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Legal Update

Fiduciary Framework for Investment by Defined Contribution Plans in Alternative Assets

With the maturing, growth and increasing importance of defined contribution plans to the retirement security of US employees, many plan fiduciaries and managers of designated investment alternatives designed for defined contribution plans are considering whether it is appropriate and prudent to include a broader array of asset classes in defined contribution plan portfolios to enhance diversification, investment return and retirement outcome for defined contribution plan participants. This Legal Update reviews recent trends, considerations under the Employee Retirement Income Security Act of 1974, as amended, ("ERISA") and potential legal risks arising out of the investment of defined contribution plans in alternative asset classes.

Background and Trends

The Pension Protection Act of 2006 (the "PPA") gave a boost to the movement to better diversify defined contribution plan portfolios. In particular, the PPA added a new Section 404(c)(5) of ERISA that created a new fiduciary safe harbor for "qualified default investment options" or "QDIAs," which are discussed in more detail below. For the first time, participants who did not direct the investment of their accounts under a 401(k) plan could be defaulted into a professionally managed, diversified investment option without the risk of fiduciary liability for the investment election. Since the PPA, thanks to the QDIA safe harbor and other PPA enhancements designed to encourage and support retirement savings and investment, including automatic enrollment,[1] assets in professionally managed, diversified target date funds and other QDIAs have grown exponentially.

Investment Case for Alternatives in DC Plans. A number of recent academic, consultant and industry group studies have focused on this trend and advocate for the need to better diversify defined contribution plan assets into private equity, hedge, real estate, infrastructure and other alternative asset classes that are commonly included in defined benefit plan portfolios. Listed below is a sampling of the resources in support of alternative investments in defined contribution plans:

- The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Pan Outcomes – Georgetown Center for Retirement Initiatives in conjunction with Willis Towers Watson 2018, https://cri.georgetown.edu/wp-content/uploads/2018/06/PolicyReport18-01.pdf (academic study urging DC industry leaders and policymakers to consider ways in which DC plan structures can be improved to increase participants' chances for success. A major concern with DC plans today is the volatility of underlying accounts, which are invested primarily in a mix of stocks, bonds and cash. The risks of such a concentrated investment mix was experienced by participants in the 2008 market recession when global equities lost 41.1 percent of their value. The study demonstrates how a diversified allocation to alternatives can significantly reduce volatility and improve retirement outcome.)

- A Path to Better Retirement Outcomes – Allocating Real Estate Assets to Defined Contribution Portfolios – Defined Contribution Real Estate Council ("DCREC") 2014, https://dcrec.org/Resource (Academic study demonstrating how an allocation to real estate in a DC plan portfolio improves retirement outcomes for plan participants.)
- Real Estate Allocation in the DC Lifecycle: A Dynamic Approach – DCREC 2016, https://dcrec.org/resources/Documents/DCREC RE Allocation Within the DC Lifecycle White Paper 12.1.16.pdf (Academic study results underscore the portfolio benefits of real estate in a DC context for a DC outcome-oriented multi-asset portfolio.)
- Institutionalizing Defined Contribution Plans – Defined Contribution Institutional Investment Association ("DCIIA") 2011, https://dciia.org/page/WhitePapers (Reviewing research into reasons for the performance gap between DB and DC plans and changes needed to "institutionalize" defined contribution plans, including adding alternative investments.)
- Is It Time to Diversify DC Risk with Alternative Investments? – DCIIA 2013, https://dciia.org/page/WhitePapers (Reviewing evolution of DC plans, the performance gap justifying need for alternatives and the considerations for including alternative assets in DC plans.)
- Capturing the Benefits of Illiquidity – DCIIA 2015, https://dciia.org/page/WhitePapers (Discusses investment benefits of hedge, real estate and private equity investments; reviews concerns and considerations for defined contribution plans, including daily valuation and liquidity, and includes case studies of four defined contribution plan sponsors that have added illiquid assets to their defined contribution plans.)
- Alternative Assets: The Next Frontier for Defined Contribution Plans–AON 2013, https://dcrec.org/page-1861906 (Alternative investments such as hedge funds, private real estate and commodities have historically been excluded from defined contribution plans. This trend is changing, and Aon expects the pace of change to accelerate over the next several years. Alternative investments are most appropriately included in defined contribution plans through multi-asset funds such as target date funds and diversified core options, which reduces the potential for misuse by plan participants. An evolving product space has led to an increasing number of attractive options.)
- The Alternative Route: A Smoother Ride for Defined Contribution Plans – NEPC 2014, https://dcrec.org/page-1861906 (White paper with research supporting better outcomes for defined contribution portfolios that include alternative assets by reducing risk with uncorrelated assets.)
- Expanding Opportunities for Investors and Retirees: Private Equity, Committee on Capital Markets Regulation, https://www.capmktsreg.org/policy-work/?fwp_categories=major-reports (Recommends that the DOL provide guidance to fiduciaries regarding how

private equity can be included in DC plans within the ERISA Section 404(c) safe harbor and should provide a new safe harbor for private equity.)

