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ERISA Benefit Plan Investment Management Agreements: Selecting 3(38) Investment Managers, Structuring the IMA

Documenting the Relationship to Minimize Risks for Plan Sponsors and Investment Advisors

TUESDAY, APRIL 16, 2019

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ERISA Benefit Plan Investment Management Arrangements

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Presentation Overview

I. Trustees, Fiduciaries and Investment Managers

II. Negotiating Investment Management Agreements

III. ERISA Considerations When Investing in Private Funds

IV. Questions

Part I

Trustees, Fiduciaries and Investment Managers

Trustees

- One goal of ERISA was to delineate responsibility and liability for investing plan assets.

- **ERISA Section 403** provides that all plan assets be held in trust and that the Trustees have exclusive authority and discretion to manage and control the plan' s assets, except to the extent that —
  - the plan provides that the Trustees are subject to the proper direction of a named fiduciary; or
  - authority to manage acquire or dispose of the plan assets is delegated to one or more investment managers

- **Discretionary Trustees** are trustees who retain investment discretion, these tend to be individuals, Taft/Hartley plan trustees, smaller plan trustees and trustees of bank collective investment trusts

- **Directed Trustees** are Trustees that follow the directions of Named Fiduciaries or Investment Managers, these tend to be banks and there function is to custody the plan's assets

Named Fiduciaries

- Every plan must have a Named Fiduciary

- A Named Fiduciary is a fiduciary named in the plan or is identified as a fiduciary under a procedure specified in the plan document

- A Named Fiduciary can appoint Investment Managers to manage assets of the plan

- This power to appoint Investment Managers is not a “trustee responsibility” and can be properly delegated to another fiduciary

Investment Managers

- Investment Managers have discretionary authority to invest plan assets

- Investment Managers MUST BE:
  - Registered with the SEC an investment advisers, including “relying advisers” but not “exempt reporting advisers”
  - Unable to register with the SEC, but registered with the State of their principle place of business
  - A bank or
  - An insurance company

- Investment Managers must acknowledge in writing that they are acting as fiduciaries to the plan

Delegation Issues

- Named Fiduciary can delegate responsibility and liability for investing plan assets to an Investment Manager; this delegation can include the authority to appoint other Investment Managers

- The appointment of an Investment Manager is subject to the ERISA fiduciary standards: to act prudently and for the exclusive benefit of the plan's participants
  - Diversification and scope of the appointment
  - Selection and due diligence of the Investment Manager
  - Fees and expenses of the investment
  - Ability to avoid prohibited transactions

- Monitoring the ongoing activity of the Investment and the Investment Manager
  - Performance
  - Proxy voting
  - Compliance
  - Reporting

Part II

Negotiating Investment Management Agreements

Issues For Negotiation Under Investment Contract

Negotiations Over Investment Management Agreement or Side Letter To Commingled/Collective Investment Documents

- **Separate account** – negotiating terms of direct investment management agreement

- **Commingled fund** – negotiating terms of plan’s side letter to supplement the fund documents that apply to the plan investor

- **Non-Plan asset investment** – negotiating side letter (usually) to “clarifies” fund documents that apply to all investors

Issues For Negotiation Under Investment Contract

Standard of Care

– For ERISA fiduciary manager = ERISA fiduciary standard

– If not ERISA fiduciary manager (because one of the exceptions applies) = negotiate whether ERISA-<u>like</u> contractual standard or ERISA-<u>light</u> contractual standard (prudence standard only)

Issues For Negotiation Under Investment Contract

Indemnification

- **Relevant whether ERISA fiduciary manager or not**

- **Investment documents should (try) to:**
  - Require manager to indemnify Plan and Trustees
  - Often mutual/parallel indemnification by plan of manager and manager of plan
  - If so, make clear that ERISA plan – AND NOT TRUSTEES—liable for any indemnification
  - Beware of "signatory below shall indemnify......"

Issues For Negotiation Under Investment Contract

Fees

- **Most Favored Nations (“MFN”) Treatment on Fees, Rights and Features**
  - All investors?
  - Similar sized investors?
  - Count affiliated investor plans?

