

# 25% Solutions: How to Manage ERISA Plan Assets in a Hedge Fund

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## What Is ERISA?

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- Employee Retirement Income Security Act of 1974
  - U.S. private sector retirement, health, disability plans
  - IRAs, Keogh plans – not ERISA but some similar rules
  - Foreign plans, government employee plans, church plans not covered
- Extensive regulation of plan provisions, administration, reporting/disclosure, investments
- Still a “young statute” with unresolved questions

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## Why ERISA Matters

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- Assets in U.S. private sector plans and IRAs at 9/30/11 > \$11 trillion; also \$2.8 trillion in state and local government plans, which have similar investment concerns\*
- Plans generally long-term investors
- ERISA significantly regulates management of plan assets
- Supersedes most state law, but not other federal law

\* Source: Investment Company Institute, 2011

# Key ERISA Concepts

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- Plan assets
- Fiduciary status and fiduciary duty
- Prohibited transactions

# Administration & Enforcement of ERISA

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- U.S. Department of Labor (“DOL”)
  - Regulations, advisory opinions, exemptions
  - Audits, investigations (at DOL initiative, based on complaint or tip, or as part of larger audit or investigation)
  - Litigation
- Private litigants

## Who Is a Fiduciary?

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- Functional definition:
  - Authority or control over plan management or management of plan assets;
  - Advises about plan assets for compensation; or
  - Authority or responsibility in plan administration
- Fiduciary status “to the extent” one does these things

## Fiduciary Duty

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- Duty of loyalty/exclusive purpose (provide benefits, pay reasonable expenses)
- Act as a “prudent man, in a like capacity familiar with such matters”
  - Fiduciary can be indemnified, but not exculpated
  - Indemnify except for “willful misconduct or gross negligence?”
- Diversify (unless not prudent)
- Follow plan documents (unless inconsistent with ERISA)
- Personally liable for plan losses due to breach; possible 20% civil penalty (may attach to individual acting as fiduciary and/or to organization with duty to supervise the individual)

## Fiduciary Duty: Prudence

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- Prudence of an investment measured in total portfolio
- Relationship to diversification requirement
  - Asset allocation decisions: who makes?
  - Management of an allocation
  - Are manager's responsibilities clear?

# Investment Managers: What Are Plan's Concerns?

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- Avoid co-fiduciary liability
- Avoid prohibited transactions
- Manager compliance with ERISA requirements, e.g., custody of assets, bonding
- These issues arise when manager managing “plan assets”

# Investment Managers: Co-Fiduciary Liability

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- ERISA plan assets: to be managed by trustee, with exceptions:
  - Trustee directed by “named fiduciary” (“NF”) (e.g., investment committee)
  - Management delegated to “investment manager” by NF
- Most pension plan trustees are directed by NF or investment manager
- Appointment of sub-managers: plan names manager as NF to appoint sub-managers
- Failure to follow appointment/delegation procedures → co-fiduciary liability

# Investment Managers: Co-Fiduciary Liability (cont'd)

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- ERISA investment manager (“IM”)
  - Registered investment adviser (“RIA”), bank or insurance company
  - Acknowledges fiduciary status
- NF that appoints IM generally not responsible for IM investment decisions
- If manager not an IM, potential co-fiduciary liability for NF
- Can non-RIA manage plan assets?

## What Are Plan Assets?

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- What the plan owns, invests in
- For example: Treasury bonds, shares of Apple, office building
- Collective, commingled investment funds:
  - Is plan asset the share, unit or certificate?
  - Or is it an interest in the fund's investments?

## When Is Manager Managing Plan Assets?

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- Plan's investment includes an interest in portfolio assets if:
  - Separate account
  - Common or collective trust fund
  - Insurance company separate account
  - Insurance company general account (to extent of plan investment)
  - Participation by benefit plan investors ("BPIs") is "significant"

# When Is Manager Not Managing Plan Assets?

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- Plan asset is the share, unit, or certificate, not portfolio assets
  - Publicly-offered securities under the Securities Act of 1933
  - Debt securities
  - Registered investment companies under the Investment Company Act of 1940
  - Operating companies, including
    - Venture Capital Operating Company (“VCOC”)
    - Real Estate Operating Company (“REOC”)
  - Participation by BPIs “not significant”

## When Is BPI Investment “Significant”?

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- For any class of equity interests:

$$\frac{\text{Value of interest of BPI}}{\text{Value of all interests}^*} \geq 25\%$$

\* Equity interests held by non-BPI with discretionary authority or control with respect to the assets of the fund, or an “affiliate” (“Controlling Persons”) are excluded from the denominator

- Calculated each time there is a change in ownership of equity interests
- “Class” not defined under ERISA, practitioners look to the law of the jurisdiction under which entity is formed, differences in economic rights
- If you call it a “class” . . .