There are several points that the recent academic, consultant and industry research and white papers agree upon with respect to the inclusion of alternative assets in defined contribution plans:

- Defined contribution plans lag defined benefit plans in investment performance, and one notable reason for this is the fact that the investment of defined benefit plans is better diversified and includes exposure to alternative asset classes.
- To improve the retirement outcome for defined contribution plan participants, defined contribution investment options should be better diversified and include exposure to alternative asset classes.
- Direct access by plan participants to alternative asset classes is problematic. First, alternative assets are generally only available through private investment vehicles that are subject to SEC restrictions that preclude investment by many plan participants. Second, such investments are often more complex and less transparent, giving rise to participant education and communication challenges. They often do not have useful benchmarks, are illiquid and hard to value. For these and other reasons, the white papers either do not advocate for, or caution against affording participants direct access to, alternative investments.
- On the other hand, alternative asset classes enhance and should be included in diversified portfolios, such as balanced funds, and even QDIAs, such as target date funds.

Current Status of DC Plan Exposure to Alternatives. Indeed, many defined contribution plan fiduciaries are adding exposure to alternative asset classes to their defined contribution plan portfolios, as noted in a November 2011 report published by the Advisory Council on Employee Welfare and Pension Benefit Plans (commonly known as the ERISA Advisory Council), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2011-hedge-funds-and-private-equity-investments.pdf

DCREC has conducted a product survey that attempts to capture the magnitude of defined contribution plan assets invested in real estate and hopes to monitor the trends over time through regular updates to its survey. An executive summary of DCREC's first survey that includes assets under management information can be found at: https://dcrec.org/DC-Product-Survey The survey identified seventeen daily valued real estate products that are available to defined contribution plans. Six of these products hold over $1 billion of defined contribution plan assets each.

Alternative DC Product Structures and Features. While alternative investment options have been available as direct participant options for defined contribution plans for many years through the recordkeeping platforms of a few insurance companies and other financial institutions, the growth in alternative DC plan products in recent years has primarily focused on the opportunity presented by the emergence of professionally managed target date and other QDIA's seeking to better diversify their portfolios. These products generally have the following features:

- Investor eligibility is limited to sophisticated fiduciaries seeking to include alternative assets as an allocation within a diversified, multi-asset investment option.
- The products that primarily offer investment exposure to private equity or private real estate or other private equity investments

are typically structured as bank collective investment trusts or insurance company separate accounts (if offered by an insurance company). The products that offer exposure to securities may also be structured as closed-end registered investment companies.

- The products provide daily valuations consistent with typical defined contribution recordkeeping and trading platforms, but do not offer daily liquidity. Some offer limited daily liquidity to accommodate the typical rebalancing needs of a multi-asset portfolio. Others offer only monthly or quarterly liquidity.

ERISA Considerations

Alternative asset classes such as private equity, hedge and real estate are customary components of a prudent and well-diversified defined benefit plan portfolio. The fundamental ERISA principles of prudence, diversification, etc., applicable to the investment of plan assets is essentially the same for defined contribution and defined benefit plans. But the structural differences between the two types of retirement plans cause many fiduciaries and their ERISA counsel to wonder whether ERISA permits inclusion of alternative assets in a defined contribution plan. This Legal Update outlines the fiduciary framework applicable to such an investment consideration.

ERISA Advisory Council. The 2011 ERISA Advisory Council report referenced above recognized the need for better guidance on alternative investments for plan fiduciaries and recommended that the Department of Labor develop a tip sheet to assist plan fiduciaries in evaluating the appropriateness of hedge fund and/or private equity fund investments, and in selecting and monitoring these investments in their plans. The Council's suggested tips for plan sponsors to consider when evaluating a hedge or private equity investment for a defined benefit plan are included as **Appendix A** to this Legal Update.

The report noted that interest in hedge funds and private equity investments has grown in the defined contribution plan area, with some plan fiduciaries choosing to offer investment alternatives that contain these strategies. The Council noted support from several witness for enhancing diversified multi-asset investment portfolios offered as investment options in defined contribution plans with an allocation to alternative asset classes. The Council observed that the factors set forth in the tip sheet may be helpful to fiduciaries of defined contribution plans considering alternatives; but that defined contribution plan fiduciaries would also need to consider certain unique issues, such as participant communications, disclosure and liquidity.

