GROOM LAW GROUP

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Hedge Funds and Private Equity Funds

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I. Introduction

During my 11 years as an employee benefits lawyer with Groom Law Group, I have had the good fortune to work with plan sponsors and financial institutions on a wide variety of projects involving the investment of ERISA plan assets. Groom's clients include large corporate and public plans who are consumers of investment management and related services and investors in a wide range of investment vehicles with mandates including global real estate, domestic private equity, hedge funds, credit and buy-out funds. We also advise financial institutions in the business of providing recordkeeping, trustee, and investment management services to plans and structuring investment vehicles for investment by institutional investors, including ERISA plans.

With trillions of dollars of the nation's wealth contained in the pension and retirement system, the investment of plan assets is necessarily a complex, sophisticated and highly regulated business. In addition to ERISA, plan sponsors and investment managers navigate federal securities, banking and insurance laws, and the federal tax code. Competition and regulation combine to create a dynamic marketplace of products and services.

I am pleased to be here today to discuss with the working group issues related to the investment of plan assets in "alternative investments" including hedge funds and private equity funds, including "best practices" for plan fiduciaries charged with selecting and monitoring such investments. I understand the working group is focusing on these practices in the context of defined benefit plans ("DB plans"), and also in the context of defined contribution plans ("DC plans"). I applaud the working group's willingness to tackle these tough issues in both contexts.

In my testimony, I will first briefly discuss, from a practitioner's standpoint, the Labor Department guidance that is available with respect to plan investments generally, and then I will outline the types of advice we provide plan fiduciaries in connection with alternative investments. Finally, I will offer a few observations on the use of alternative investments in the context of DC plan investments, including with respect to target date funds that include an allocation to alternative investments.

II. Legal Authority Governing Investment of Plan Assets

A. DOL Prudence Regulations

ERISA imposes a code of conduct on plan fiduciaries, including those fiduciaries who manage plan assets. Each investment fiduciary is subject to duties of loyalty, prudence, the duty to diversify plan assets, to follow plan terms and to avoid causing the plan to engage in prohibited transactions.

Under ERISA's prudence requirement, an investing fiduciary will be held to the standard of a prudent investment professional not of a prudent layman.[1] In addition to the statutory requirements and prohibitions, the DOL has issued a regulation that provides guidance to fiduciaries on how to satisfy the prudence requirement in the investment context.[2] Under this "Prudence Regulation" the fiduciary must give "appropriate consideration" to facts and circumstances that the fiduciary knows, or should know, are relevant to the particular investment or investment course of action, including the role that the investment plays in the plan's investment portfolio, and then act accordingly. "Appropriate consideration" by a fiduciary requires determination that an investment is reasonably designed, as part of the plan's portfolio, to further the purposes of the plan, taking into consideration the risk of loss, the opportunity for gain, the extent of the portfolio's diversification, the portfolio's liquidity and the investment's projected return.

[1] Whitfield v. Cohen, 682 F.Supp. 188, 194 (S.D.N.Y. 1988); Marshall v. Snyder, 1 EBC 1878 (E.D.N.Y. 1979).

[2] 29 C.F.R. § 2550.404a-1

Notably, the focus of the analysis under the prudence requirement is the process used to reach a decision, rather than the merits of the decision itself. In the preamble to the Prudence Regulation the Department was careful to point out that, while a prudent process involves an assessment of the risk of loss and potential for gain of an investment or an investment course of action, an investment made after due consideration of the surrounding facts and circumstances, "should not be deemed imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk."[3]

B. DOL Information Letter to E. Ludwig

In an information letter issued in 1996, the DOL expressed its views "with respect to the utilization of "derivatives" in the management of a portfolio of assets of an ERISA covered pension plan."[4] Thus, the guidance in the Ludwig Letter focuses on "financial instruments whose performance is derived in whole or in part from the performance of an underlying asset," including "futures, options, options on futures, forward contracts, swaps, structured notes and collateralized mortgage obligations." The DOL staff has indicated that it views the Ludwig Letter as useful to fiduciaries in considering the investment of plan assets in alternative investments, other than derivatives.

The Ludwig Letter generally advises that investments in derivatives are subject to the same fiduciary standards as other plan investments, meaning it is important to consider:

- How the investment fits in plan's investment policy;
- The role of the investment in the plan's portfolio; and
- The potential exposure to losses through use of the investment.

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[3] Prudence Regulation, 44 Fed. Reg. 37221, 37224 (Jun. 26, 1979).

[4] DOL Info. Ltr. To E. Ludwig (Mar. 21, 1996) (the "Ludwig Letter" or the "Letter").