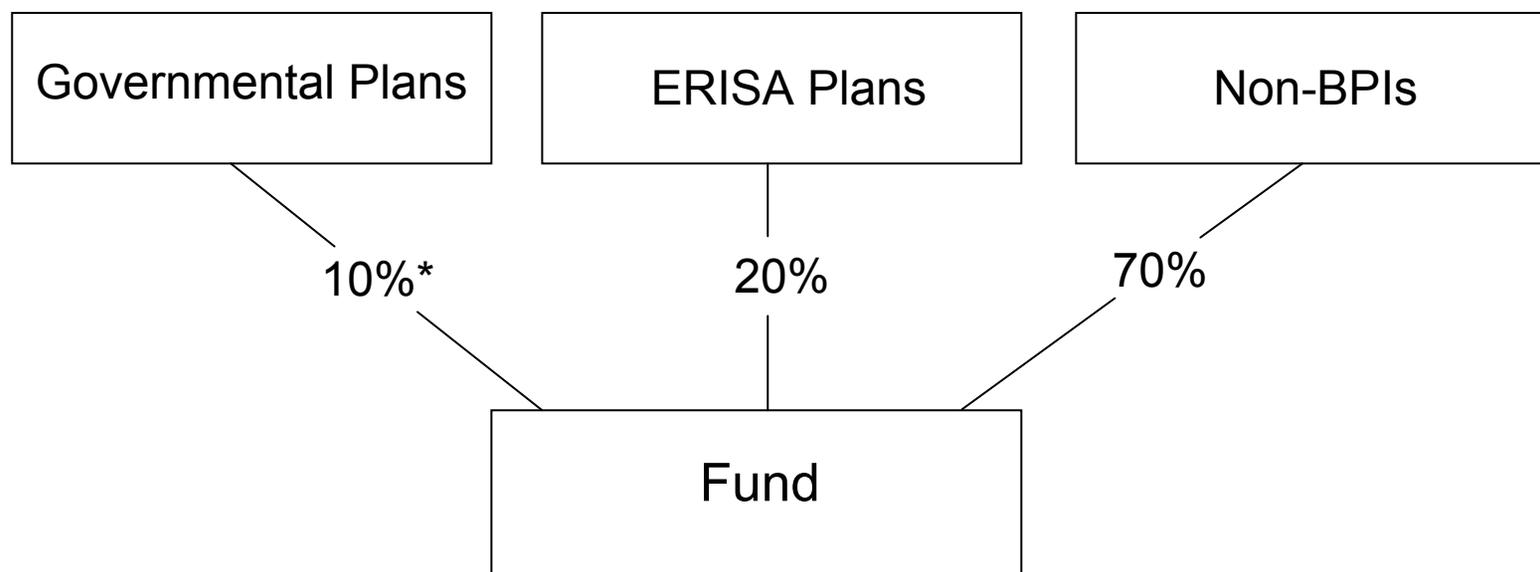
## Benefit Plan Investors

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- Employee benefit plans subject to fiduciary rules of ERISA
- Plans subject to Tax Code Section 4975
- Entities deemed to hold “plan assets” by reason of a plan’s investment in the entity, but only to the extent the percentage of its equity interests held by BPIs
- Does not include:
  - Foreign plans
  - Government plans
  - Church plans (generally)