Prudence Standard of Care. In 1974, ERISA revolutionized the investment of US pension assets by moving away from the traditional common law prudent investor standard of care to the modern portfolio investment theory embodied in ERISA's prudent person standard of care. In lieu of requiring each investment to be prudent and conservative, the modern portfolio theory applies the standard on a portfolio basis, opening the door to an investment allocation across the risk and return spectrum. As a result, since 1974, pension assets have been diversified into the broader universe of investment alternatives, including equities, derivatives, and alternative asset classes. Plan fiduciaries and their consultants have long embraced the importance of alternative asset classes, such as real estate, to the prudent diversification of investment risk and return to their portfolios.

Factors Relevant to Prudent Investment Decisions. Although defined benefit and defined contribution plans are governed by exactly the same standards of care, the standard must be applied taking into account the unique factors of each plan. Department of Labor regulations[2] state that a plan fiduciary should give "appropriate consideration" to the following factors when investing the plan's portfolio:

i. the composition of the portfolio with respect to diversification,
ii. the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and
iii. the projected return of the portfolio relative to the funding objectives of the plan.

The daily trading environment of 401(k) plans is one of the factors that might preclude the inclusion of illiquid alternative asset classes as a direct investment option in such plans. On the other hand, if a relatively small allocation to an illiquid investment were considered for a diversified, multi-asset investment option within the plan, the plan fiduciary would need to consider whether the investment option as a whole could continue to provide the requisite daily liquidity in light of the inclusion of the illiquid investment. This is not unlike the cash flow considerations a defined benefit plan fiduciary must take into account with respect to allocations to illiquid assets within the defined benefit plan's portfolio.

ERISA Section 404(c). Section 404(c) of ERISA provides that no person is a fiduciary to the extent that a participant exercises control over the investment of his or her account under an individual account plan. As a result, plan fiduciaries are relieved of fiduciary responsibility and liability for investment decisions made by plan participants in a plan that meets the requirements of ERISA Section 404(c). Plan fiduciaries continue to be responsible for selection of the investment alternatives made available to participants on the plan's platform. In order to meet the requirements of ERISA Section 404(c), the plan must, among other requirements, offer participants the opportunity to give investment instructions among "a broad range of investment alternatives."

A 404(c) plan may impose reasonable restrictions on the frequency with which participants may give investment instructions. However, in no event would such a restriction be reasonable with respect to a particular investment option unless the participants have the opportunity to give investment instructions with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject.

Although plan fiduciaries are not required to comply with ERISA Section 404(c), its liability protections provide a tremendous incentive for fiduciaries to adhere to its guidelines. In principle, plan participants should be willing to accept or agree to limited liquidity with respect to contributions made on their behalf to fund their retirement in exchange for an improved investment outcome. But current law provides no incentive to plan fiduciaries to consider such options.

QDIA Rules. To the extent that a participant in a 401(k) plan fails to affirmatively direct the investment of his or her account, plan fiduciaries will be protected from fiduciary liability for the investment of the participant's account if the default option under the plan is a qualified default investment alternative, or QDIA. A QDIA is an investment alternative that "applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures. . . .," such as balanced funds and target date funds.[3]

Defined contribution plan fiduciaries are likely to find significant support in the academic and consultant investment research for the conclusion that the inclusion of alternative asset classes in a professionally managed, multi-asset portfolio is consistent with the requirement of a QDIA to apply generally accepted investment theories to diversify the portfolio so as to minimize the risk of large losses and provide varying degrees of long-term appreciation and capital preservation.

Consistent with the requirements under ERISA Section 404(c), a QDIA must offer participants the opportunity to transfer out of the QDIA at least as often as participants are permitted to transfer into the QDIA, but not less frequently than once in any three-month period.

Balancing Prudent Diversification and Liquidity Considerations. Although defined contribution plans have different liquidity considerations than defined benefit plans, the principles under ERISA Section 404(c) and the QDIA safe harbor evidence a policy intent to afford participants in defined contribution plans the same level of investment diversification and return that would generally be considered prudent for any retirement plan. therefore, the manager of a QDIA could, consistent with its fiduciary duties, include an allocation to private equity, hedge, real estate and other less liquid, alternative asset classes in the QDIA, provided that the overall portfolio is appropriately diversified in light of the liquidity needs and risk and return objectives. And a defined contribution plan fiduciary could, consistent with its fiduciary duties, select such a QDIA for the plan.

