Key Considerations with Alternative Investments for Pension Plans

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Alternative Investments

- Private equity
- Hedge funds
- Real estate
- Commodities

Increased Use for Pension Plans

- According to a Willis Towers Watson's Global Alternatives Survey, the world's 100 largest alternative asset managers saw their assets rise 10% in 2016 to $4 trillion
- Among fund types, pension funds hold 33% of alternative assets
- Approximately $660 billion of public pension funds are invested in hedge funds and private equity funds

ERISA Plan Asset Rules – Default/“Look-Through” Rule

When a plan makes an equity investment in another entity, the underlying assets are considered plan assets unless the investment is in:

- a “publicly-offered security;
- a security issued by an investment company regulated under the Investment Company Act of 1940 (mutual funds);
- an operating company; or
- an entity for which participation by benefit plan investors is not significant.

Benefit Plan Investor "Significant" Investment Rule

- If "Benefit Plan Investors" hold less than 25% of the value of <u>any</u> <u>class</u> of equity interests in the entity, benefit plan investor participation will not be considered significant.
- Therefore, the underlying plan assets will not be considered plan assets and fiduciary duties will not attach to those dealing with the underlying assets of the investment.
- Hedge funds often use master-feeder structure. Tax-exempt investors invest in off-shore blocker entities that feed into main fund. Feeder could fail 25% test, but master could pass it. Set up feeder so that its only investment can be in master. General Partner of feeder would have very limited / no discretion as fiduciary.
- 25% test must be calculated every time investor buys into entity or investor redeems interest in entity.

Benefit Plan Investor Definition

- **Plans subject to Part 4 of Title I of ERISA**
  - Corporate pension plans
  - VEBAs
  - Multiemployer plans
- **Plans subject to Section 4975 of the Code**
  - Individual retirement accounts
  - Keogh plans
- **Entities whose underlying assets include plan assets**
  - Hedge fund whose equity interests are held 25% or more by benefit plan investors and insurance company's general account
  - Benefit plan investor is ERISA-covered plan or IRA or entity with plan assets (like comingled trust). In fund of funds or master-feeder fund arrangement, if feeder fund as 30% plan participation in total equity of feeder, only 30% of feeder's investment in master fund is considered plan assets.

Benefit Plan Investor - Exclusions

- Governmental plans
- Foreign plans
- Non-electing church plans
- “Top-hat” plans

Performing the 25% Calculation

- From the denominator (i.e., the total number of equity interests held), exclude any interests held by a person with discretionary authority or control with respect to the assets of the entity and interests held by a person who provides investment advice for a fee, including affiliates.
- For example, calculation must exclude interests held by hedge fund manager and its affiliates.
- Calculation applies to each class of equity.
- The following features may create a new class of equity:
  - Preferential redemption rights
  - Waiver of management or incentive fees
  - Waiver of redemption fees

Operating Company Exception

Operating Company is an entity primarily engaged, directly through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital.

- Venture capital operating company (VCOC)
- Real estate operating company (REOC)

Venture Capital Operating Company (VCOC)

Entity is VCOC if, on date of first long-term investment and on one day during entity's "annual valuation period":

- At least 50% of its assets (other than short-term investments), valued at cost, are invested in "venture capital investments" or "derivative investments"; and
- During each 12 month period after annual valuation date, entity exercises substantial management rights regarding at least one of its venture capital investments.

Examples – Board seat, right to regularly advise management, receive financial statements, examine books and records.

Definitions

- **Initial Valuation Date:** Date VCOC makes its first long-term investment.
- **Annual Valuation Period:** Pre-established annual period of no more than 90 days that begins no later than anniversary date of initial valuation date. This period generally cannot be changed.
- **Annual Valuation Date:** A day within annual valuation period on which VCOC determines if it meets VCOC compliance tests.
- **Venture Capital Investment:** VCOC's investment in operating company that gives it required management rights.
- **Management Rights:** Contractual rights directly between operating company and VCOC giving VCOC right to substantially participate or influence management operating company.

Real Estate Operating Company (REOC)

- Entity is REOC if on date of first long term investment and on one day during its annual valuation period, at least 50% of its assets, valued at cost, are invested in real estate that is managed or developed by REOC.
- Management or development may be done by third parties if REOC has right to supervise and right to terminate manager or developer.

Hedge Fund Structural and Operational Issues

- **Hedge funds often use master-feeder structure. Tax-exempt investors often invest in offshore blocker entities that feed into main fund. General Partner of feeder would have very limited discretion.**
- **Other funds exceed 25% benefit plan investors, but the manager qualifies as a "qualified professional asset manager" ("QPAM"). QPAMs have a fairly broad ERISA prohibited transaction exemption.**
- **Requirements for "QPAM" status:**
  - Registered investment advisor
  - $85M assets under management
  - $1M shareholders' equity
- **Investment manager appointment and fiduciary acknowledgment in subscription agreement.**

Problems if a Fund Holds ERISA Plan Assets

- Manager of fund typically must be appointed "investment manager" under ERISA and acknowledge its status as a fiduciary
- ERISA fiduciary standard of conduct / "highest standard under law"
- Risk of prohibited transactions and excise taxes
- Personal liability of plan fiduciary/co-fiduciary liability
- Manager's conflict of interest problems
- Performance fees raise conflict and self-dealing issues
- Fidelity bond for ERISA fiduciaries
- "Indicia of Ownership" of plan assets must be in the United States

Typical Side Letter Provisions

- Additional ERISA "plan asset avoidance" representations/feeder vehicle structure
- Allow routine assignment to successor trustee
- Allow a more immediate withdrawal in the event of an ERISA violation or plan asset situation
- Provide that anti-money laundering representations apply to the benefit plan trust and not to the underlying plan participants

Questions?