## Example 1

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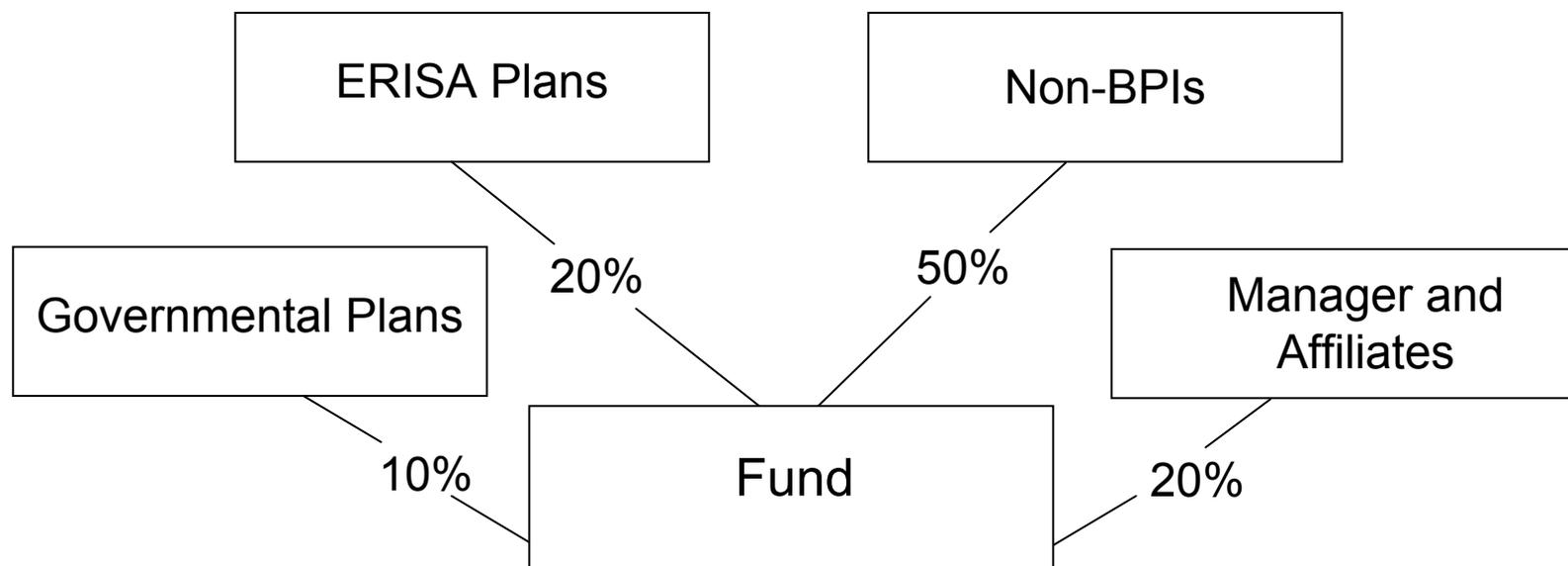


BPI % = 20%: Fund not deemed to hold plan assets

\*In each Example, the percentage indicates the percent of the total equity interests in the investee that are held by that class of investors.

## Example 2

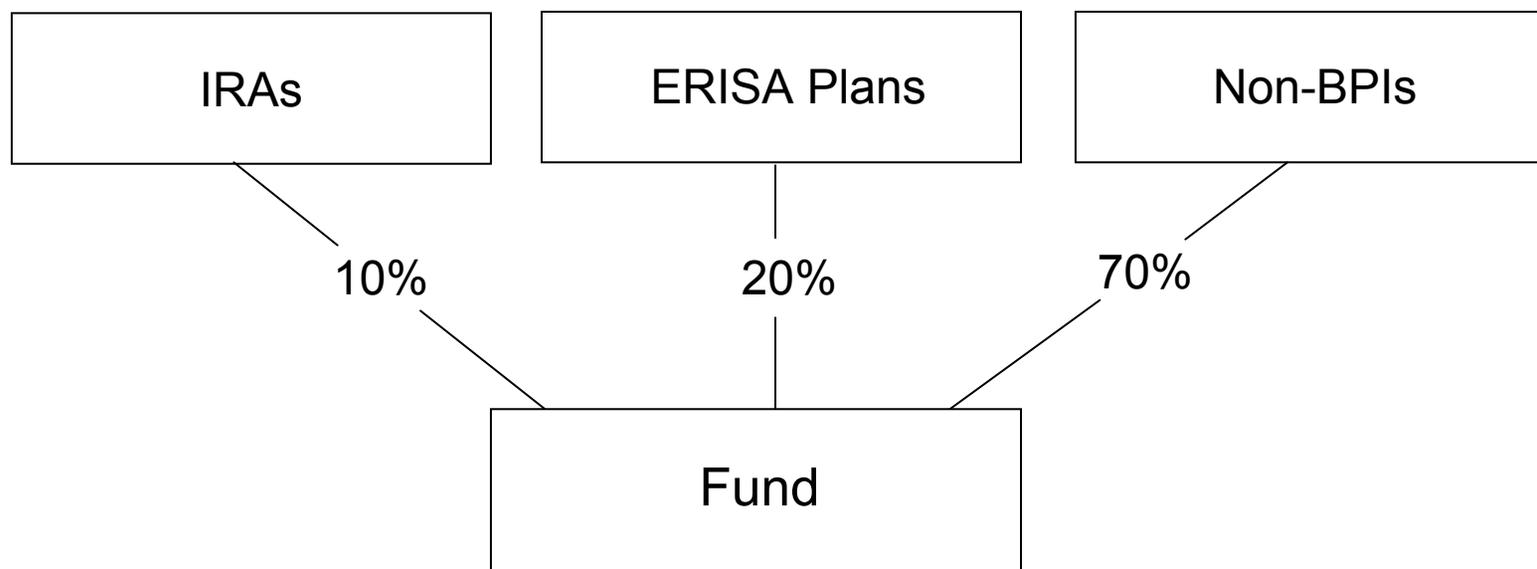
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Interests of Manager and Affiliates excluded; BPI % =  $20/80 = 25\%$ :  
Fund deemed to hold plan assets