Fee Disclosures to Plan Fiduciaries and Participants. Alternative investments are inherently more expensive as an asset class, both in terms of operating costs and fees. The ultimate consideration for plan fiduciaries and participants should be the net return and retirement outcome generated from a prudently managed retirement portfolio. However, the intense ERISA litigation focus on fees in 401(k) plans often triggers even sophisticated defined contribution plan fiduciaries to place a disproportionate emphasis on reducing fees. While fiduciaries may wish to closely scrutinize the expenses associated with alternatives relative to their value, gathering and reporting fees and expenses associated with alternative assets may present additional challenges.

Alternative investments do not often fit neatly within the ERISA guidelines on fee disclosure under ERISA Section 408(b)(2) and regulations thereunder[4] (disclosures required by covered service providers to plan fiduciaries) and ERISA Section 404(a) rules on disclosures required by plan fiduciaries to plan participants.[5] As a result, plan fiduciaries may need to do additional diligence in this area to obtain the information necessary to have an "apples to apples" comparison of investment alternatives available with respect to gross and net fees and operating expenses.

For example, the 408(b)(2) fee disclosure rules do not require the manager of a fund that qualifies for a plan asset exception[6] to make 408(b)(2) disclosures with respect to compensation it receives from the fund. Many hedge, private equity and direct real estate funds qualify for a plan asset exception. Other (otherwise similar) alternative funds may be structured as plan asset funds. The managers of plan asset alternative funds would be treated as covered service providers for the purpose of the 408(b)(2) fee disclosure requirements. To further confuse matters, compensation received by managers of funds that rely on the less than 25 percent benefit plan investor plan asset exception under the plan asset rules, is reportable compensation that plan fiduciaries are required to obtain and disclose on the plan's Form 5500 Schedule C even though such managers are not considered fiduciaries or service providers to the plan under ERISA. Therefore, plan fiduciaries should look beyond disclosures required by ERISA to be sure they obtain full fee and expense information relevant to an investment decision. Alternative investment products are generally marketed with more detailed offering disclosures than a typical defined contribution investment option, including disclosure of offering, operating and other fees and expenses, conflicts, legal and risk considerations. Plan fiduciaries considering alternative investments also often supplement the standard marketing disclosures with questionnaires, RFIs or RFPs to the managers under consideration.

Similarly, the ERISA rules governing required investment disclosures to plan participants do not do a good job of addressing alternatives. As discussed above, investment products that include illiquid alternative assets are typically structured through non-registered investment fund vehicles. The Department of Labor's guidance on how plan fiduciaries should disclose annual operating expenses for designated investment options that are not registered under the Investment Company Act of 1940 refer fiduciaries to the disclosure requirements under Securities and Exchange Form N-1A, applicable to registered funds.[7] In the case of a fund of funds target date option, the Form N-1A requirements, when applied strictly, may result in the internal fees and expenses of certain types of underlying investment vehicles being pulled into the target date option's total annual operating expenses for 404(a) reporting purposes, while the fees and expenses of other types of vehicles would merely be factored into the investor's net return. As a result, plan fiduciaries that include alternative funds in their defined contribution plan portfolios will need to consider whether the 404(a) investment disclosures to participants should be accompanied by any additional explanation or participant education to assist participants with evaluating the information provided.

ERISA Litigation Risk

The fear of ERISA class action litigation has a chilling effect on defined contribution plan fiduciaries that often prevents them from innovating, even where there is strong support for the conclusion that it would benefit plan participants. For this reason, many defined contribution plan fiduciaries may be reluctant to consider the inclusion of alternative investments until the practice becomes more established or the Department of Labor provides clear guidance. There is little litigation focused specifically on the appropriateness of alternative investments for defined contribution plans. Below is a summary of a few noteworthy complaints and rulings.

Complaints Involving Alternative Investment Options Available to Participants. During the last economic recession, a widely publicized complaint was filed against Principal Financial Group Inc. and its affiliated companies, alleging they breached their fiduciary duties to their pension plan clients by mishandling a real estate investment fund known as the "Principal U.S. Property Account."[8] The Principal U.S. Property Account is a daily valued and daily traded insurance company separate account that holds direct real estate interests. At the heart of the complaint was a freeze imposed on daily redemptions during the extremely illiquid markets at that time. While the complaint was ultimately settled with no conclusion on the merits of the allegations, it continues to cast a shadow on the advisability of offering plan participants direct access to alternative assets.