- **Incentive Fees**
  - Warrant under DOL guidance?
  - Valuation of Portfolio and Potential Conflicts

- **Claw back If Incentive Fees**
  - Avoid *heads manager wins, tails fund loses*
  - How is high-water mark for payment of incentive fees set and reset?

Issues For Negotiation Under Investment Contract

- **More Fees -- Unrelated Business Taxable Income**
  - Effort to avoid?
  - Protections if taxable income is earned?
  - Impact of tax on net return/incentive fee?

- **Key Man Provisions – If strategy depends on superstar/few key people, what happens if they are unwilling or unable to continue to manage investment?**

Issues For Negotiation Under Investment Contract

Confidentiality

- **When can manager release ERISA plan's information?**
  - What notice is required to plan?
  - Disclose to manager's potential clients?
  - When can plan prevent disclosure?

- **When can ERISA plan release information about investment?**
  - Any limits on what ERISA plan can disclose?
  - What notice is required to manager?
  - Disclose to plan's professionals to operate ERISA plan?
  - When can manager prevent disclosure?
  - Section 101(k) for multiemployer plans

- **Special issue – DOL, IRS audits**

Issues For Negotiation Under Investment Contract

Reporting

- Sufficient for ongoing monitoring by plan’s investment consultant?
- Sufficient for ERISA plan’s auditor to prepare financial statements?
- ERISA plan auditor needs financial statement of underlying investments “tiered” investment structure – example, in hedge fund.

Issues For Negotiation Under Investment Contract

- **Conflicts of Interest**
  - Avoided, either because manager is ERISA fiduciary or by contract?
- **Bonding**
  - ERISA Section 412 requires any person handling plan assets to be bonded
  - ERISA fiduciary manager should have own bond
- **Proxies**
  - Agreement should make clear who votes proxies (if any)

Issues For Negotiation Under Investment Contract

- **Termination of Agreement**
  - For separate account investment, usually at any time
  - If commingled/collective vehicle – what is frequency/ liquidity?
  - Timing of notice

- **Redemptions/Liquidation of Investment**
  - <u>When and with what notice period?</u>
  - Does strategy make liquidation impractical or inadvisable even if unrestricted?
  - What is fund getting back—in kind securities or cash?
  - If in kind securities, who manages until liquidated and for what fee?

What Is A QPAM?

- "**Qualified Professional Asset Manager**" ("QPAM") is investment professional that meets regulatory and asset minimums under Prohibited Transaction Exemption (PTE) 84-14.

- PTE 84-14 is a class exemption – applies to transactions that meet the rules in PTE – no separate filing with DOL to meet exemption.

- Under PTE 84-14, as amended, QPAM is entity meeting definition of investment manager that also has substantial assets
  - Bank with equity capital in excess of $1,000,000
  - Insurance company with net worth in excess of $1,000,000, or
  - Registered investment adviser with total client assets under management in excess of $85,000,000 and with partners/shareholders equity in excess of $1,000,000.

Rules to Meet QPAM Exemption

QPAM transaction must meet following rules:

- Assets of plan (and related plans) in transaction cannot exceed 20% of all assets managed by QPAM.

- Terms of transaction must be at least as favorable to plan as terms available in arm's length transaction.

- Counterparty (and its affiliates) cannot have power to appoint or terminate QPAM as manager of plan assets or to negotiate for plan over terms of QPAM's engagement.

Part III
ERISA Considerations When Investing in Private Funds

The Plan Asset Look-Through Rule

- In 1987, the Department of Labor issued the "Plan Asset Regulation" deeming the assets of an entity to be "plan assets" of each investing plan in situations where plans, through their investment in the entity, are essentially acquiring investment management services

- The Plan Asset Regulation provides that, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 the plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that—
  - the entity is an operating company, or
  - equity participation in the entity by benefit plan investors is not "significant"

Significant Participation or the 25% Test

- Private Investment Funds typically rely on the significant participation exclusion to avoid an ERISA plan asset look-through

- 25% or more of the value of any class of equity interests in the entity is held by "benefit plan investors"

- Calculation is computed upon each acquisition or redemption of equity interests in the Fund
  - ➢ Benefit Plan Investors (BPIs): Section 3(42) of ERISA which modified the Plan Assets Regulation defines a BPI as:
    - An employee benefit plan subject to the fiduciary rules of Part 4 of ERISA
    - Any plan to which § 4975 of the Internal Revenue Code applies, and
    - Any entity whose underlying assets include plan assets by reason of a plan's investment in such entity

Significant Participation or the 25% Test

- Pension Protection Act: Foreign plans and other non-ERISA plans no longer count toward 25% limit.