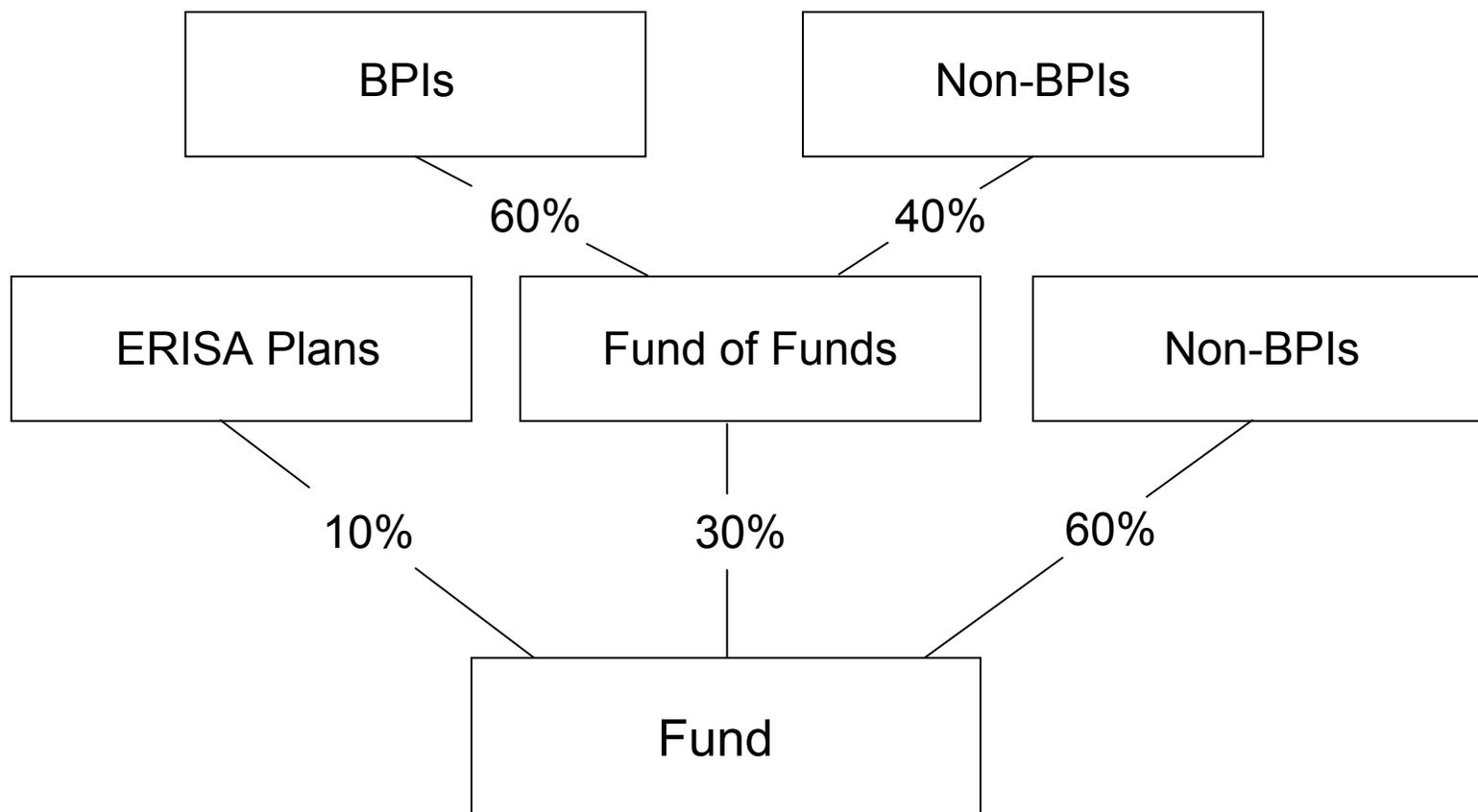
## Example 3

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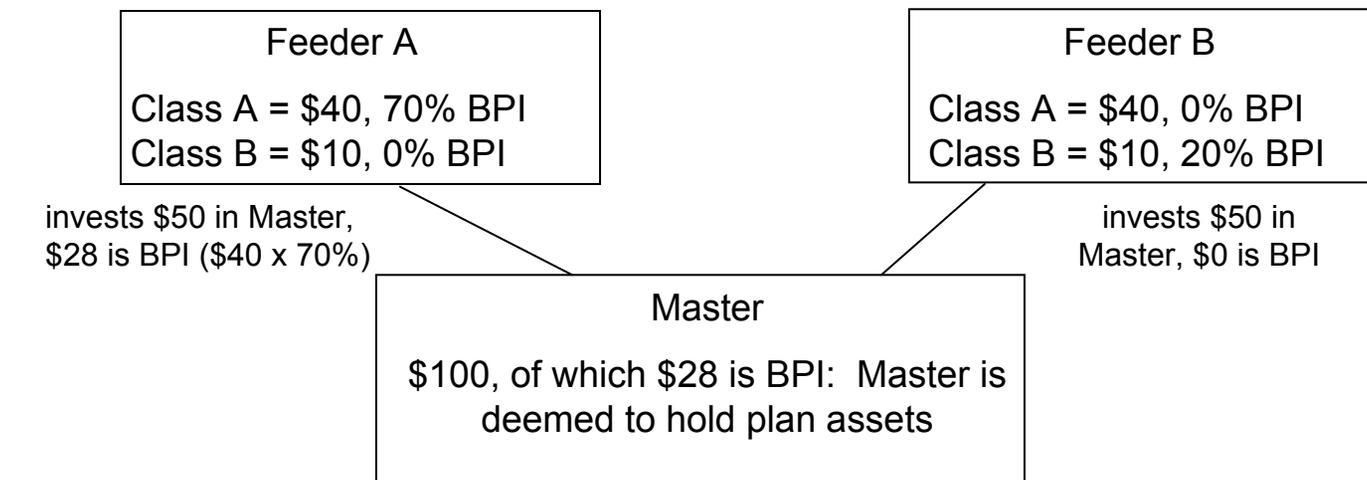
BPI % = 30%: Fund deemed to hold plan assets  
If 30% IRAs, 0% ERISA plans, BPI % = 30%: Fund deemed to hold IRA assets for purposes of Tax Code §4975

