



Fees, Forms, Fiduciaries and Plan Assets:
*Representing Plans and Funds in the
Alternative Investment Arena*

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Introduction

- **Relevance**

- **Alternative Investment Market**
 - Third largest share of assets under management in Texas
 - Major alternative investment pioneers based in Texas
 - Rebound expected in alternative investment business
- **The Role of Benefit Plans as Investors**
 - Funded plans often are coveted investors
 - Requisite capital / expertise to make these investments
- **Significant Regulation of Benefit Plans as Investors**
 - Fiduciary / prohibited transaction limitations
 - ERISA, IRC and similar state / local law
 - Information disclosure requirements
 - ERISA and similar state / local law

Getting Started - Terminology

- "Alternative Investments"
 - Broadly defined group of asset classes
 - Outside the confines of traditional investments
 - Traditional investments - stocks, bonds, etc.
 - Benefit plans usually hold equity interests in "funds"
 - LP or LLC interests in private equity / hedge funds
- "Benefit Plans"
 - Funded retirement & funded welfare plans
 - Single employer / multiemployer retirement plans
 - Includes defined benefit and some types of defined contribution
 - Excludes nearly all participant directed plans
 - IRAs (distinguishable from participant directed plans)
 - VEBAAs

Getting Started - Applicable Rules

- Fiduciary Duty Rules - ERISA / Similar Law
 - Investing **plan assets** is a fiduciary action - (ERISA 3(21))
 - Duty of care & duty to diversify - (ERISA 404)
 - Prudent expert standard - (ERISA 404)
 - Personal liability for breach - (ERISA 409)
- Prohibited Transaction Rules - ERISA / IRC / Similar Law
 - Prohibition on using **plan assets** in transactions involving:
 - (1) Persons with a connection to the plan - "parties in interest" or "disqualified persons" - (ERISA 406 / IRC 4975)
 - Such persons can include fiduciaries and service providers to the plan
 - (2) Self dealing or conflicts of interest - (ERISA 406 / IRC 4975)
- Disclosure Rules - (Form 5500, ERISA 408(b)(2) Reg.)
 - Assist plans in completing annual Form 5500 filing
 - Compensation related reporting for **investment funds**

Fiduciary Duty / Prohibited Transaction Rules

- **Application of the Rules Depends on Existence of *Plan Assets***
 - Rationale for the Plan Assets Criteria
 - Fiduciary duty / prohibited transaction rules apply to investment decisions of traditional plan investment managers
 - Engaged directly by plan to manage plan assets
 - Contract to provide investment management services
 - Shouldn't fiduciary duty / prohibited transaction rules sometimes apply to investment decisions of fund managers
 - Engaged indirectly by plan / investment managers
 - Investment terms establish contract to provide investment management services
 - Plan asset rules close what would otherwise be a major loophole in the fiduciary duty / prohibited transaction rules

Aside: Fiduciary Duty Definition

- **Relevant Definition of Fiduciary**
 - Historic functional test still in place ERISA 3(21)
 - Relevant provision - exercise (discretionary) authority or control over management or disposition of **plan assets**
 - Newly proposed fiduciary definition by DOL
 - Rationale for new definition:
 - Relationships between investment advisers and plan clients have changed due to increased complexity of investment products and services **and enhance DOL enforcement**
 - New definition primarily concerned with investment advice
 - New definition changes test for when investment advice is being provided (eliminates requirement that advice be regularly provided and the primary basis for the investment decisions with respect to **plan assets**)
 - New definition has minimal effect on most fund managers
 - Most fund managers seek to avoid ERISA by preventing their funds from holding **plan assets**

Plan Assets Regulation - Background

- **Timeline**

- 1975 - 1985

- Regulation proceeds from predecessor to proposed forms

- 1986-1987

- Regulation finalized and becomes effective

- 1989 and Beyond

- Regulation analyzed in DOL Advisory Opinions / Info Letters

- Leading Advisory Opinions:

