

Alternative Investments in ERISA Retirement Plans: Mitigating Liability Risks for Hedge and Private Equity Funds and Pension Plan Fiduciaries

Exercising Due Diligence to Avoid Investment Landmines for Institutional Investors and Fund Managers

WEDNESDAY, MAY 24, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Dr. Susan Mangiero, Managing Director, **Fiduciary Leadership**, Trumbull, Conn.

Tiffany N. Santos, Director, **Trucker Huss**, San Francisco

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**Alternative Investments in ERISA
Retirement Plans: Mitigating Liability
Risks for Hedge and Private Equity
Funds and Pension Plan Fiduciaries**
**Exercising Due Diligence to
Avoid Investment Landmines
for Institutional Investors and Fund Managers**

Faculty:

Dr. Susan Mangiero (Fiduciary Leadership, LLC)

Tiffany N. Santos, Esquire (Trucker Huss)

May 24, 2017

1:00 pm to 2:30 pm EDT

SPEAKER BIOS



Susan Mangiero, PhD

AIFA®, CFA®, CFE, FRM®, PPC™

- Dr. Susan Mangiero is a managing director with Fiduciary Leadership, LLC. She is a CFA® charterholder, certified Financial Risk Manager®, Certified Fraud Examiner, Accredited Investment Fiduciary Analyst™ and Professional Plan Consultant™.
- She has provided testimony and behind-the-scenes forensic analysis, calculation of damages and rebuttal report commentary for various investment governance, investment performance, fiduciary breach, prudence, risk and valuation matters. Her work includes compliance, enforcement and litigation matters involving hedge funds, private equity funds, real estate, commodities and other types of alternative investments and strategies.
- She has over 20 years of experience in capital markets, global treasury, asset-liability management, portfolio management, economic and investment analysis, derivatives, financial risk control and valuation. This includes work on trading desks for several global banks, in fixed income, foreign exchange, interest rate swaps, futures and options.
- She is a frequently invited speaker and has keynoted or led workshops for organizations such as the Stable Value Investment Association, Harvard Law School, AICPA – Employee Benefits Section, National Association of Corporate Directors and Financial Executives International.
- Susan can be reached at contact@fiduciaryleadership.com or (203) 261-5519.



Tiffany N. Santos Esquire

Tiffany N. Santos is a director with Trucker Huss. She counsels employers and multiemployer trusts on all aspects of their employee benefit plans, including health and welfare plans, Section 125 cafeteria plans, and qualified retirement plans. She is a frequent speaker on health plan matters, including health care reform, HIPAA, COBRA, and cafeteria plans, and on investment-related matters, including ERISA's impact on alternative investments.

Tiffany can be reached by sending an email to tsantos@truckerhuss.com or calling 415-421-2017.

HEDGE FUND AND PRIVATE EQUITY FUND CONSIDERATIONS

ERISA Plans and Investing in Alternatives

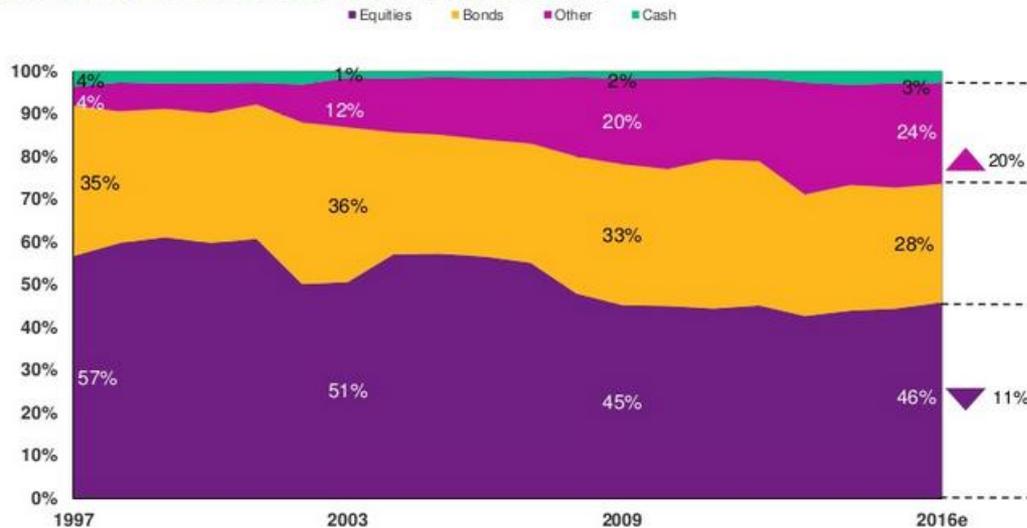
- Surveys show increased allocations to alternatives
- Credit crisis of 2008 resulted in liquidity and trading risk “surprises”
- New rules regarding disclosures
- Regulatory focus on alternatives