## Example 4

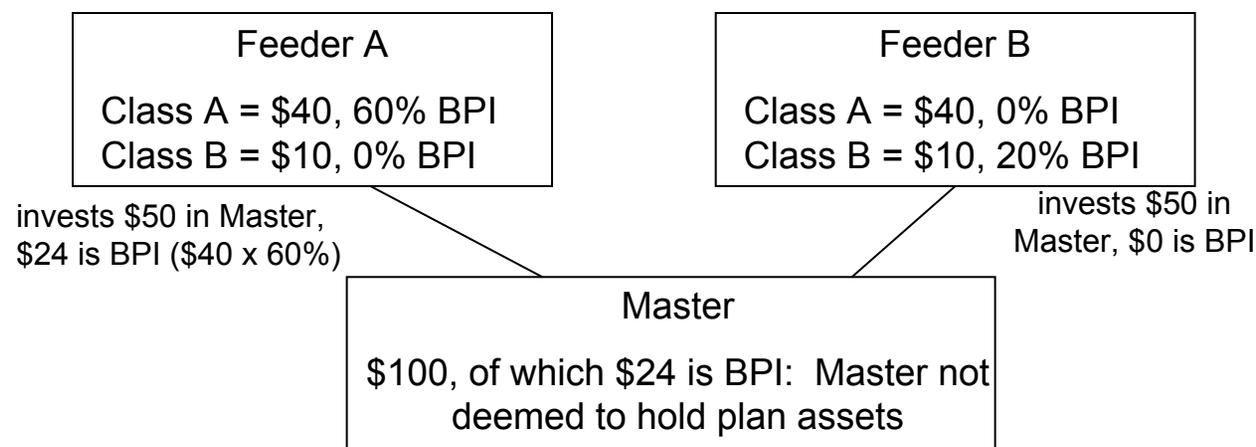


BPI % of Fund of Funds = 60%; BPI % of Fund =  $10 + 18/100 = 28\%$ :  
Fund is deemed to hold plan assets