More recently, the issue has appeared in many of the numerous complaints that have been filed against university Section 403(b) plans that are working their way through the court system.[9] *Sacerdote v. New York University*,[10] was one of the first of the 403(b) cases to reach a trial court decision. As with many of the 403(b) case complaints, the complaint in the NYU case focused on a range of allegations, including too many investment options, excessive administrative and recordkeeping fees, multiple recordkeepers, asset-based revenue sharing, float, high-cost share classes when lower cost identical funds were available, duplicative investment options, retention of underperforming funds and failure to monitor fiduciaries.

One of the allegedly underperforming funds targeted in the NYU case and many of the other 403(b) cases was the TIAA Real Estate Account. The Real Estate Account is a daily valued and daily traded insurance company separate account invested directly in real estate. Plaintiffs focused on the Real Estate Account because it had been put on a watch list by the NYU investment committee. There also did not appear to be a clearly appropriate benchmark for this type of investment option. The plan fiduciaries defended their retention of the Real Estate Account with support from an independent investment expert who opined on the diversification benefits of real estate. In ruling for the defendants on all claims in its decision issued on July 31, 2018, the court acknowledged the investment value of real estate and also took favorable note of the fact that of TIAA's 200 largest investors only two did not include the Real Estate Account in its plan's investment line up.

The NYU decision provides some hope for fiduciaries looking to include alternative asset classes in their defined contribution plans. However, the outcome of this case has not been finally settled. In addition, similar allegations involving other university plan fiduciaries are still working their way through the litigation process in other Federal courts that could rule differently.

Complaints Involving Diversified Multi-Asset Investment Options that Include Alternative Assets. A 2015 complaint filed against Intel Corporation criticized Intel's inclusion of private equity and hedge investments in certain diversified, multi-asset investment options offered in its defined contribution plan. Plaintiffs alleged that such investments are per se imprudent in a 401(k) plan. Intel Corporation was one of the innovators in defined contribution plan investment design, having designed a custom target date fund option that included private equity, hedge and commodity exposure.

The 2015 complaint alleges that the Intel fiduciaries breached ERISA by:

- "investing a significant portion of participants' assets in risky and high cost hedge fund and private equity investments."
- "adopting asset allocation models for participant accounts that differed dramatically from prevailing standards employed by professional asset managers and plan fiduciaries."

Regarding the harm suffered by plan participants, the complaint points to the higher fees relative to other investment options available in the market place with specific reference to Fidelity's passively managed target date funds. There is specific reference to annualized underperformance for the three-year period ending June 2014 relative to such passive index funds of 400 basis points. The complaint translates this underperformance as amounting to hundreds of millions in lost account value that the plan would have realized if the Intel fiduciaries had invested in an industry-accepted index target date fund.

Finally, the complaint alleges breach of fiduciary duty on behalf of the plan's administrative committee for inadequate disclosures relating to the target date investment. The suit claims "Virtually nothing about the strategy, the risks, the fees or anything about underlying [hedge and private equity] investments was disclosed in anything that Defendants provided to or made available to participants."

The District Court in the Northern District of California granted Intel's motion for summary judgment that the claims were barred by the three-year statute of limitation under ERISA on the ground that the plaintiffs received disclosure that the investment option included the alternative investments that are alleged to be imprudent.[11] According to finding of facts, the plaintiffs received annual notices, quarterly fund fact sheets, targeted emails, and two separate websites with information on the nature of the investments in the fund option.

The Ninth Circuit subsequently reversed the District Court's dismissal, and Intel appealed to the Supreme Court, which granted certiorari to consider the narrow ERISA statute of limitation issue. Specifically, the Supreme Court is set to decide whether the three-year limitations period for "actual knowledge" starts when disclosures are made available to participants or if it begins only if/when the participant actually reads the disclosure.

While, as of the date of this Legal Update, Intel had not yet filed any briefs responding to the substantive ERISA allegations in the complaint pending the determination of the statute of limitations question, one would expect that Intel would rely heavily on expert support for the investment merits of alternatives, and the ERISA principles set forth above. The ultimate outcome of the Intel case will be significant for fiduciaries who have or are considering investment options that include an allocation to alternative asset classes.

APPENDIX A

Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable Hilda L. Solis,

United States Secretary of Labor

Hedge Funds and

Private Equity Investments

November 2011

Tips for Plan Sponsors to Consider when Evaluating a Hedge Fund or Private Equity Investment for a Defined Benefit Pension Plan

ERISA imposes a standard of care on ERISA fiduciaries in choosing investments for a pension plan that includes giving appropriate consideration to the facts and circumstances that a fiduciary knows, or should know, about a particular investment option. This standard of care includes a duty to evaluate the role an investment option plays in the plan's portfolio, including whether such investment option would further the purposes of the plan, taking into consideration the risk of loss, the opportunity for gain, and the portfolio's diversification, liquidity and projected return of the investment, and the cost of due diligence. ERISA holds the fiduciary, when making investment decisions, to a high standard of care so that the fiduciary acts under the standard of a professional investment expert, not under the standard of an individual with little or no investment expertise.