Asset Allocation Trends

P7

Pension asset allocation

Aggregate P7 asset allocation from 1997 to 2016



Source: Willis Towers Watson and secondary sources

- Since 1997, bonds, equities and cash allocations have been reduced to varying degrees while allocations to other assets (real estate and other alternatives) have increased from 4% to 24%
- Pension fund assets managed by the top 100 alternative asset managers amount to USD 1,492.8 billion in 2016 according to Willis Towers Watson's [Global Alternatives Survey](#)

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Willis Towers Watson 25

Hedge Funds in 401(k) Plans

- “Liquid alternative mutual funds are growing faster than any other segment of the \$15 trillion mutual fund industry, according to Morningstar research. Assets rose to \$285 billion in the first quarter of 2014. There are more than 500 alternative funds competing for investors’ retirement money. To put their nascence in perspective: over half of those have been created since 2008.”
- “A recent [s]urvey conducted by Pimco’s DC practice probed 49 consulting firms that serve 7,800 clients with aggregate DC assets in excess of \$2.8 trillion. Nearly all of the consultants surveyed (98 percent) support or strongly support the use of alternatives in custom target-date funds. What those consultants are saying is clear: the biggest risk in alternatives is in not accessing them.”

Alternative Investments

- Generally involves “direct” investment in a limited partnership, LLC or collective trust
- Offering documents
 - Private placement memorandum, limited partnership agreement, subscription agreement, etc.
 - Generally very little room for negotiation of terms
 - If plan will be a part of the initial closing, may be able to negotiate terms of governing documents
 - Contract terms may be negotiated in a side letter

Some Questions About Investing in Alternatives

- Will the investment further the plan's diversification objectives?
- What are the risk and return characteristics of the investment?
- How will the investment be categorized? As Equity? Fixed Income? Hedge Funds? Private Equity Funds? Alternatives? Other?
- Will the investment affect the plan's liquidity and/or funding needs?
- What is the vehicle? Direct investment? Fund of funds? Mutual fund? Exchange Traded Fund? Other?
- Will the investment result in a prohibited transaction?
- Do the plan documents permit the investment? (e.g., investment policy statement)

Decision Making

- Who is responsible for making investment decisions for the investment vehicle?
 - Is it the plan fiduciary?
 - i.e., Board of Trustees, investment committee, delegated chief investment officer, etc.
 - Is there an investment manager?
 - Is the general partner the investment manager or is there a separate investment manager?
 - Will the investment manager acknowledge that it is a fiduciary under ERISA?
 - Is an investment consultant/fiduciary involved?
 - Does an outside party serve as fiduciary?

Due Diligence “To Do” Items

- Understand underlying reasons for items on checklist
- Assess risk holistically – not just legal or financial risk
- Hire outside experts with the ability to kick the tires on pricing models and valuation, review vendor contracts, ensure that internal controls are in place, monitor quality and quantity of collateral related to derivatives trading and structured finance investments
- Ask to meet with the Chief Risk Officer, Chief Compliance Officer, Senior Marketing Executive, Head of Sales Team
- Review financial statements over a sufficiently long “enough” period to assess whether they reflect expected returns for a given strategy and whether they comport with industry best practices for reporting

More Due Diligence “To Do” Items

- Ask about the existence of side pockets, side letters, restrictions on liquidating assets, ownership of voting rights as relates to the fund’s ability to restructure if needed
- Assess conflicts of interest
- Gauge whether alternative fund managers have policies in place for prohibited transactions and party-in-interest trades
- Ask about strategy and latitude regarding investment drift
- Query about diversification of client (investor) base
- Understand legal structure and existence of feeder funds

Lock-Up and Withdrawal Rights

- Is there a lock-up period?
 - Initial period of time during which investors may not withdraw investment
- What are the plan's withdrawal rights?
 - Withdrawal rights may be limited
 - May be limited to instances when continued investment by the plan would result in a breach of fiduciary duty, for example
 - Can the plan withdraw without penalty?
 - Early withdrawal may trigger valuation issues
 - Payment upon withdrawal may be in a form other than cash (i.e., in-kind) – can plan manage the distributed assets?

