Davis Polk

Expanding 401(k) access to alternative investments: Thinking beyond asset allocation funds

June 18, 2026 | Client Update | 13-minute read

The Department of Labor released its highly anticipated proposed rule that aims to expand access to alternative investments by 401(k) and other individual account plans. Although a step in the right direction, the proposed rule should be modified to facilitate the inclusion of more than just asset allocation funds in plan menus. In this update, we discuss modifications that would expand access to alternative investments through other fund options and how the SEC can support this effort.

The Department of Labor (DOL) released its highly anticipated proposed rule that aims to expand access to alternative investments by 401(k) and other individual account plans. The proposed rule is a direct response to President Trump's Executive Order from last summer (Executive Order 14330) and is intended to reduce the risk of "burdensome lawsuits" (as noted in the Executive Order) faced by plan fiduciaries. While the proposed rule represents a significant step in democratizing access to alternative investments for retirement investors, as we discuss in our joint and individual comment letters to the DOL, the rule can be modified to better achieve this objective. In that regard, as we focus on here, although the DOL states that the rule is asset-class neutral and allows for the inclusion of alternative assets in more than just asset allocation funds, the rule's proposed standards seem to favor these funds. As we noted in our prior client update discussing the Executive Order, although asset allocation funds (which invest a limited portion of their portfolio in alternative assets) will be suitable for some plan participants, many participants may wish to customize their exposures to alternative assets more than can be done with asset allocation funds.

To truly democratize access to alternative assets, plan participants should be able to tailor their individual investment exposures based on personal objectives. These objectives may include primarily seeking exposure to non-alternative assets through an asset allocation fund, but seeking exposure to alternative assets through other means. This proposition reflects the reality that 401(k) and other individual account plans typically do not offer only target date funds, but also allow their participants to choose between a variety of equity and bond funds. Therefore, to ensure that plan participants have access to appropriate choices, the DOL, in its rulemaking, should explicitly contemplate the inclusion in plan menus of funds regulated under the Investment Company Act of 1940 (the 1940 Act) that focus their investment strategies on alternative assets. These Regulated Alternatives Funds, such as closed-end 1940 Act funds (that are listed or operate as interval or tender offer funds) and business development companies (BDCs), can invest substantially all of their portfolios in alternative assets, thereby providing plan participants greater freedom of choice to incorporate alternative asset-centric strategies. Moreover, these Regulated Alternatives Funds offer the same investor protections of the 1940 Act, including with respect to fees, leverage, independence and public reporting.

Below, we identify ways in which the DOL can modify its proposed rule to expand plan participants' access to alternative investments through Regulated Alternatives Funds on plan menus. We also discuss one specific way that the Securities and Exchange Commission (SEC) can take action that would enable Regulated Alternatives Funds to more easily fit within the safe harbor proposed by the DOL.

Overview of proposed rule

Pursuant to the Executive Order, the proposed rule seeks to reduce litigation risk that currently disincentivizes plan fiduciaries from offering alternative investments on plan menus. To achieve this objective, the rule proposes a process-based safe harbor that includes six factors for a plan fiduciary to consider when selecting investment options for the plan menu. If a plan fiduciary objectively, thoroughly and analytically considers the six factors following the processes described below, its judgment regarding the factor is presumed to be reasonable and, according to the proposed rule, is entitled to significant deference.

The six factors are:

