DCREC
DEFINED CONTRIBUTION REAL ESTATE COUNCIL

Fiduciary Framework for Investment by
Defined Contribution Plans in Alternative Assets
Information Statement

> *"..The manager of an investment portfolio subject to ERISA (including one intended to be a QDIA) could, consistent with its fiduciary duties, include an allocation to direct real estate, infrastructure, private equity, hedge funds and other less liquid, alternative asset classes in the portfolio.."*

With the maturing, growth and increasing importance of defined contribution plans to the retirement security of U.S. employees, many plan fiduciaries and managers of funds offered as designated investment alternatives in defined contribution plans are considering whether it is appropriate and prudent to include a broader array of asset classes in DC portfolios to enhance diversification and investment return. This paper outlines the fiduciary framework applicable to such an investment decision.

Prudence Standard of Care

In 1974, ERISA revolutionized the investment of U.S. pension assets by moving away from the traditional common trust law standard of care, which historically meant investing in a conservative portfolio (i.e., fixed income investments), to a prudent person standard. ERISA requires that a fiduciary invest plan assets in a manner consistent with how a prudent person with investment expertise would invest those assets in light of certain factors (discussed below). Effectively, ERISA facilitated an investment allocation across the risk and return spectrum consistent with generally accepted investment principles including modern portfolio theory. As a result, pension assets have been diversified into the broader universe of investment alternatives, including equities, derivatives, and alternative asset classes. Plan fiduciaries and their consultants have long embraced the importance of alternative asset classes, such as real estate, to the prudent diversification of investment risk and return to their portfolios. As discussed below, more recently, the Department of Labor concluded that the same generally accepted investment principles should be the basis for constructing a fund or other portfolio offered as a qualified default investment alternative in a defined contribution plan.

Factors Relevant to Prudent Investment Decisions

Although defined benefit and defined contribution plans are governed by exactly the same standards of care, the standard must be applied taking into account the unique factors of each plan. Department of Labor regulations state that a plan fiduciary should give "appropriate consideration" to the following factors when investing the plan's portfolio:

I. the composition of the portfolio with respect to diversification;
II. the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
III. the projected return of the portfolio relative to the funding objectives of the plan.

The daily trading environment of 401(k) plans has resulted in valuation and liquidity concerns that have, to date, limited the inclusion of alternative asset classes in such plans. However, managers of real estate and other less liquid investment classes have recently created products that mitigate the valuation and liquidity limitations.

ERISA Section 404(c)

Plan fiduciaries are relieved of fiduciary responsibility and liability for investment decisions made by plan participants in a plan that meets the requirements of ERISA Section 404(c), however, plan fiduciaries continue to be responsible and liable for the selection of the investment alternatives made available to participants on the plan's platform. In order to meet the requirements of ERISA Section 404(c), the plan must, among other requirements, offer participants the opportunity to give investment instructions among "a broad range of investment alternatives."

A 404(c) plan may impose reasonable restrictions on the frequency (not less than quarterly) with which participants may give investment instructions. However, in no event would such a restriction be reasonable with respect to a particular investment option unless the participants have the opportunity to give investment instructions with a frequency that is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject.

Qualified Default Investment Alternative

To the extent that a participant in a 401(k) plan fails to affirmatively direct the investment of his or her account, plan fiduciaries will be protected from fiduciary liability for the investment of the participant's account if the default option under the plan is a qualified default investment alternative, or QDIA, as long as the selection of the QDIA satisfies the ERISA fiduciary standards. A QDIA is an investment alternative that "applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures. …," such as balanced funds and target date funds. Consistent with the requirements under ERISA Section 404(c), a QDIA must offer participants the opportunity to transfer out of the QDIA at least as often as participants are permitted to transfer into the QDIA, but not less frequently than once in any three-month period.