ERISA ASSET LIMITS AND IMPLICATIONS

25 Percent Threshold

- Once threshold is met, the fund is subject to the following significant requirements and obligations:
 - The fund manager becomes an ERISA fund manager creating co-fiduciary liability. Fund managers and plan trustees are thus liable for each other's actions.
 - Certain limitations with respect to block trades and cross trades.
 - Fund documents must be reviewed for compliance with ERISA laws.
- The 25% threshold is calculated each time there is a change in ownership of equity interest of the fund.
 - Calculation only includes limited partners' capital. Controlling equity interest of the fund is not included.
- 25% threshold is calculated on each class of partners' capital.

ERISA Assets and Controls

- Ensure controls are in place to monitor the 25% threshold. These can include controlling redemptions and capital contributions so that the threshold is not inadvertently crossed.
- It may be necessary to adjust operating documents to add redemption provisions. Such provisions may be:
 - Preventing non-benefit plan investors from receiving a distribution that would cause the fund to fail the 25 Percent Test and
 - Requiring benefit plan investors to take distributions from the fund if it is necessary for the fund to continue to pass the 25 Percent Test.
- Regardless of what internal controls are in place, managers should review all fund documents to determine what steps need to be taken to avoid violating the 25% test.

Venture Capital Operating Company

- Vehicle is a VCOC if at least 50% of its first and subsequent investment(s) is in one or more operating companies for which the vehicle has management rights that it actually exercises each year

Real Estate Operating Company

- Vehicle is an REOC if at least 50% of its first and subsequent investment(s) is in real estate for which the vehicle has management rights that it actually exercises each year

Contract Considerations

- VCOC and REOC exemption from plan asset rules
 - DOL view: where an investment vehicle has rights that are considerably greater than the rights of an ordinary investor, and exercises those rights, the investment vehicle is acting more like an operating company managing a business than as an investment company
 - Therefore, the general partner/manager should not be considered an “investment manager” subject to ERISA fiduciary rules

Contract Considerations

- Kick the tires – ask to see documents upon which VCOC/REOC opinion is based
- Require manager to monitor exemption, certify annual compliance with exemption and immediate notify if exemption not met
- What happens if exemption not met?
 - Appointment as fiduciary and investment manager?
 - Withdrawal right

ERISA FIDUCIARY DUTIES AND ROLES

Fiduciary Duties



Source: <http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html>

Plan Fiduciary's Responsibilities

- As legal counsel to plans, note that the following are the ERISA fiduciary duties that drive the selection and retention of investment consultants/advisers and managers
 - Discharge duties solely in the interest of plan participants and beneficiaries
 - For the exclusive purpose of providing benefits to participants and their beneficiaries and to defray expenses of administering the plan

Plan Fiduciary's Responsibilities

- Must act with the care, skill, prudence and diligence of a prudent man acting in a like capacity and familiar with such matters would use under similar circumstances
- Diversify plan's investments so as to minimize risk of large losses
- Discharge duties in accordance with plan documents and instruments
- ERISA compliance is process driven

Plan Fiduciary's Responsibilities

- Background – ERISA requires plan fiduciaries to administer and manage plans prudently
 - If plan fiduciaries lack investment expertise, may consider hiring investment consultant and other advisers/managers with appropriate knowledge and expertise to invest plan funds
- Any such contract or arrangement and compensation must be reasonable – ERISA Sec. 408(b)(2), Labor Reg. Sec. 2550.408(b)-2

Contract Considerations Regarding Investment Managers

- Fiduciary status
 - Is the manager a fiduciary within the meaning of ERISA Sec. 3(38)?
 - Does the manager exercise any discretionary authority or control regarding the management and disposition of plan assets?
 - Is the manager any of the following:
 - Registered as an investment adviser under the Investment Advisors Act of 1940 or otherwise exempted under such Act because it is registered under applicable State law; or
 - A bank;
 - An insurance company qualified to perform investment management services under the laws of more than one State
 - If the manager is none of these, it cannot be designated as an “investment manager” under ERISA
 - Will the manager acknowledge fiduciary status in the contract?

