. Target date fund sponsors should also consider performing market research on the typical fee structures for Private Market Investment managers to help 401(k) plan fiduciaries understand and gain comfort that the fees charged by managers used in their funds are not excessive when compared to similar managers.[12]

Securities Law Issues: Target date managers should be aware of the issues that may arise when 401(k) plans invest in private investment funds that rely on the Section 3(c)(1) or Section 3(c)(7) exceptions under the 1940 Act. Section 3(c)(1) applies to a fund whose outstanding securities are owned by not more than 100 persons and Section 3(c)(7) applies to a fund whose outstanding securities are owned exclusively by “qualified purchasers” (as defined by the 1940 Act). In certain cases, funds need to look through to the beneficial owners of an entity participating in the fund, such as the participants in a 401(k) plan, for purposes of compliance with the 100-investor limit or the qualified purchaser requirement. A series of SEC no-action letters provides that a fund does not need to look through a 401(k) plan to the plan participants for these purposes, as long as the fund limits its investment in Section 3(c)(1) and Section 3(c)(7) funds to not more than 50 percent of the fund's assets, the manager of the fund determines when and how much to invest in particular underlying Section 3(c)(1) and Section 3(c)(7) funds, and the fund does not represent that it will invest in particular Section 3(c)(1) and Section 3(c)(7) funds.[13]

Target Date Funds as “Plan Asset” Entities: Decisions relating to the design of a product to be offered to ERISA plans should not be viewed as fiduciary decisions subject to ERISA's fiduciary responsibility requirements. However, if a target date fund is an ERISA “plan asset” entity, such as a fund structured as a collective investment trust, the target date manager is subject to ERISA's fiduciary responsibility standards and prohibited transaction restrictions when managing and operating the fund. Managers of such funds should consider their

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duty to avoid non-exempt prohibited transactions under ERISA, such as transactions between the fund and a "party in interest"[14] of plans investing in the fund and economic or other benefits flowing to the target date manager or its affiliates (e.g., additional fees) as a result of a decision by the target date manager to cause the fund to enter into a transaction. Managers should carefully consider whether compliance with a prohibited transaction exemption, such as DOL prohibited transaction exemption 84-14 or 91-38, or other steps are advisable to avoid prohibited transactions.

We believe the DOL's letter provides a helpful analytical framework to assist plan fiduciaries in selecting and monitoring target date funds that include an allocation to Private Market Investments. In time, the DOL's letter should help level the playing field between defined benefit pension plans, which invest hundreds of billions of dollars in Private Market Investments, and 401(k) plans, which rarely invest in Private Market Investments.

We anticipate continued interest and developments in this area due to the vast market opportunity for managers of Private Market Investments, regulatory support from the SEC as well as the DOL,[15] and the potential for diversifying investment risk and enhancing investment returns for plan participants. In the coming months, fund complexes and managers of Private Market Investments will likely seek to develop products consistent with the legal and operational complexities that are inherent in managing 401(k) plan assets.

The asset management and investment funds practice at K&L Gates has decades of experience advising ERISA fiduciaries, U.S. registered investment companies, and private fund sponsors. As a single integrated team, we stand ready to help navigate the diverse regulatory issues associated with structuring investment options to access this market opportunity.

FOOTNOTES

[1] Investment Company Institute

[2] ERISA is a federal law containing rules that plan sponsors and other fiduciaries must comply with when establishing and operating retirement plans. Company sponsored 401(k) plans and 403(b) plans sponsored by private tax-exempt employers are subject to ERISA. In this Alert, we refer to these plans collectively as 401(k) plans.

[3] Information letters are for informational purposes only and are not binding on the DOL or any other party.

[4] The discussion in this Alert is focused on target date funds. However, the DOL's guidance applies to other managed account structures as well.

[5] When a plan has a QDIA as the default investment option, the plan's fiduciaries must still satisfy ERISA's fiduciary responsibilities when selecting and monitoring the QDIA.

[6] Custom Target Date Fund (cTDF) Survey

[7] Investment Company Liquidity Risk Management Programs, Release No. 33-10233; IC-32315 (Oct. 13, 2016).

[8] Target date funds structured as mutual funds are not subject to ERISA and, therefore, do not cause their underlying private funds to be subject to ERISA.

[9] 29 C.F.R. Section 2510.3-101.

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[10] Pursuant to Rule 22e-4 of the Investment Company Act of 1940, as amended (1940 Act), open-end management investment companies are required to have a liquidity risk management program reasonably designed to assess and manage liquidity risk (i.e., the risk that the fund could not meet redemption requests without significant dilution of remaining investors' interests in the fund). The Investment Company Liquidity Risk Management Programs rule codified the SEC's longstanding guideline limiting investments in illiquid assets for registered open-end investment companies to 15 percent.

[11] Section 2(a)(41) of the 1940 Act requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations for those securities are “readily available,” and, when a market quotation for a specific portfolio security is unreliable or otherwise not readily available, by using the fair value of that security, as determined in good faith by the fund's board of directors.

[12] Such a process would also benefit advisers of registered investment companies in the preparation materials provided to boards in response to Section 15(c) of the 1940 Act which requires that boards “request and evaluate…such information as may be reasonably necessary to evaluate the terms” of the advisory contract at issue.

[13] *See* H.E. Butt Grocery Company, SEC No-Action Letter (avail. May 18, 2001); Standish, Ayer & Wood, Inc. Stable Value Group Trust, SEC No-Action Letter (avail. Dec. 28, 1995); PanAgora Group Trust, SEC No-Action Letter (avail. Apr. 29, 1994).

[14] Section 3(14) of ERISA defines the term “party in interest” to include any fiduciary as well as any person providing services to a plan, together with certain affiliates of such a person.

[15] Chairman of the SEC, Jay Clayton, said the DOL's letter, “will provide our long-term Main Street investors with a choice of professionally managed funds that more closely match the diversified public and private market asset allocation strategies pursued by many well-managed pension funds as well as the benefit of selection and monitoring by ERISA fiduciaries.” Secretary of Labor, Eugene Scalia, said, “This Information Letter will help Americans saving for retirement gain access to alternative investments that often provide strong returns. The Letter helps level the playing field for ordinary investors and is another step by the Department to ensure that ordinary people investing for retirement have the opportunities they need for a secure retirement.”

KEY CONTACTS



WILLIAM P. WADE
SENIOR OF COUNSEL

LOS ANGELES
+1.310.552.5071
WILLIAM.WADE@KLGATES.COM



RUTH E. DELANEY
PARTNER

LOS ANGELES
+1.310.552.5068
RUTH.DELANEY@KLGATES.COM

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