

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

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What Is ERISA?

- 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

- 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

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

Administration & Enforcement of ERISA

- 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?

- 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

- 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

- 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?

- 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

- 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)

- 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?

- 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?

- 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?

- 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”?

- For any class of equity interests:

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

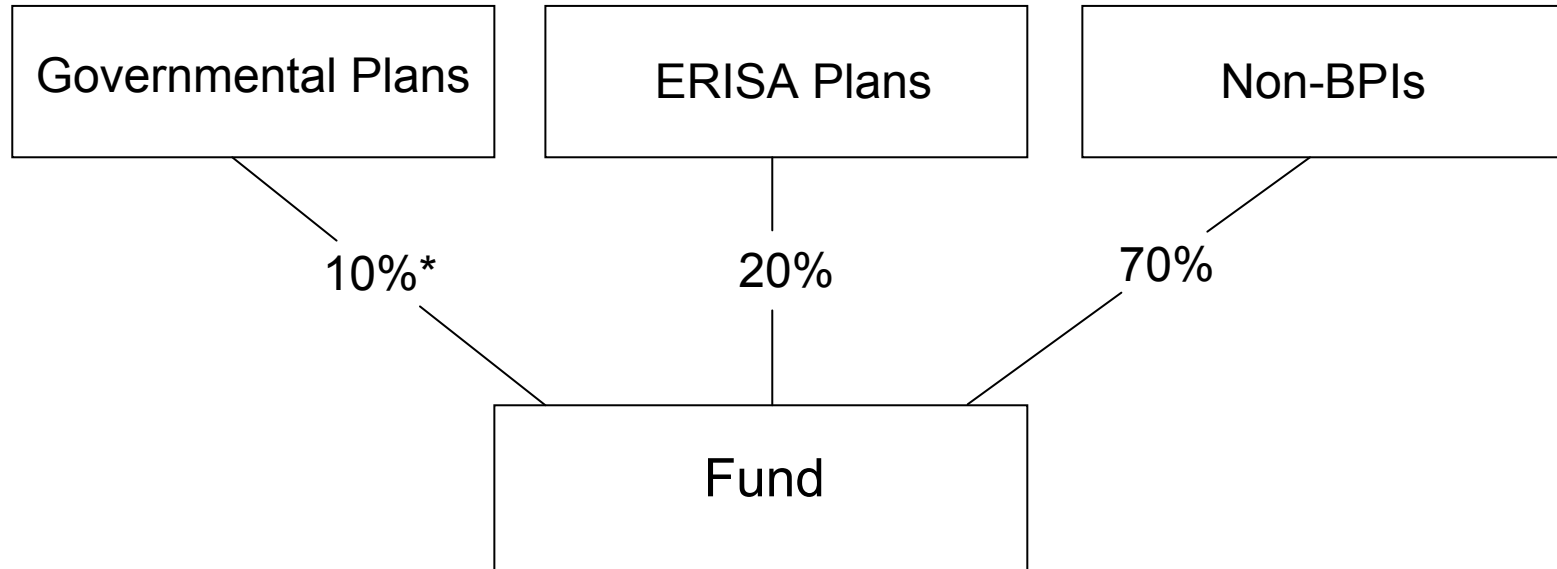
* Equity interests held by non-BPI with discretionary authority or control with respect to the assets of the fund, or an “affiliate” (“Controlling Persons”) are excluded from the denominator

- 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

- 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)