- 25% excludes entity controlling investment and its affiliates (example: general partner of partnership) or rendering investment advice for fee excluded in applying 25% limit.

- Trustees have not delegated fiduciary control to manager of operating company.

- Trustees remain fiduciary in control of those plan assets.

Investment by Benefit Plans Not Significant

- **Example**: ERISA plan buys shares of Great Dane Opportunities Fund, Ltd., limited liability corporation formed to invest in privately held companies.
- Great Dane Opportunities Fund, Ltd. managed by Slobber Management, L.P.
- Dubai Sovereign Pension Plan owns 10% of equity interest in Great Dane Opportunities Fund.
- ERISA benefit plan investments own 15% of equity interest in Great Dane Opportunities Fund.
- Slobber owns 8% of equity invest in Great Dane Opportunities Fund.
- Slobber not fiduciary to ERISA plan – does not control plan assets because ERISA plan investors hold less than 25%.
- BUT ERISA plan (usually) does negotiate with Slobber over side letter to modify terms to buy equity interest in Great Dane Opportunities Fund.

VCOCs and REOCs

- Private Equity and Real Estate Funds typically rely on the Venture Capital Operating Company (VCOC) and the Real Estate Operating Company (REOC), respectively, exclusions to avoid an ERISA plan asset look-through

- A VCOC is an entity that satisfies two specific tests: the investment test and the exercise test
  - ➢ The Investment Test, at least 50% of the fund's long-term investments, valued at cost, must be invested in "venture capital investments" or "derivative investments"
  - ➢ The Exercise Test, also the fund must, in the ordinary course of its business actually devote substantial resources to the exercise of management rights for one or more of the operating companies in which it invested

- A REOC is an entity like a VCOC that satisfies an investment test and an exercise test, but which invests in real estate and devotes substantial resources to managing or development activities

Investment Monitoring

- Should the Trustees hire an Independent Consultant who is an ERISA Section 3(21) fiduciary for performance reporting and monitoring of managers?

- Most plan do. Consultants can provide Trustees with:
  - Performance reporting
  - Risk measurement
  - Ongoing manager due diligence
  - Compliance monitoring.

- Ongoing manager due diligence and compliance monitoring includes ongoing monitoring all of the items originally reviewed in the RFP and evaluating any changes.

Tax Implications

- Side letters typically address the following tax issues:
  - Entity classification
  - AEOI compliance
  - Reportable transactions
  - Notification of tax reporting obligations

- If the Fund's investment strategy utilizes leverage or otherwise generates UBTI it generally makes tax sense to invest in an offshore blocker, onshore blocker side letters typically also include:
  - Withholding notification and reporting representations
  - Partnership audit representations
  - UBTI representations

Non-Plan Asset Funds

- A side letter for Private Investment Fund that intends to stay below its 25% threshold typically include:
  - A representation that the Fund is not now and will not be deemed to hold plan assets as defined in section 3(42) of ERISA
  - A representation that the Fund will mandatorily redeemed Benefit Plan Investors (BPIs) to keep the Fund below its 25% threshold
  - A representation that if the plan's investment is redeemed to maintain the Fund's non-plan asset status, the amount redeemed will not be more than the plan's pro-rata share among all the BPIs
  - A representation that should the Fund change its policy and elect to become a plan assets fund, the plan will receive prior notice with sufficient time to redeem its investment without penalty prior to the Fund being deemed to hold plan assets
  - Some accommodation regarding in-kind distributions should be reached