In the Ludwig Letter, the Department recognized the use of derivatives as tool for managing risk and for diversification. I think it may be fairly stated that the Department recognizes that other types of alternative investments may also provide these benefits. The Ludwig Letter also indicates the Department's view that derivative investments may require a more sophisticated financial understanding than some other types of investments. The Ludwig Letter cautions fiduciaries that derivatives may be volatile, may depend on leverage, may be hard to value and (at least in 1996) had "limited market testing."

The Ludwig Letter notes the need for securing "sufficient information" to understand a derivative/alternative investment and the need to conduct "independent analysis" of relevant risks associated with a particular investment (including credit risk and market risk). The Letter urges fiduciaries to determine a method for indentifying the necessary information to evaluate market risk. It further suggests that stress simulation models might be useful tools for this evaluation. While, the Ludwig Letter's discussions of credit risk, market risk and testing in abnormal markets may be viewed as unique to derivatives, the fact that the Letter focuses on the types of risk that are uniquely relevant to a particular type of investment is instructive for all types of investments.

The Letter also advises obtaining reliable price comparisons, and notes the need for ongoing monitoring, including obtaining timely information about credit risk, and about the current market value of an investment.

The Ludwig Letter also addresses other types of risk, including the risk that a fiduciary will not have the “expertise, knowledge and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment." And the Letter argues for documentation that the plan fiduciary has “adequate information and risk management systems" for the nature, size and complexity of plan investments in derivatives, and access to competent persons manage these systems.

In the case of pooled investment funds utilizing derivatives, the Ludwig Letter recommends that the plan fiduciary selecting the investment should understand the role of derivatives within the fund, and the extent of their use.

The Ludwig Letter also notes that fiduciaries must evaluate the legal risk of an investment, including assuring proper documentation of the investment or contract governing the investment.

Finally, the Ludwig letter identifies on-going monitoring as important, and consistent with the prudence regulation, notes that the frequency and degree of monitoring should depend on the nature of the investments and their role in the plan's portfolio.

III. Investment and Legal Due Diligence Practices

In my experience, ERISA plan fiduciaries and their advisors and support staff undertake significant due diligence and on-going monitoring with respect to alternative investments. Because my expertise is in legal due diligence, I will discuss that process in some detail below. With respect to investment due diligence, I can make a few observations based on the opportunities I have had to discuss the investment due diligence process with my clients and colleagues.

A. Investment Due Diligence

In my experience, the first step in conducing investment due diligence is the process a fiduciary undertakes to arrive at an appropriate asset allocation for the plan. Once the asset allocation has been set, the selection of investments to fulfill the plan's allocations can begin. One way to describe investment due diligence is the process of collecting, reviewing and evaluating information material to the decision as to whether a particular investment is an appropriate investment for a particular plan. In my experience, this type of due diligence is most often conducted by experienced staff, often the same individuals who are or have been responsible for managing corporate investments. These treasury and finance professionals have the knowledge base to evaluate financial reports and performance information, as well as the investment strategies and approaches used by alternative managers. Investment staff often, although not always, work with consultants and outside advisors to cull through a myriad of options that might be available to fulfill a plan's allocation to alternative investments. Once a leading investment fund or manager is identified by the plan fiduciary, the legal due diligence commences. If the results of this process are satisfactory to the plan fiduciary, and no other information is uncovered or changes required by unforeseen circumstances, the investment will go forward.

B. Legal Due Diligence

Groom provides legal advice to fiduciaries about the legal due diligence process and assists in conducting the legal due diligence itself. In the course of doing this work, we have developed some tools to help with the process. Of course, alternative investments come in all shapes and sizes, as do plans. The number of variables involved, including the investment type (i.e., private equity, hedge fund, real estate, among others) and structure (bank collective fund, limited partnership, limited liability company, separately managed account, plan assets vehicle, non-plan assets vehicle) the size of the fund, and the size of the plan, are such that there is simply no “one-size fits all approach” to legal due diligence.

However, in general, I view legal due diligence for alternative investments by ERISA plans as the process of analyzing the legal terms of a potential plan investment for the purposes of:

(1) Identifying the rights, responsibilities and liabilities of each of the manager and the investors;

(2) Evaluating the extent to which the terms of the investment complies with the requirements of ERISA;

(3) Advising the investor with respect to negotiations of the terms of the investor's investment; and

(4) Assisting with respect to the documentation of the process undertaken to select and monitor the investment.

The legal due diligence process typically involves a review of documents that describe the legal terms of the investment. These can include investment management agreements for separately-managed accounts, and offering memoranda, due diligence questionnaires, operating agreements and subscription agreements for various types of private placement investments. Our review of documents is comprehensive, although to some degree varies depending on the precise nature of the investment. In general, however, we would expect to focus on the following types of questions:

Does the Fund hold "Plan Assets"[5] for purposes of ERISA?