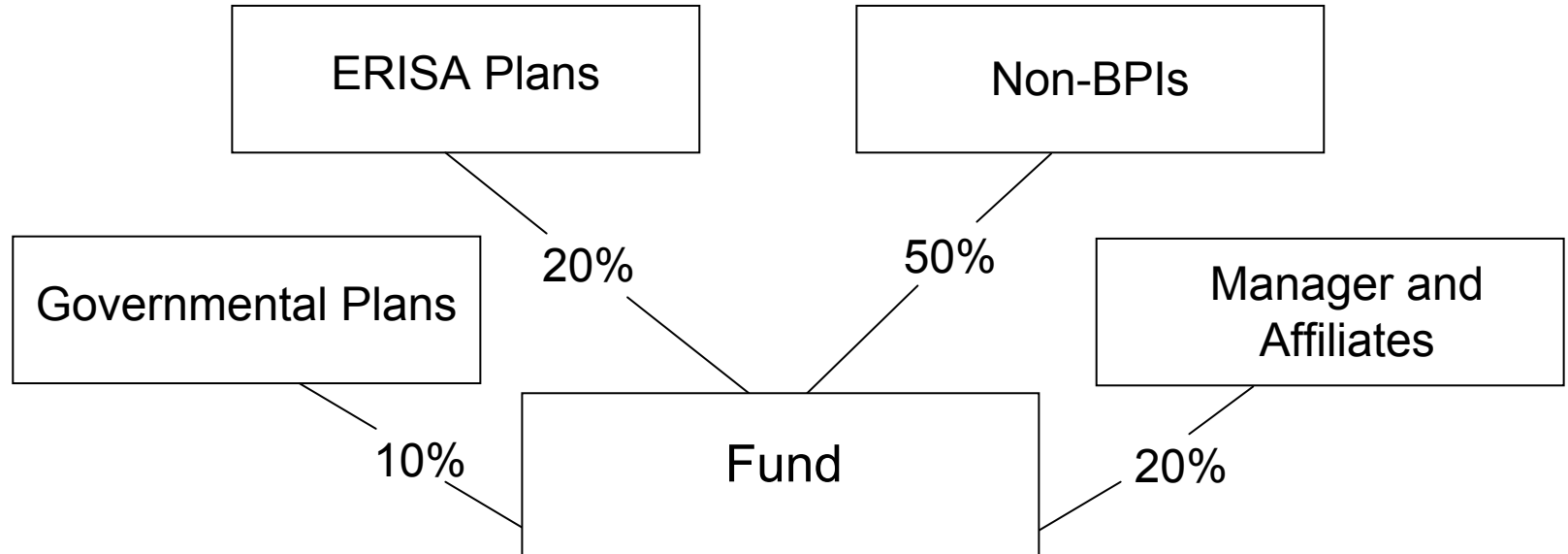
Example 1



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

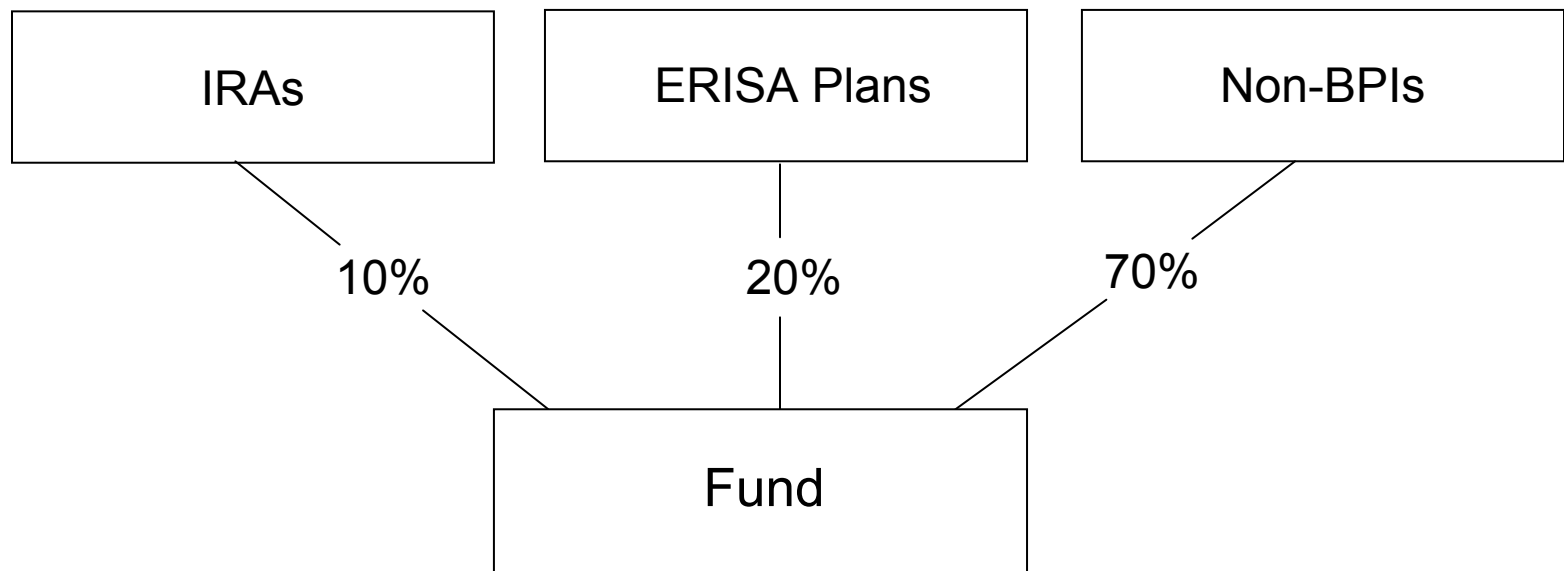
*In each Example, the percentage indicates the percent of the total equity interests in the investee that are held by that class of investors.