- **Performance**: The fiduciary must consider a reasonable number of similar investment options and determine that the risk-adjusted expected returns of the chosen investment option, over an appropriate time horizon and net of anticipated fees and expenses, furthers the purposes of the plan. The fiduciary should not focus solely on expected returns, but must also account for the risks of the investment and the risk capacities of the plan participants.
- **Fees**: The fiduciary must consider a reasonable number of similar investment options and determine that the fees and expenses of the chosen investment option are appropriate, taking into account its risk-adjusted expected returns, net of fees and expenses, and any other "value" it brings. Other values include benefits, features or services other than risk-adjusted returns net of fees.
- **Liquidity**: The fiduciary must consider whether the investment option will have sufficient liquidity to meet the anticipated liquidity needs at both the plan and individual participant levels. While fiduciaries are not required to offer fully liquid options, they must ensure that the chosen investment option can satisfy any promises of liquidity that are made to plan participants.
- **Valuation**: The fiduciary must consider whether the investment option has adopted adequate measures to ensure that it is capable of being timely and accurately valued in accordance with the needs of the plan.
- **Benchmarking**: The fiduciary must consider whether the investment option has better performance than a "meaningful benchmark." A meaningful benchmark is defined as "an investment, strategy, index, or other comparator that has similar mandates, strategies, objectives, and risks to the designated investment alternative." Notably, the meaning of "meaningful benchmark" is the subject of litigation in the *Anderson v. Intel Corporation* case at the Supreme Court level; it remains to be seen how a DOL definition will impact or interact with a Supreme Court interpretation.
- **Complexity**: The fiduciary must consider whether it has the skills, knowledge, experience and capacity to sufficiently comprehend the complexity of the investment option, or whether it must seek assistance from a qualified investment advice fiduciary or other adviser.

Measures to expand access to alternative investments through Regulated Alternatives Funds on plan menus

Do not use 1940 Act mutual fund standards as the guidepost for the liquidity factor

Because mutual funds are required under the 1940 Act to adopt and implement liquidity risk management programs, the DOL states that a plan fiduciary selecting mutual funds as investment options is deemed to have met the liquidity standard under the safe harbor. For other funds, however, the examples in the proposed rule suggest that plan fiduciaries should have assurances from fund managers that the funds have adopted and implemented liquidity risk management programs *substantially similar* to those required under the 1940 Act.

Using the 1940 Act requirements for mutual funds as the guidepost for liquidity presumes that the daily liquidity offered by mutual funds is necessary — or at least preferable — for plan participants. However, as the DOL itself acknowledges in the proposed rule, 401(k) and other participant-directed individual account plans are long-term retirement savings vehicles, and a prudent fiduciary process may lead to a decision to sacrifice some liquidity in the pursuit of additional risk-adjusted return. In the preamble to the proposed rule, the DOL recognizes that "[m]any retirement savers, particularly younger workers, have long investment time horizons until retirement and, therefore, fit the profile of an investor who can benefit from a liquidity premium" and then goes on to say that "[t]o achieve the goal of clarifying that ERISA gives fiduciaries the discretion to offer designated investment alternatives that contain illiquid alternative investments, the regulation also provides that plans do not need to offer fully liquid investment options."

Compliance with a daily liquidity requirement may result in fiduciaries sacrificing higher risk-adjusted returns offered through more illiquid investment options. And since plan participants should be afforded the agency to choose alternative assets and strategies aligned with their individual goals, we propose that the DOL adopt a different standard for its liquidity factor given that Regulated Alternatives Funds are intentionally not required to offer the same level of liquidity as mutual funds under the 1940 Act.

We also propose that the DOL set a maximum liquidity timing limit for vehicles that do not provide daily redemption rights, such as a quarterly periodic liquidity limit as we discussed in our prior client update, which is common among Regulated Alternatives Funds. If fiduciaries select Regulated Alternatives Funds that provide periodic liquidity with a frequency that falls within the maximum timing limit and satisfy any other liquidity requirements to which such funds are subject under applicable regulations, they should be deemed to have met the safe harbor's liquidity factor.

In addition, we believe that it is critical for the proposed rule to make clear that it applies to funds that offer liquidity through means other than redemption rights. In the DOL's proposed rule, it is unclear when a fund's liquidity risk management program is considered substantially similar to that required under the 1940 Act. Mutual funds offer liquidity through redemption rights, but Regulated Alternatives Funds offer liquidity through other means. Listed closed-end funds and BDCs offer ongoing liquidity by being listed on national securities exchanges, and unlisted closed-end funds and BDCs generally offer liquidity through periodic repurchase offers or liquidation after a specified period of time. By referencing the 1940 Act mutual fund liquidity requirements, the proposed rule implicitly excludes many Regulated Alternatives Funds from the scope of the safe harbor.