- Side letter for Private Equity and Real Estate Funds that intend to qualify as VCOCs or REOCs typically include:
  - A "should" level opinion of council that the upon the Fund's 1st investment it qualifies as a VCOC or REOC
  - A representation to provide an annual certificate regarding the Fund's continuing status as a VCOC or REOC

Hardwired Master-Feeder Funds

- After the PPA, this is a very common fund structure because an entity whose underlying assets include plan assets is deemed to hold plan assets "only to the extent" of the percentage of its equity interests held by BPIs
  - For example, if a feeder fund has $100M in assets, 50% of which is held by BPIs, the investment by the feeder fund into the master fund would result in the master fund taking into its 25% calculation only $50M of BPI investment related to the feeder fund's $100M interest in the master fund and if the onshore feeder fund also invests $101M into the master fund the master fund would not be deemed to hold plan assets

- "Hardwiring" requires that all of the investable assets of a feeder fund is invested in the master fund
  - The feeder fund may maintain a minimal amount of cash to pay expenses, but in many cases all expenses are paid by the master fund
  - Offering documents for the feeder funds often refer to them as mere conduits and will specifically state that the feeder fund is required to invest all their investable assets into the master fund
  - The feeder fund can accept BPIs over its 25% threshold, but the master fund stays below its 25% threshold, so that neither the master fund' investment nor its investment manager are subject to ERISA
  - While the feeder fund is a plan asset look-through vehicle, its manager is not acting as an ERISA fiduciary when follows the investors' direction to invests the assets from the feeder fund into the master fund
  - All managerial discretion is removed from the feeder fund so that there is nothing other than ministerial actions for the manager to undertake in connection with the management of the feeder fund

ERISA Plan Asset Funds

- The person executing the side letter on behalf of the plan has the authority to appoint the Fund's manager as an "investment manager" (as defined in Section 3(38) of the ERISA) of the plan

- Representations from the Fund and its manager that during any period when the Fund is deemed to hold "plan assets":
  - The Manager acknowledges that it is a fiduciary (as defined in Section 3(21)(A) of ERISA) with respect to the plan, and is not prohibited from acting as a fiduciary to an ERISA plan under Section 411 of ERISA
  - The Manager is registered as an investment adviser under the Investment Advisers Act of 1940. The manager will maintain its status as an "investment manager" (within the meaning of Section 3(38) of ERISA) for so long as the assets of the plan are invested in the Fund
  - The Manager shall conduct the affairs of the Fund in accordance with the fiduciary responsibilities imposed by ERISA Section 404, and shall not cause the Fund to engage in any non-exempt prohibited transaction as described in ERISA Section 406 or Section 4975 of the Code
  - The Manager meets the qualifications to be a "QPAM" as defined in Part VI of PTE 84-14
  - The Manager represent that any provisions in the formative documents of the Fund providing for exculpation or indemnification shall only be construed to provide for exculpation or indemnification of the Manager to the extent such exculpation or indemnification is permitted by ERISA.
  - The Fund shall maintain a fidelity bond in accordance with and in an amount not less than the amount required by Section 412 of ERISA
  - The Fund will provide the plan the fair market value of the assets held by the Fund as may be necessary to enable the Subscriber's investors to complete their annual returns/reports

ERISA Plan Asset Funds

- **Side letter Issues to Consider:**

  - Soft Dollars: the Fund will only use soft dollar commissions in compliance with Section 28(e) of the U.S. Securities Exchange Act of 1934, as amended; EU managers are subject to MiFID II; certain strategies utilize single issuer swaps to trade in non-US jurisdictions. Consider requiring soft dollars only be spent to brokerage or research as defined by 28(e)
  - Valuation: for any securities held by the Fund for which market prices are unavailable, such securities will be valued either by an independent third party or by utilizing an objective pricing methodology. In the event an independent third party is used, the Manager agrees to provide the Subscriber with the name of such independent third party. In the event an objective pricing methodology is used, the Manager agrees to provide the Subscriber with a description of the methodology and the data necessary to establish the methodology's objectivity.
  - Indica of Ownership
  - MFNs: size based; forward looking fee liquidity
  - Managers that don't give side letters
  - Managers that don't give MFNs

Part IV

Questions?