Example 2



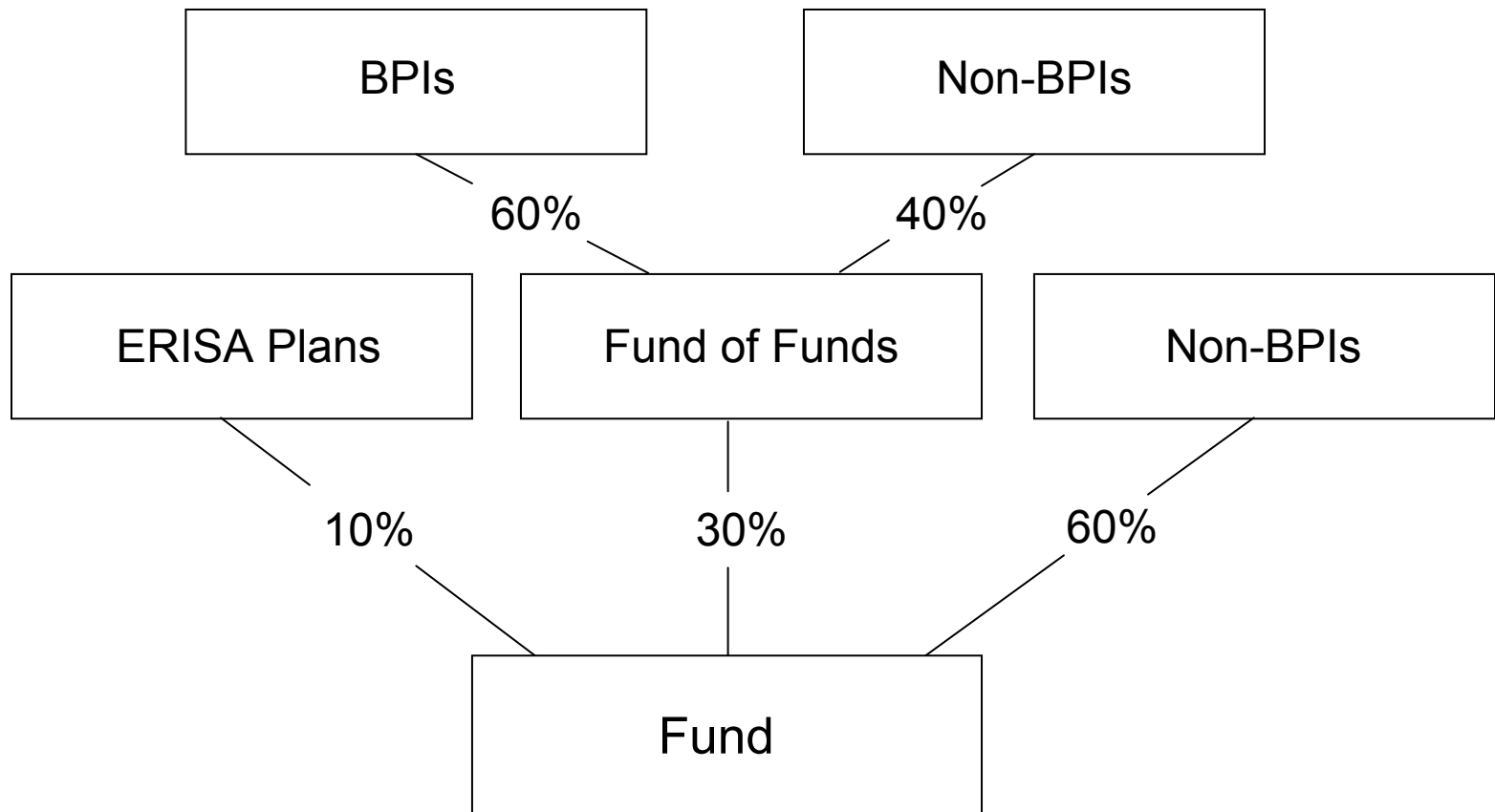
Interests of Manager and Affiliates excluded; BPI % = $20/80 = 25\%$:
Fund deemed to hold plan assets