Be more practical on conflicts management for the valuation factor

The DOL's examples suggest that plan fiduciaries should have assurances from fund managers that private assets held by the funds are valued no less frequently than quarterly through an *independent*, *conflict-free* process consistent with Financial Accounting Standards Board requirements. The DOL does not clarify what constitutes such a process, but the language of the proposed rule suggests that the valuation process must be devoid of all conflicts and can only take into account inputs from third-party agents. Such a standard would have a disproportionate impact on Regulated Alternatives Funds, as many hold private assets. It also goes beyond the requirements of the 1940 Act itself and does not align with current best practices of how most Regulated Alternatives Funds conduct valuation processes, interact with independent valuation firms and manage the associated conflicts of interest. Furthermore, this standard is likely unattainable for fund managers who have multiple funds across successful platforms — the type of fund managers whom we believe the DOL seeks to encourage to participate in the democratization of private assets under the proposed rule.

We propose that the DOL adopt a more practical approach for valuing private assets in a fund. Instead of requiring a conflict-free process, the DOL can simply deem a Regulated Alternatives Fund's valuation process under the 1940 Act sufficient to satisfy the valuation factor. By doing so, the DOL will not be sacrificing investor protection, since the 1940 Act already imposes a robust framework for valuation, and the associated oversight of valuation processes, of such Regulated Alternatives Funds (e.g., by requiring oversight of such processes by the fund's independent board of directors and registered investment adviser).

Strengthen the proposed safe harbor by setting clearer parameters and covering the duty to monitor

While not specific to the goal of expanding access to alternative investments through Regulated Alternatives Funds, we propose that the DOL strengthen the safe harbor by setting more concrete parameters for certain factors, to the extent possible, and covering the duty to monitor.

With respect to more concrete parameters, in our prior client update we had proposed thresholds for fees that, if satisfied, would result in a fiduciary being deemed to have satisfied the fees factor of the safe harbor. More specifically, we had proposed that if the selected Regulated Alternatives Fund's expense ratio was not in the highest quintile of expense ratios of a group of comparable funds selected by an independent benchmarking service, the fees factor be deemed automatically satisfied. By adopting similar thresholds for at least the more objective factors like performance, the DOL can further reduce the risk of excessive litigation.

We also propose that the DOL expand the safe harbor to cover the duty to monitor. The reason is simple — absent a similar safe harbor for the duty to monitor, even if plan fiduciaries get comfortable that their initial selection of investments for inclusion on plan menus will be presumed to be prudent, their ongoing retention of such investments may open them up to litigation, and much of the litigation in this space has focused on the retention of investments after the initial selection. We propose that the DOL clarify that if a fiduciary objectively, thoroughly and analytically considers and makes

determinations on each investment option in view of the safe harbor factors on at least an annual basis, it will be deemed to have satisfied its duty to monitor. This annual review cadence would be consistent with the requirements applicable to periodic reviews of investment advisory contracts under the 1940 Act, which also envisions the monitoring of an investment product by a fiduciary.

The SEC can amend Rule 17a-7 under the 1940 Act to help Regulated Alternatives Funds more easily fall within the proposed DOL safe harbor

The Executive Order instructed the SEC, in consultation with the DOL, to consider ways to facilitate retirement account access to private investments. In furtherance of this mandate, we believe there are certain regulatory changes the SEC could make to facilitate the inclusion of Regulated Alternatives Funds on plan menus. In particular, we believe the SEC could amend Rule 17a-7 under the 1940 Act to allow Regulated Alternatives Funds to increase their liquidity — a core factor under the DOL safe harbor — through cross-trading with affiliated funds, which could serve to significantly facilitate the inclusion of Regulated Alternatives Funds on plan menus.