Balancing Prudent Diversification and Liquidity Considerations

Although defined contribution plans have different liquidity considerations than defined benefit plans, the principles under ERISA's prudence requirements, ERISA Section 404(c), and the QDIA safe harbor support an intent to afford participants in defined contribution plans the same level of investment diversification and return that would generally be considered prudent for any retirement plan. Therefore, the manager of an investment portfolio subject to ERISA (including one intended to be a QDIA) could, consistent with its fiduciary duties, include an allocation to direct real estate, infrastructure, private equity, hedge funds and other less liquid, alternative asset classes in the fund, provided that the overall portfolio is appropriately diversified in light of liquidity needs and risk and return objectives. A defined contribution plan fiduciary could also, consistent with its fiduciary duties, select such a portfolio for the plan.

The above statement, subject to the footnoted statements below, is neither legal advice nor investment advice, and any investment decision needs to be made independently by each plan fiduciary considering the facts and circumstances of each plan and each individual investment. We encourage plan fiduciaries to discuss the particulars of this memo and their own portfolio with their legal counsel, or other advisors, prior to investing in any illiquid assets.

This information statement was prepared in consultation with the following leading law firms:

1. Alston & Bird, Rosemarie Thurston and David Baum
2. Goodwin Procter LLP, John Cleary and Scott Webster
3. Groom Law Group LLP, Steve Saxon, Jennifer E. Eller and David C. Kaleda
4. King & Spalding LLP, Kenneth Raskin
5. Mayer Brown LLP, Lennine Occhino and Bert Krueger
6. Willkie Farr & Gallagher LLP, James Silk and Ian Levin

Certain of the firms listed above may provide legal services or have other business dealings with the DCREC or its members. This information statement is intended for informational purposes only and does not constitute a legal opinion or advice with respect to the matters covered herein.

Technical Notes:

1. *DC Plans Covered by ERISA (including those relying on the fiduciary exemption under 404(c) (including qualified default investment alternatives)): as discussed above, ERISA does not prohibit the allocation to illiquid investments of a portion of a portfolio the management of which is subject to ERISA.*

2. *40 Act Funds (including certain Target Date and Target Risk Funds): the management of investment funds registered under the Investment Company Act of 1940 or "ICA" is not subject to ERISA. Non-Money Market registered open-end investment companies ("mutual funds") are permitted to hold up to 15% of their net assets in illiquid assets*. Registered closed-end investment companies generally have no limitation on the amount of illiquid assets that they may hold (certain restrictions apply to interval or so-called "hybrid" funds).*

3. *Other Investment Funds or Entities (including certain Target Date or Target Risk Funds): ERISA Plans may invest in funds or other entities that in turn invest in illiquid assets. Such funds or other entities, for example, may be structured as collective investment trusts (CITs), separate accounts/unitized accounts, or entities the assets of which are deemed "plan assets" by reason of Section 3(42) of ERISA. The managers of these funds or other entities may be subject to ERISA's fiduciary duty provisions. As discussed above, ERISA does not preclude investment in illiquid assets, but rather requires the managing fiduciary to undergo the fiduciary analysis described above.*

**For the purpose of determining the percentage of a registered open-end investment company's assets that may, consistent with the interpretations of Section 2(a)(32) of the ICA promulgated by the staff of the Securities and Exchange Commission, be invested in such assets, "illiquid assets" are defined as assets that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund values the investment.*

About DCREC

Defined Contribution Real Estate Council (DCREC): The DCREC is dedicated to ensuring that participants of defined contribution (DC) plans have the opportunity to benefit from the long-term attributes of commercial real estate investments that participants in defined benefit plans have enjoyed for many decades. More specifically, DCREC was formed to promote the inclusion of direct commercial real estate and real estate securities, including REITs, within DC plans by furthering education about, advocacy for and best practices of, such investments. This particular Information Statement is focused on education related to the legal issues underlying investments by defined contribution plans in alternative investments, which may include certain types of real estate investments.

For more information, please contact any of the listed law firms or Marcus Wignell, member of the DCREC Research Committee, via the *Contact Us* link at www.dcrec.org

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