- Have the general partner and manager acknowledged that they are ERISA fiduciaries?
- Has the manager acknowledged that it is an "investment manager" under Section 3(38) of ERISA? Has the manager represented that it is a QPAM under PTE 84-14?
- Have the general partner and manager agreed to avoid causing non-exempt ERISA prohibited transactions?
- Have the general partner and manager obtained fiduciary bonding coverage? Are they covered by fiduciary insurance?

[5] See 29 C.F.R. § 2510.3-101

- Will the Fund adequately disclose fees under ERISA 408(b)(2) regulations and Form 5500 requirements?

If the Fund will not hold "plan assets," what is the basis for this determination?

- Will the Fund limit benefit plan investors to less than 25% in the aggregate, or qualify as a "Real Estate Operating Company" or a "Venture Capital Operating Company"?

- If applicable, has the Fund agreed to provide annual certifications or legal opinions confirming its REOC or VCOC status?

- If, at some point during the life of the Fund, it is deemed to hold plan assets, will the general partner and manager acknowledge their fiduciary status and comply with ERISA?

- If the Fund holds plan assets, can ERISA investors withdraw? Must they provide a legal opinion as a precondition to doing so?

- May the general partner force the sale or transfer of ERISA investors' shares to avoid the Fund's holding plan assets? Will the general partner agree to do so equitably or pro rata, so that investors are treated equally? Are investors permitted to refuse distributions if the same could result in a non-exempt ERISA prohibited transaction?

Fees and Expenses

- What is the fee structure (e.g., asset-based, incentive-based)? If incentive-based, does the fee arrangement comply with DOL guidance?

- Under what conditions are management fees subject to reduction (e.g., payment of placement fees)?

- Will the Fund or investors pay any "administrative" fees?

- What expenses are borne by the general partner or manager, and the Fund or investors, respectively?

Valuation Procedures

- How are Fund assets valued (e.g., by general partner, by an independent appraiser)?

- Do the valuation procedures appear to be appropriate?

Standard of Care/Exculpation/Indemnification

- What is the standard of care to which the general partner and manager are held (e.g., willful misconduct, gross negligence, breach of fiduciary duty)?

- What are the investors' and Fund's indemnification obligations to the general partner, manager, and affiliated individuals?

- Do the Fund documents provide that such obligations "are subject to applicable law," including ERISA?

Liquidity Considerations

- Does the Fund permit redemptions and transfers of investor interests/shares?

- What conditions must investors satisfy to redeem or transfer (e.g., advance notice to general partner, opinion of counsel, etc)?

- What restrictions apply to redemptions or transfers (e.g., sufficiency of cash in Fund, pro rata where cash is limited, no material adverse impact on Fund or other investors, etc.)?

- Will the Fund give advance notice to investors concerning "in-kind" distributions? If the Fund makes in-kind distributions will the manager act as an ERISA § 3(38) "investment manager" with respect thereto and/or provide assistance in disposing of such distributions?

- Can the Fund require investors to return distributions previously paid (e.g., to satisfy the Fund's indemnification obligations)?

Side Letters and Most Favored Nation Status

- Does the Fund permit side letters?

- Are any provisions of the Fund operating agreement or subscription agreement *excluded* from side letter coverage (e.g., liquidity terms, fee structure)?
- Will the Fund provide copies of side letters with other investors?

- Will the Fund notify investors if it extends more favorable rights to other investors? Will investors so notified have an opportunity to accept or reject such terms?

Parallel Funds, etc.

- Will the general partner establish parallel funds, feeder funds, or alternative investment funds? For what purpose?

- Are investors *required* to participate in such funds?

- Will the general partner give notice to investors concerning participation in such funds and copies of the governing documents?

- Does the general partner guarantee equal protections and terms under such funds?

Confidentiality

- Do the confidentiality provisions in the Fund documents permit investors to comply with regulatory reporting and disclosure requirements (e.g., Form 5500)?

- Under what circumstances may the Fund or general partner disclose information pertaining to investors?

UBTI

- Are Fund investments likely to generate UBTI (e.g., through unrelated operations, debt acquisition)?

- Are there structures in place to block UBTI (e.g., blocker corporations)? Do such structures entail other potential costs (e.g., taxes, operating expenses)? Do investors have the option to accept or reject such structures depending on their relative economic advantages or disadvantages?

- Will the manager agree to give the Plan all of the information it needs in order to timely file any required federal and state returns in connection with UBTI?

Extensions of Credit

- Will the Fund establish a credit facility to borrow money for Fund capital needs? Will the Fund make contingent commitments?