Considerations for Investment Management Contracts

- Shift of fiduciary liability/responsibility to investment manager
 - ERISA Sec. 405(d): if an investment manager has been appointed, no trustee shall be liable for the acts or omissions of such manager or be under any obligation to invest or otherwise manage any asset of the plan which is subject to the management of such manager
 - But, plan fiduciary remains responsible for prudently selecting and monitoring manager

Considerations for Investment Manager Contracts

- Bonding requirement (ERISA Sec. 412)
 - Does the service provider “handle” plan assets? See Labor Regs. Sec. 2580.412-6
 - Prohibited transaction
 - Will any PTEs apply? (e.g., agency cross transactions)
 - To the extent investment strategy permits allocation of funds to an affiliate of the investment manager, will the manager receive any fees or other compensation in connection with such allocation?

Considerations for Investment Manager Contracts

- Will the indicia of ownership of the plan's assets remain within the jurisdiction of the U.S. district courts?
 - If plan assets will be maintained outside the jurisdiction of the U.S. district courts, will the requirements of Labor Reg. Sec. 2550.404b-1 be satisfied?

Considerations for Investment Manager Contracts

- Proxy voting – has investment manager adopted written policies and procedures for exercising proxy voting in the best interest of the plan?
 - See Labor Reg. Sec. 2509-94-2 Interpretive Bulletin
 - Such policies and procedures must be disclosed to plan
 - Investment manager must keep accurate written records of its exercise of all ownership rights of securities under its management
 - Provide reports to plan annually and upon request

Considerations for Investment Manager Contracts

- Does the contract allow the plan to terminate contract without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into a disadvantageous arrangement?
 - See Labor Reg. Sec. 2550-408b-2(c)
- Does the contract require the manager or consultant to maintain errors and omissions insurance (includes fiduciary liability)?

Other Contract Considerations

- Will the investment generate “unrelated business taxable income” (UBTI)?
 - When will K-1 be provided? Estimate?
- Confidentiality requirement
- Memorialize ERISA fiduciary obligations (standard of care, obligation to act solely in the interest of the plan, etc.)
 - Is the manager a QPAM?
- Distributions – in-kind, in currency other than USD, notification prior to distribution

DISCLOSURES AND INFORMATION ACCESS

ERISA Section 101(k)

- Multiemployer plan
 - Will alternative investment vehicle's reports include proprietary information for purposes for ERISA Sec. 101(k)?

Purpose of Side Letters

- Side letter provisions are intended to help plan fiduciaries demonstrate that they have prudently selected investment and have implemented procedures to help plan monitor the investment

SEC Review

- Side Letters
 - SEC continues to review side letters of investment managers.
 - If a side letter provides rights to investors that are different enough from those of other investors that constitute a separate “class” of equity interests, the fund, depending on the composition of investors in each class, could be deemed to be holding the “plan assets” of benefit plan investors.
 - The manager would thus be deemed an ERISA fiduciary.
 - Best Practices:
 - Managers should consider early in planning stages of the fund what side letter provisions may be granted.
 - New funds should be created with flexibility to create and issue new share classes

Questions to Ask

- Funds that offer MFN provisions should monitor side letters on an ongoing basis
- Consider creating a managed account if side letter creates fiduciary concerns to other investors
- As an investor, ask to see terms of all side letters before investing in a fund
- Determine nature of documents for onshore versus offshore versus non-U.S. fund managers
- Assess whether fund documents comport with industry accepted practice

Calendar Considerations

- Do fiscal year of plan and investment vehicle run concurrently?
 - If not, plan's financial statements may not include appropriate valuations of the investment

Suggested Components

- Negotiate obligation to notify plan of:
 - Withdrawal of any investor
 - Any delivery of any notice of withdrawal on the basis that the investor believes that the investment vehicle ceases to satisfy an exception to the “plan asset” rules
 - Any developments with respect to the general partner or partnership or affiliates which would have a material adverse effect
 - All material facts with respect to general partner’s financial condition or to legal or disciplinary actions that may impair its ability to meet its obligations under the investment’s governing documents
 - Any request for indemnification, claim on insurance

More Items to Include

- Keyman provision - e.g., provide for withdrawal without penalty if a key investment professional departs
- Confidentiality provision
- MFN language
 - General partner may be reluctant to disclose arrangements with other investors for confidentiality reasons

Bonding, Insurance and Clawbacks

- Obligation to maintain liability insurance coverage
- Bonding requirement, if applicable
- Provisions regarding clawback
 - From general partner/manager – must it return any fees it received (e.g., failing to meet minimum rate of return on wind-up)
 - From investors – any obligation to return distributions (e.g., for indemnification obligation)

Fees and Federal Reporting

- Will financial information be provided to plan to enable plan to timely file Form 5500 and other required returns?
(Schedule C)
- Are the total fees paid to the general partner reasonable?
 - What is the compensation?
 - Investment management fee
 - General partner distributions
- Does 408(b)(2) disclosure reg apply?