## Example 5



but -



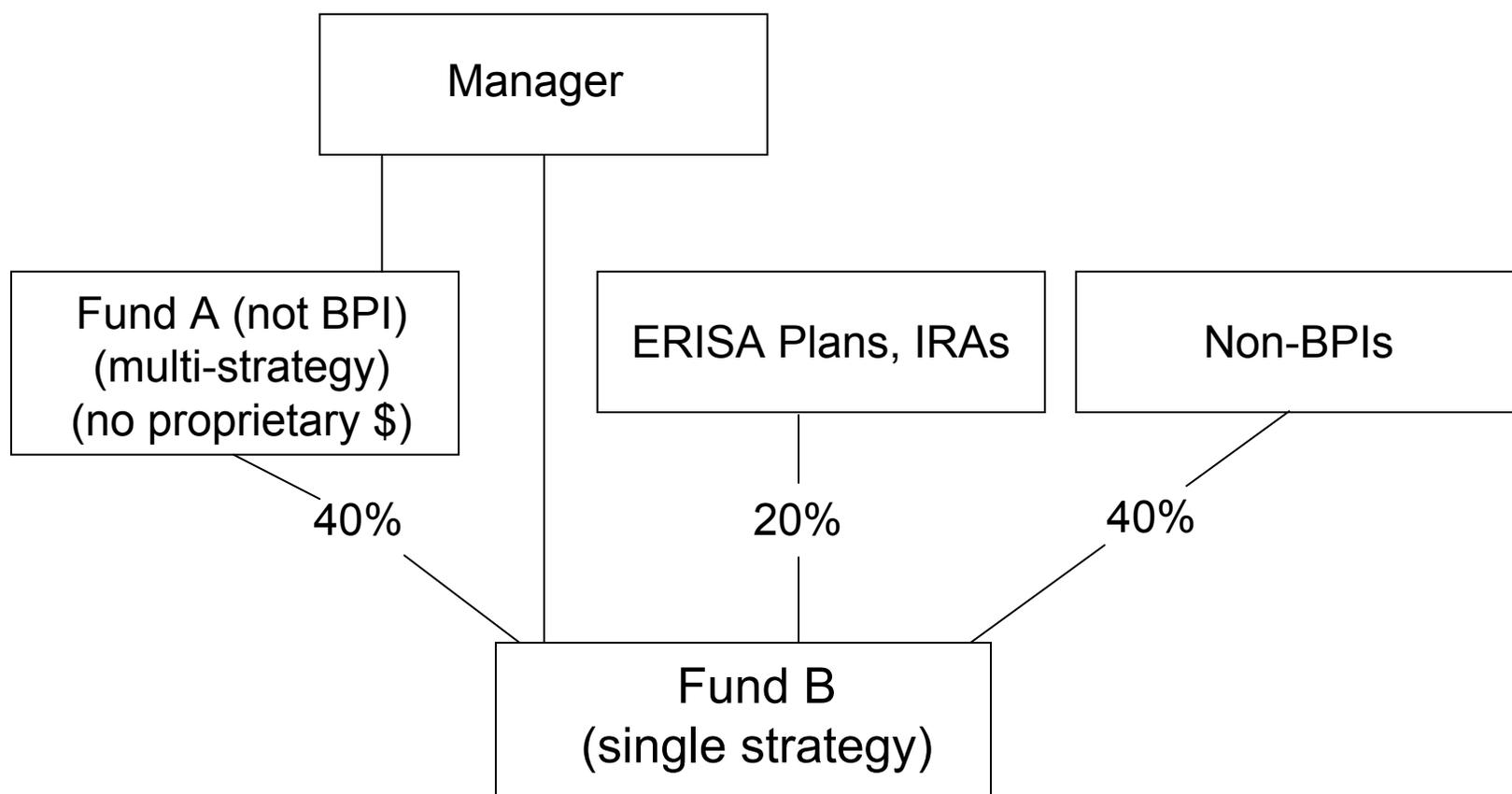
## Master-Feeder Structure

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- “Company intends to invest substantially all its assets in Master”
- “Fund will generally invest its assets in Master”
- “Hard-wire” feeder, clearly disclose
  - BPI% computation
  - Fiduciary duty

## Example 6

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BPI % = ?

## Prohibited Transactions

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### **“Party in Interest” (“PI”) and “Disqualified Person” (“DP”)**

- PI is ERISA term; DP is Tax Code
- Definition of PI/DP is broad:
  - fiduciaries
  - service providers
  - employer
  - owners of employer
  - officers, directors, shareholders, partners, joint venturers of a PI/DP
- PI and DP definitions not always identical

## Prohibited Transactions (cont'd)

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- A. A “party in interest” prohibited transaction is any of these between a plan and a Party in Interest/Disqualified Person (PI/DP):
1. Sale/exchange/lease of any property
  2. Lending of money, other extension of credit
  3. Furnishing of goods/services/facilities
  4. Plan assets transferred to, used by PI/DP
  5. Acquisition of employer securities or real property in excess of statutory limits

## Prohibited Transactions (cont'd)

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- B. A “self-dealing” prohibited transaction is where a fiduciary of a plan:
1. Deals with plan assets in his own interest or for his own account
  2. Acts in transaction involving the plan on behalf of a party with interests adverse to the plan
  3. Receives consideration for his own account from party dealing with plan in connection with a transaction involving plan assets

All except A-5 and B-2 are prohibited transactions under Tax Code §4975

## Prohibited Transactions (cont'd)

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### Penalties:

- Excise Taxes
  - 15%/year of amount involved until transaction corrected
  - 100% of amount involved after tax assessed
  - Payable by any DP who participates in transaction
- May be enjoined by court under ERISA
- DOL Penalty
  - 20% of amount recovered in settlement or proceeding