- Will credit facility borrowing or contingent commitments be secured with investors' capital commitments? Will investors be required to guarantee payment of such indebtedness to lenders or other third parties? May investors be permitted to "opt out" of such borrowing or guarantees?

- Will the Fund allow investors to pre-fund their share of credit facility borrowing, giving reasonable advance notice of such pre-funding opportunities (for avoidance of UBTI and potential prohibited extensions of credit under ERISA § 406(a)(1)(B))?

Placement Agents

- Does the Fund use placement agents in connection with investors' participation in the Fund? To whom are placement fees paid?

- Have all such placement agents and fees been disclosed prior to closing?

Removal of General Partner and Manager/Amendment of Fund Documents

- Does the Fund operating agreement contain a mechanism by which investors can remove the general partner or manager and/or amend the operating agreement?

- What percentage of investors' shares/interests is required to effect such removal/amendment?

- Are there other barriers to removal (e.g., certain "bad" conduct by the general partner or manager) or amendment (consent of general partner)?

- Will the Plan receive copies of all amendments or modification to the fund's operating documents and other documents such as PPMs/Offering Memoranda.

Anti-Money Laundering Representations

- Does the Fund subscription agreement require investors to make anti-money laundering and related representations?

- To whom do such representations apply (e.g., board of trustees, contributing employers, participants and beneficiaries)?

Applicable Law

- What law governs the operating agreement and subscription agreement?

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Based on the document review and other information collection, we will often discuss the legal terms of the investment with the financial professionals acting for the plan or the plan fiduciaries and help them evaluate legal or operational concerns with the terms of the investment. In addition, we may assist a plan client in negotiating the terms of a side letter or other communication clarifying the legal terms of the investment. Finally, we may assist in documenting the process of review and negotiation that was undertaken.

IV. Alternative Investments in Defined Contribution Plans

A number of commenters have argued that alternative investments ought to be available to participants in the DC plans. While I personally agree that the benefits of diversification of investments in DC plans, including alternative investments, are significant and would enable DC plan participants to access their investment more readily, I leave to the financial professionals and policy makers the ultimate question of whether such access is a good idea. I do believe, however, that in order for participants to benefit from access to alternative investments, policy makers will have to adopt policies that do not expose plan fiduciaries to excessive risk, and allow, or perhaps even encourage innovation in product development and implementation.

In this regard, I would argue that it is absolutely possible for a plan fiduciary to undertake a prudent process in selecting and monitoring plan investment options that contain alternative investments. In fact, I believe that the process might be virtually identical to the process the same fiduciary might undertake in selecting and monitoring an investment for a DB plan. However, I also believe that such a fiduciary might reasonably be concerned that the risk of acting on behalf of the DC plan are significantly greater. Risks that such a fiduciary might reasonably be concerned about include the following:

- **Fees.** It is generally the case that alternative investments require more "active" and therefore costly management expertise. Given the tremendous focus on fees during the last several years, including in litigation, legislative initiatives and DOL guidance, a plan fiduciary could reasonably determine that even where a fee differential is justified by superior performance, there remains a risk that higher gross fees alone could increase the likelihood of a participant lawsuit or DOL inquiry.

- **Liquidity Concerns.** While not legally required, most DC plans have evolved to provide that participants may trade into and out of plan investment options on a daily basis. In addition, loans, withdrawals, distributions and frequent contributions are necessary elements of most DC plans, each of which can present a greater need for flexibility and liquidity in plan investment options. That said, participants in DC retirement plans are generally long term investors. As such, it may not make sense for DC plan investment options to be limited to those that provide liquidity at the expense of value to the long term investor.

- **Participant investment education and advice.** Plan fiduciaries with whom I work are often convinced that participants need investment education and advice, but unsure of how to provide for it effectively. This concern might be amplified in connection with alternative investments, especially where the investment fiduciary's liability for participant losses, or ability to show that the investment fiduciary has fulfilled his responsibilities depends on whether sufficient information about the investment has been provided to participants.

It may be the case that target date funds, which are widely available and relatively popular, offer a way to include alternative investments within existing options available to DC plan participants. In fact, some existing target date funds include allocations to alternative investments. This role for alternative investments could mitigate the fee, liquidity and participant education concerns noted above. However, to the extent that policy makers wish to encourage (or at least not to inhibit) the inclusion of alternative investments within target date funds, it would be useful to consider whether guidance can be provided that would further address some of these concerns. For instance, the Department could articulate (again) the position that low fees are not the sole priority in connection with investment options. The Department could also identify ways that additional liquidity could be made available to target date funds under certain circumstances, or could explain in guidance that in selecting plan investment options (including date funds) it may be reasonable to select options that favor long term investment goals over immediate liquidity. Finally, the Department could continue to consider ways that fiduciaries and providers can offer education to participants with respect to alternative investments.

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