Example 3



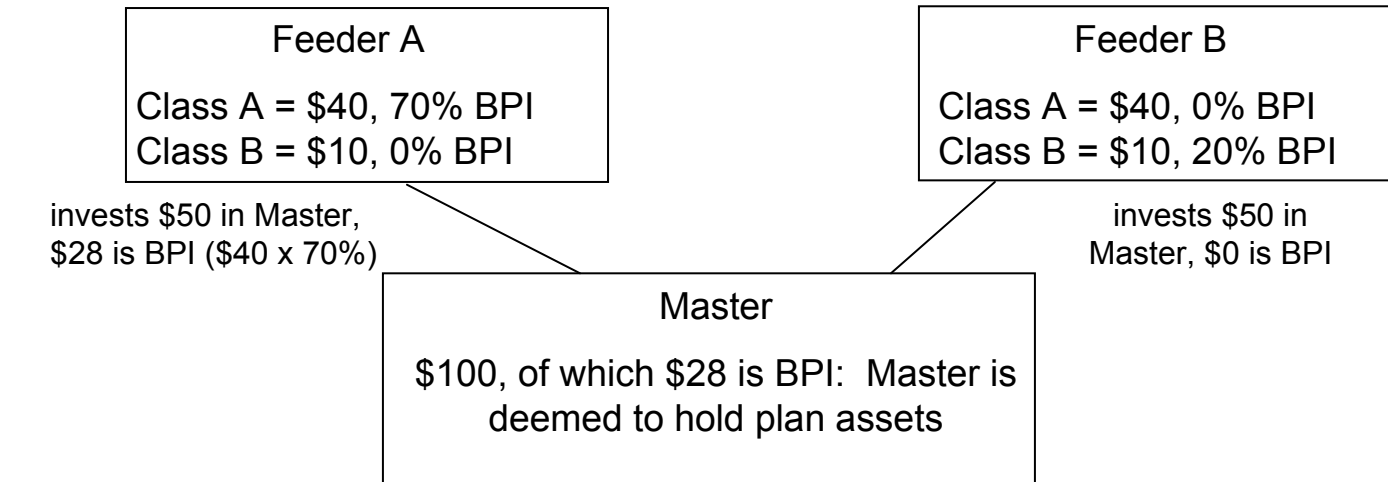
BPI % = 30%: Fund deemed to hold plan assets
If 30% IRAs, 0% ERISA plans, BPI % = 30%: Fund deemed to hold IRA assets for purposes of Tax Code §4975

Example 4

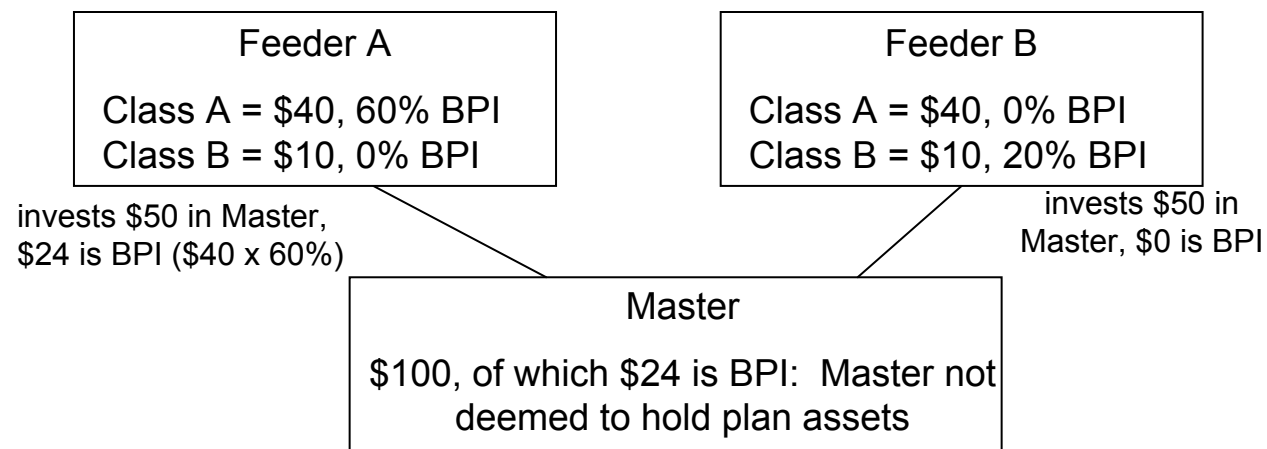


BPI % of Fund of Funds = 60%; BPI % of Fund = $10 + 18/100 = 28\%$:
Fund is deemed to hold plan assets