General Contract Requirements

- Must disclose all services to provided to the plan under the contract
- Must disclose the service provider's compensation or fees
 - Money or any other thing of monetary value (e.g., gifts, awards, trips, etc.)
 - Received or to be received directly from the plan or plan sponsor or indirectly from any other source
 - By the service provider or its affiliate in connection with the services provided under the contract or because of the position of the service provider or an affiliate with the plan

VALUATION

Market Valuation Requirements

- July 1, 2008 letter from DOL Boston office
 - Plan fiduciaries must have a process in place to independently value alternative assets.
 - “A process which merely uses the general partner's established value for all funds without additional analysis may not insure that the alternative assets are valued at fair market value.”
 - Asset at issue in letter was valued “at cost”, not “fair market value”
 - “If you take proper corrective action, then the department will not bring a lawsuit with regard to these issues.”

Challenge of Getting Valuation Information

- Dilemma: plan fiduciaries are responsible for investments in alternative vehicles, but investment manager may not provide sufficient information to plan fiduciaries to value these “hard-to-value” assets
 - Information disclosed by managers often is limited for competitive reasons

Reliance on General Partners

- “A process which merely uses the general partner's established value for all funds without additional analysis may not insure that the alternative assets are valued at fair market value.”
 - At negotiation stage, ask general partner how assets are valued (estimated fair market value?)

Role of Independent Appraiser

- Plans may need to independently value alternative assets
 - Many plans rely on the financial statements of general partners to report the value of those investments in their Form 5500s
 - Some have opined that the DOL letter may require plan fiduciaries to incur new expense and workload
 - May need to hire appraisal firms, investment banks or new in-house staffers with appraisal expertise

Other Valuation Process “To Do” Items

- Understand manager’s valuation practices
- Distinguish between market valued portfolios and assets that mostly require fair valuation
- Request reports of manager’s evaluations of its valuation process (if the manager doesn’t evaluate the efficacy of its valuation process, that’s a red flag)

LITIGATION AND LESSONS LEARNED

Lessons from Recent Litigation

- Saint Vincent Catholic Medical v. Morgan Stanley
 - Plan invested in high risk mortgage-backed securities as part of its fixed income portfolio – alleged breach of fiduciary duty of prudence
- Tibble v. Edison International, U.S. 135 S. Ct. 1823 (2015)
 - Under ERISA, duty of prudence requires fiduciary to monitor investments continually and to remove imprudent ones
 - Must give appropriate consideration to whether an investment is reasonably designed as part of the portfolio to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment
- Trout v. Oracle Corp., 2017 WL 663060 (D. Colorado)
- Tatum v. RJR Pension Invs. Comm., 2017 WL 1531578 (4th Cir. 2017)

Lessons from Recent Litigation

- Proposed class actions against retirement plans of 12 universities
 - Henderson v. Emory Univ., N.D. Georgia
 - Clark v. Duke Univ., M.D. North Carolina
- Johnson v. Fujitsu Technology and Business of America, Inc. (N.D. Cal)
 - Alleged excessive fees and imprudent target date funds (imprudent in light of their cost, performance and underlying inappropriate and speculative investments)
- Sulyma v. Intel Corporation Investment Policy Committee, 2016 WL 7740523 (N.D. Cal)
 - Alleged imprudent custom target date funds and excessive fees (40% of TDFs in alternative investments – private equity, hedge funds, and commodities)

Lessons from Recent Litigation

- Fiduciary must have a prudent process when selecting and removing investments
 - Prudence standard focuses on fiduciary's conduct in arriving at investment decision, not on results (i.e., returns) – were appropriate methods used to investigate and determine merits of investment
 - Strong deliberative process
 - Rationale for selection
 - Continuous duty to monitor/oversee investments
 - Performance/underperformance (benchmark, watchlist, etc.)
 - Fees
 - Compliance with plan documents, including investment guidelines

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