In order to assist plan sponsors who are considering whether to invest pension plan assets in hedge funds and/or private equity funds, fiduciaries can use the following set of questions and answers to assist them in selecting and monitoring these types of investments.

1. ***What are hedge funds and private equity funds?***

- The term "hedge fund" is commonly used to describe a pooled investment vehicle that is privately offered to institutions and other sophisticated investors where the fund is not registered (like a mutual fund or an exchange traded fund) with the SEC. The hedge fund often engages in active trading of various types of securities, commodities, derivatives, option contracts and other investment vehicles and may employ borrowing, or "leverage," techniques to help it achieve its objectives.

- The term "private equity fund" is commonly used to describe a pooled investment vehicle that is privately offered and includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange.

2. ***How can I determine if a hedge fund or a private equity fund is an appropriate investment for a plan?***

- Each hedge fund and private equity fund has one or more investment strategies. Identify the fund's specific investment strategy or strategies and determine their fit to the plan's investment policy and current investment portfolio. Hedge fund strategies could include global macro, event driven, equity market neutral and other strategies. Private equity strategies could include venture capital, corporate buyouts, and other strategies.

- Many hedge fund strategies are structured to produce smooth market returns in anticipation of lower volatility. Other strategies essentially give the investment manager complete discretion over the selection of investments for the fund.

- Private equity investments are structured to take advantage of different phases of a business development cycle, with different risk characteristics. Investor contributions will be structured over a period of 3-5 years, or longer, and each fund will have its own unique payout structure, thereby making the comparisons between funds difficult. This is generally true even within funds that employ similar strategies because the investment managers each have unique approaches to the selection of investments.

- Conduct research and understand the differences in the investment strategies and determine the role a selected investment strategy will play in the portfolio of the pension plan. Note if a fund has a certain geographical or market sector bias that may or may not fit with your plan.

- Consider the differences between a direct investment in a private equity or hedge fund, and an indirect investment through a fund of funds option (i.e., a fund that invests in a number of underlying hedge funds or private equity funds). Particularly for a small plan, a fund of fund approach may enable the plan to indirectly invest in funds not otherwise available to a small plan, especially since the plan would be making a smaller fund investment. The fund of funds also offers additional diversification and layers of due diligence (especially if SEC registered), in exchange for adding another layer of management fees and administrative costs. Understand the investment strategies of any underlying investment managers (“sub-managers”) of a fund of funds product.

- In all cases, meet with the managers of the fund (hedge fund, private equity fund, and fund of funds) and consider sending out a follow up Request for Information and a Due Diligence Questionnaire to the fund managers. The correspondence should include questions about their investment process, organization and fees, in addition to reviewing the fact sheet, offering memorandum, and partnership agreements applicable to the investment. Overall, evaluate the fit of the investment to the investment goals, investment policy, and other relevant goals of retirement plan, participants, and beneficiaries under the plan.

3. *What are some of the issues in evaluating the historical return and risk profile of a specific hedge fund or private equity fund investment strategy relative to a broad market index?*

- For a hedge fund investment, evaluate the annualized return and the risk (as measured by the standard deviation of return) of the investment strategy over a 7-10 year period. Compare these metrics to the metrics of a broader market-based index such as the S&P 500. Comparison to hedge fund index, such as the HFRI Composite Index, or to a subset of a hedge fund index that only includes funds with specific strategies (e.g., event driven hedge funds), may be helpful. Review the manager's use of leverage or derivatives to achieve superior performance.

- For a private equity investment, consider the track record performance of previous funds structured by the general partner, and compare to a composite index, such as Thomson Venture Economics, for similar strategies over similar investment periods.

- Understand that any index of such funds may include performance bias, such as selection and survivorship biases.

4. *Do I have the expertise and time needed to evaluate whether the hedge fund or private equity fund is appropriate for my plan?*

- Hedge funds and private equity funds can be much more complex than other investments, and generally require a greater level of investment sophistication and due diligence to evaluate the investment risks associated with the fund in both the selection of a fund, and monitoring the fund on an ongoing basis. If you do not have the expertise to make the necessary evaluation of these funds, you should hire an expert investment professional to assist you. You can also consider investing through a fund of funds and hiring an investment professional to assist you in choosing the appropriate fund of funds. The investment professional should be independent, rather than someone whose compensation depends on what he or she sells to the plan.