Sections 17 and 57 of the 1940 Act generally restrict the ability of 1940 Act-regulated funds to engage in purchase and sale transactions with affiliated funds (cross-trades). Rule 17a-7 exempts certain cross-trades from these restrictions. To fall under the Rule 17a-7 exemption, cross-trades must (1) involve a purchase or sale, only with cash consideration, of a security for which market quotations are readily available and (2) be effected at the independent current market price of the security, among other requirements. These requirements currently limit the ability of 1940 Act-regulated funds to cross-trade illiquid private assets with affiliated funds. As Regulated Alternatives Funds may invest significantly in private assets, Rule 17a-7 as it stands now greatly restricts a Regulated Alternatives Fund's ability to access liquidity through cross-trades with affiliated funds.

Cognizant of the need to expand the availability of the Rule 17a-7 exemption in general, the SEC is already considering amendments to the Rule, as mentioned in its most recently published regulatory agenda. Industry participants are also lobbying the SEC to amend Rule 17a-7 to specifically allow for cross-trades of private assets. We believe the SEC should use this as an opportunity to follow the Executive Order's direction and adopt amendments to Rule 17a-7 to allow Regulated Alternatives Funds to generate liquidity — to meet the requirements of retirement plans and their participants — by selling private investments to affiliated funds (with appropriate safeguards).

While the private investments held by Regulated Alternatives Funds will generally be illiquid Level 2 or Level 3 assets for which market quotations may not be readily available, we do not believe that should be a reason for the SEC not to extend Rule 17a-7 to cross-trades involving those assets. In particular, Rule 2a-5 under the 1940 Act already provides a robust framework for the valuation of a Regulated Alternatives Fund's assets under the supervision of the Fund's independent board of directors. The valuations derived by a Regulated Alternatives Fund and its adviser under Rule 2a-5 are already used to price both purchases and redemptions or repurchases of the fund's shares at net asset value. If these valuation methodologies are robust enough to support these core transactions for a Regulated Alternatives Fund, there is no reason that they should not also be reliable enough to use as the pricing for a cross-transaction under Rule 17a-7. While there are of course conflicts for a Regulated Alternatives Fund's adviser inherent in a cross-trade, there are conflicts involved in most situations in which valuations are used (e.g., calculating an adviser's management fee). Indeed, an affiliated fund could today permissibly invest in a Regulated Alternatives Fund based on its Rule 2a-5-derived net asset value, which presents very similar conflicts to a cross-trade between the funds. We believe boards of regulated funds should be free to approve the use of cross-trades for their funds and to implement the procedures they believe appropriate to monitor such trades and the valuation used for them.

Conclusion

The DOL has taken a significant step in providing a safe harbor for plan fiduciaries to meet their duty of prudence in selecting alternative investments for the plan menu. However, the proposed safe harbor tilts toward including alternative assets through asset allocation funds, and the risk of excessive litigation still looms large. By adopting the measures suggested above, the DOL and the SEC can move one step closer to truly achieving the Executive Order's goals of "democratizing access to alternative assets" and reducing "burdensome lawsuits."

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Leor Landa
+1 212 450 6160
leor.landa@davispolk.com

Oran Ebel
+1 212 450 4114
oran.ebel@davispolk.com

Christopher P. Healey
+1 202 962 7036
christopher.healey@davispolk.com

Michael S. Hong
+1 212 450 4048
michael.hong@davispolk.com

Gregory S. Rowland
+1 212 450 4930
gregory.rowland@davispolk.com

Aaron Schlaphoff
+1 212 450 4244
aaron.schlaphoff@davispolk.com

Elise M. Dolan
+1 212 450 4037
elise.dolan@davispolk.com

Leon E. Salkin
+1 212 450 3395
leon.salkin@davispolk.com

Matthew R. Silver
+1 212 450 3047
matthew.silver@davispolk.com

Chaoyuan (Charles) Shi
+1 212 450 3346
charles.shi@davispolk.com