Example 5



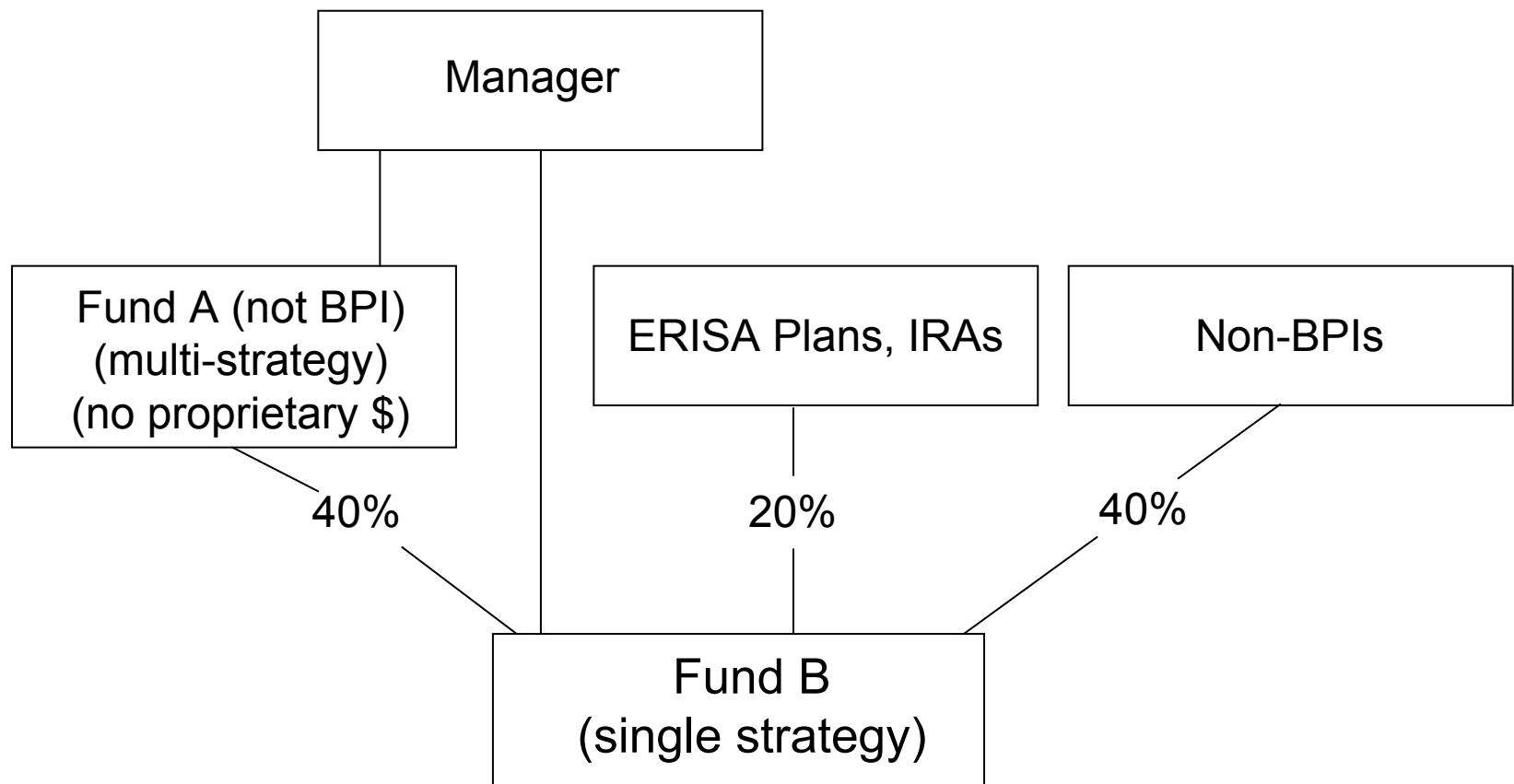
but -



Master-Feeder Structure

- “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



BPI % = ?

Prohibited Transactions

“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)

- 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)

- 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)

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

- 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

- 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

- 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)

- 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

- 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)

- “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

- 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

- 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

- 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)

- 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)

- 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)

- 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

- 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 3rd 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 and 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)