- Whether the assets of the pension plan are invested in the fund directly or through a fund of funds, and whether you engage an outside investment professional to assist you, you should evaluate whether all fiduciaries involved with the plan have adequate time and resources to devote to the prudent selection and monitoring of the investment.

5. *What do I need to understand about hiring an investment firm to assist me?*

- If you are hiring an investment firm to assist in the selection and monitoring of hedge fund and/or private equity investments, understand how the investment firm evaluates and monitors the fund investments in the plan's portfolio, and how the hedge fund or private equity investment enhances portfolio diversification for the plan. How frequently do they evaluate and monitor the plan's holdings?

- Ask the investment firm how they evaluate risks to the plan's portfolio and how do they control portfolio risk. Do they perform stress testing and risk analysis, and what is the state of their technology to support it? What assumptions do they make about the future and how do they develop scenarios to stress test? Are they using state of the art technology, and is it developed in-house, or do they use off-the-shelf programs? Have their investment processes or models been validated by outside experts? What is the past experience of their quantitative team? Will they perform an investment liquidity analysis?

- Understand the investment firm's due diligence process. Review how, and how often, the investment firm conducts financial analysis, operational due diligence and background checks on their personnel. Ask about their procedures to evaluate the fund's internal controls and compliance, and how would they uncover a trading fraud.

6. *How should I conduct the due diligence process before investing in a hedge fund or private equity fund?*

- You may hire an independent outside investment firm to conduct the due diligence process before investing in a hedge fund or private equity fund, or you may handle the due diligence process in house. In either case, you should anticipate that the due diligence process will be more involved from a time and cost standpoint than the process used in selecting other investments for the plan.

- The due diligence process should evaluate fund performance, investment risk, use of leverage and derivatives, credit risk, operational risk, legal risk, valuation and reporting.

- Request and check references and perform background checks on the fund and the individual managers. Request a copy of documents, such as the fund manager's compliance manual, code of ethics, and a yearly audit. Conduct a site visit.

- Understand how private equity funds create the cash flow projections that form the basis of the investment terms. In addition, for a private equity investment, review copies of any legal agreements, especially for capital calls/draw down and capital recovery at the exit. Also understand the level of liability of the general partner versus the limited partners.

- If the investment is in a fund of funds, become familiar with the underlying funds.

7. *Since hedge fund and private equity returns are highly dependent on manager expertise, how should I evaluate that expertise?*

- Discuss the level of experience and background of senior managers across all disciplines within the organization.

- Evaluate previous investment and managerial experience, including the manager's experience with other funds. Many hedge fund and private equity managers operated in traditional investment strategies prior to moving to alternative investments and may have a previous performance track record that can be evaluated.

- Understand the implications for the fund in the case of loss of a key person(s).

8. *What are some of the issues in evaluating fees? Are there additional fees being charged?*

- Fees associated with hedge fund and private equity investments may be higher and more complex than traditional investments. Most hedge fund and private equity investments have both asset-based management fee and a performance-based fee (called “carried-interest” for private equity funds). The investment manager will collect a fee for achieving an annual performance over a stated level (often called a “high water mark” or “hurdle rate”). The performance-based fee calculation can be complex, but you should understand situations that drive this fee, other fees, and how the fees are disclosed.

- Many investments have additional fees, such as upfront, placement, early redemption, and administrative fees.

- Private equity investments may impose substantial penalties if a capital commitment is not met, and special provisions for "carried interest," which is the portion of the profits that are retained by the general partner.

- If you are considering the fund of funds route to investing, understand that in addition to the fees charged by the underlying fund managers, the fund of funds will have its own fee structure, that could also include an additional asset-based management fee and a performance- based fee.

- When evaluating whether the fees being charged are appropriate for your plan, note that the fee should be evaluated according to the nature of the investment and that it may be appropriate to pay a higher fee for the services obtained.

9. ***What do I need to understand about the liquidity of the hedge fund or private equity fund with respect to my plan?***

- Investigate the liquidity of the investments, and your ability to move some or all of the investment out of the fund when needed. Unlike registered investments, hedge funds and private equity funds do not have a secondary market and are not redeemable at will, and ownership cannot be terminated unless agreed upon with the investment manager. Most funds have lock-up provisions, gates, early termination rights, and pre-determined payment restrictions, any of which could delay your ability to move out of the fund.

- Strongly consider the impact of illiquidity on the plan's overall investment strategy, and the relationship of the plan’s asset portfolio to its liabilities, benefits obligations, and expected payout requirements.

- For example, private equity funds are very illiquid, and could have a capital commitment period of 3-5 years and an investment could be locked up for as much as 10-15 years.