  - Levied on fiduciary

## Potential Prohibited Transactions

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- Transactions involving plan assets and PIs/DPs
- Examples:
  - Plan engages in principal transaction with PI/DP
  - Cross-trade for plan with another client of manager
  - Manager trades for plan through broker-dealer affiliate
  - Manager's prime broker is custodian of IRA that invests in manager's >25% fund
  - Swap involving plan assets where counterparty is PI/DP
- Common pitfalls:
  - Affiliate transactions
  - Additional compensation to a fiduciary
  - Counterparty is PI/DP

## Prohibited Transaction Exemptions

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- Contained in ERISA or issued by DOL: permit otherwise-prohibited transactions if specified conditions satisfied
- Qualified Professional Asset Manager Exemption (“QPAM”), PTCE 84-14
- Service provider exemption, ERISA 408(b)(17)
- Necessary services from PI/DP, ERISA 408(b)(2)
- Numerous others

## QPAM

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- Permits many “party in interest” transactions
- To be a QPAM, RIA with:
  - \$85 million under management at end of last fiscal year
  - \$1 million in shareholder or partnership equity, or guaranteed by affiliate with that equity
  - Acknowledges in writing that it is a fiduciary
  - Bank or insurance company can also be QPAM
- QPAM must negotiate transactions and must decide to enter into transactions on behalf of plan
- Sub-manager issues: if QPAM manages fund of funds holding plan assets and invests in investee fund holding plan assets, prohibited transactions in investee fund not covered (unless investee fund manager is QPAM)

## QPAM (cont'd)

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- Does not cover transactions with:
  - Persons and their affiliates who have power to:
    - Appoint/terminate QPAM or negotiate terms of management agreement with QPAM, but
    - Deemed satisfied for plans which are < 10% of Fund
- PIs/DPs with respect to any plan (or group of related plans) which represents > 20% of QPAM's total AUM: cannot engage in prohibited transactions with those PIs/DPs
- QPAM and its related persons
- What is an INHAM?

## 408(b)(17) Service Provider Exemption

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- Covers many party in interest transactions (A-1, A-2, A-4 at slide 24) under these conditions:
  - Transaction between plan and a PI/DP who only provides services or is affiliated with a service provider
  - Not a transaction with person who is fiduciary with respect to the assets used in the transaction
  - Plan must receive not less than or pay any more than “adequate consideration,” as determined by fiduciary who causes transaction
  - May be available where QPAM exemption is not

## 408(b)(17) Exemption (cont'd)

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- “Adequate Consideration” means:
  - Price prevailing on a registered national securities exchange
  - If not traded on such an exchange, a price not less favorable than the offering price established by the current bid and asked prices quoted by person independent of the parties in the transaction
  - Otherwise, the fair market value as determined in good faith in accordance with DOL regulations (see proposed regs from 1988)

## 408(b)(2) Exemption

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- Allows fiduciary to retain PI/DP to provide services to plan (or entity holding plan assets) under these conditions:
  - Necessary service
  - Reasonable contract or arrangement
    - Must permit termination by plan on reasonably short notice without penalty
    - Beginning 4/1/12, service provider must disclose direct and indirect compensation received to plan
  - Reasonable compensation
  - Fiduciary cannot use exemption to retain its affiliates

## Fund-of-Fund Considerations

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- Example: FOF has BPT%  $\geq 25\%$ , invests in another fund; investee fund becomes  $\geq 25\%$  BPI from FOF investment
- FOF manager:
  - Avoid co-fiduciary liability for sub-manager's acts
  - FOF manager as NF
  - Sub-manager as IM
  - No prohibited transactions at sub-manager level
- Sub-manager now managing plan assets
  - IM? QPAM?
  - Decline BPI FOF investments?

## Compliance with ERISA Requirements

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- Review agreements with prime broker, swap counterparties, etc. for “no plan assets” reps
- Carefully review all fund documents; potential issues include:
  - Indemnification
  - Soft dollars
  - Use of affiliates
  - Expenses charged against fund

## Compliance with ERISA Requirements (cont'd)

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- Performance Fees
  - Could be self-dealing prohibited transaction
  - Advisory Opinions indicate no prohibited transaction if certain conditions met, including:
    - Fee arrangement approved by plan fiduciary
    - Performance based on realized and unrealized gains
    - Most investments have readily available price quotations
    - Other investments appraised by independent appraiser selected by plan and acting on behalf of plan
    - Performance measured over pre-established time period

## Compliance with ERISA Requirements (cont'd)

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- Custody of Plan Assets
  - Hold “indicia of ownership” within jurisdiction of U.S. courts
  - Alternate compliance available for foreign securities, currency
    - Under management/control of U.S. fiduciary, or
    - Held in designated foreign locations under DOL regulations
  - Offshore entity may also consent to U.S. jurisdiction and service of process with respect to plan assets, to satisfy requirement

## Compliance with ERISA Requirements (cont'd)

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- ERISA Bond
  - Required for any:
    - Fiduciary
    - Person who handles funds or property
  - Per plan coverage: lesser of \$500,000 and 10% of plan assets
  - Exceptions
    - Broker-dealer registered under 1934 Act if subject to bond requirements of a self-regulatory organization
    - Trust or insurance companies with capital and surplus > \$1 million
  - Different from ERISA fiduciary insurance

# Reporting and Disclosure Requirements

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- Form 5500, Annual Report of ERISA plan, includes:
  - Schedule C, “Service Provider Information”
    - Direct compensation paid by plan, e.g., management fees
    - Indirect compensation paid by 3<sup>rd</sup> parties to service provider, e.g., soft dollars, 12b-1 fees, gifts & entertainment
  - Detailed rules of what is to be disclosed to plan and how: see [www.dol.gov/ebsa/faqs/faq\\_scheduleC](http://www.dol.gov/ebsa/faqs/faq_scheduleC) and [www.dol.gov/ebsa/faqs/faq-sch-C-supplement](http://www.dol.gov/ebsa/faqs/faq-sch-C-supplement)
- Schedule H, “Financial Information”
  - Includes schedule of investments
  - Commingled investment vehicle may file information with DOL (“direct filing entity”) or provide information directly to plan
- Beginning 7/1/12, expanded disclosure to plans of service provider compensation under ERISA 408(b)(2)