- Redemption notification periods and requirements with a considerable payment lag can be expected.

10. ***What is involved in legal due diligence?***

- Ensure that the investment is consistent with the plan's investment policy.

- Utilize legal counsel that has experience with these types of funds and with ERISA plans.

- It is important that legal counsel review all the documentation that will affect the plan's rights, responsibilities and liabilities when it invests in a hedge fund, private equity fund, or a fund of funds. This will include multiple documents, such as the fund's offering memorandum, due diligence questionnaire, operating agreements, subscription agreement, and side letters.

- Determine whether the investment manager of the hedge fund, private equity fund, or the fund of funds, is a fiduciary under ERISA because the assets of the hedge fund, private equity fund, or fund of funds are ERISA plan assets. Also, evaluate whether the investment manager could become an ERISA fiduciary if there is a change in the proportion of fund assets held by ERISA plans and IRAs. Question the general partner about the access to capital as they build the fund.

- If the fund holds plan assets, it is important to assess whether the fund meets the requisite ERISA requirements, and if so, confirm that the fund manager is willing to accept and be governed by fiduciary status under ERISA.

- Determine what limitations of liability apply to the fund's investment adviser, any investment advisor engaged directly by the plan, and other agents, and whether any such limitation affects the willingness to invest the plan assets.

- Determine which jurisdiction's law will govern in the event of a dispute or for other purposes. Evaluate whether any particular venue will create additional legal difficulties for the plan in the event of litigation.

- Understand that certain investment strategies may not have a custodian based in the United States. Evaluate whether this particular factor would have an effect on your risk tolerance.

- For a private equity investment, understand the allocation of liability between the general partner structuring the investment and the limited partner investors. Search public databases for information and review regulatory documents such as Form ADV.

11. What is involved in operational due diligence?

- Consider the roles credit, operations, and legal support play in the investment organization.
- Review the report of the fund's independent auditors,
- How does the fund handle trading errors?
- Are there controls, checks and balances, disaster recovery, and back-up systems?
- In well run hedge fund and private equity firms, operational, credit and compliance staff will have a direct influence on investment decisions. Review the qualifications and experience of the support staff, and consider the ratio of support staff to investment/trading personnel. For private equity firms, quality legal expertise is paramount in structuring transactions and setting terms and liability.

12. *What about the third party organizations that support the hedge funds or private equity funds such as prime brokers, custodial banks, accountants and their legal counsel?*

- Third party support organizations often serve as a check- and- balance on a portfolio investment process, including a verification of portfolio holdings and valuation, in the case of a hedge fund. Consider the reputation and level of expertise of these support organizations. Request a reference about the fund manager from these organizations.
- Be attentive to potential conflicts of interest especially if the hedge fund restricts its use of a type of service provider to an organization affiliated with the hedge fund manager.

13. *What about client reporting, the level of transparency available to fund investors, and valuation of the fund's holdings?*

- Unlike mutual funds and similar investment vehicles, hedge funds may not reveal their individual strategies or holdings in their portfolio. Private equity funds may not reveal the names of the underlying companies in the fund until all capital has been committed and the fund is fully operational. However, most investment managers can present a potential investor with a relevant amount of information about their planned or actual investments.

- Question a manager on the methods used to evaluate an investment on an on-going basis, and how frequently can they provide updates, especially for illiquid instruments. For private equity, find out how they project cash flows and whether they are using alternate appraisal methods. This is especially important as they evaluate new technologies.

- It is especially important to understand how and when the assets held by the hedge fund or private equity fund will be valued and whether the valuation procedures appear to be appropriate.

For more information about the topics raised in this Legal Update, please contact the following lawyer.

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Endnotes

[1] ERISA Section 514(e).

[2] 29 C.F.R. § 2550.404a-1.

[3] 29 C.F.R. 2550.404c-5(e).

[4] 29 C.F.R. § 2550.408b-2(c).

[5] 29 C.F.R. § 2550.404a-5.

[6] 29 C.F.R. § 2510.3-101, as modified by Section 3(42) of ERISA.

[7] 29 C.F.R. 2550.404a-5(h)(5)(ii).

[8] *Cruise v. Principal Global Investors LLC,* S.D.N.Y., No. 09 CV 9889, *lawsuit filed* 12/2/09.

[9] As of the date of this Legal Update, complaints had been filed against 19 universities with respect to their 403(b) plan investments.

[10] *Sacerdote v. N.Y. Univ,* 328 F.Supp.3d 273 (S.D.N.Y. 2018).

[11] *Sulyma v. Intel Corporation Investment Policy Committee*, No 17-15864 (Nov. 28, 2018).