- 89-04A, 89-05A, 89-15A, 95-04A and 2002-01A

- Leading Info Letter:

- PWBA Info. Ltr. Sept. 23, 1998

- 2006

- Regulation amended by Congress in ERISA (ERISA 3(42))

Plan Assets Regulation - Overview

- General Rule (ERISA 3(42); Reg. 2510.3-101)
 - When a plan acquires an equity interest in a fund:
 - the plan's equity interest in the fund is treated as plan assets; **and**
 - Note: there is no exception to this aspect of the general rule
 - the fund's underlying assets are treated as plan assets ***unless an exception applies***
- Exceptions
 - There are four exceptions to the general rule
 - Two of the exceptions are very important for funds
 - Insignificant equity participation exception (ERISA 3(42); Reg. 2510.3-101)
 - Operating company exception (Reg. 2510.3-101)
 - The other two exceptions plus a de-facto exception
 - Publicly traded securities exception
 - Mutual funds
 - Non-equity interest exception - not really a vehicle for investment management services (*not described as an exception in the regulation*)

Plan Assets Regulation - Rationale for Exceptions

- Insignificant Equity Participation Exception
 - No need to subject fund managers to fiduciary / prohibited transaction rules if plans do not hold a significant interest in the fund
 - When plans do not hold a significant interest, the fund cannot really be viewed as a vehicle for indirectly providing investment management services to plans
- Operating Company Exception
 - No need to subject management of (sufficiently) active businesses to fiduciary / prohibited transaction rules,
 - These types of businesses are not really engaged in the business of providing investment management services
- The Other Exceptions
 - Securities law controls
 - Non-equity is not really managed

Insignificant Equity Participation Exception

- If benefit plan investors ("BPIs") hold less than 25% of the value of each class of equity interests in the fund then equity participation is insignificant (ERISA 3(42); Reg. 2510.3-101)
 - ***Four Components to the Exception***
 - **BPI definition - which plans are counted for the 25%?**
 - Plans subject to fiduciary rules under Title I of ERISA
 - Plans subject to prohibited transaction rules of 4975
 - Entities whose underlying assets are plan assets
 - **Basis for the calculation - what interests are not counted?**
 - Interests held by persons who can control fund assets or provide investment advice to the fund and their affiliates
 - **Class of equity interests - what constitutes a class?**
 - Look to analogous securities guidance and/or the "market"
 - **Frequency for the calculation - when is testing warranted?**
 - Must test after each "acquisition" - including redemptions (Adv. Opn. 89-05A)

Aside: Class of Equity Interests

- There is no official definition on what is a class
 - Conservative approach
 - Any differences in the interests creates a new class
 - Side letters, side pockets, early investor privileges
 - Middle of the road approach
 - Material differences in the interests creates a new class
 - Significant differences on distributions, liquidity, voting, fees, etc.
 - Facts and circumstances - fall back approach of the regulation
 - Approach tracks Section 12(g) of Exchange Act
 - Class includes set of interests with substantially similar characteristics
- Worst approach
 - *Do not describe a particular set of interests as a separate class if the creation of a separate class is not desired*

Operating Company Exception

- ***Three Exceptions Rolled Into One***
 - **Ordinary Operating Company ("OOC") Sub-Exception**
 - An entity that is primarily engaged in the production or sale of a product or service other than investment services, either directly or through one or more majority owned subsidiaries
 - **Real Estate Operating Company ("REOC") Sub-Exception**
 - An entity that invests at least 50% of its assets in "real estate" that is managed or developed and the entity has the right to substantially participate directly in such management or development activities
 - Real estate can include entities that own real estate
 - **Venture Capital Operating Company ("VCOC") Sub-Exception**
 - An entity that invests at least 50% of its assets in "venture capital investments" as to which the entity has "management rights" which are actually exercised in the ordinary course of business
 - Venture Capital Investment - OOCs & REOCs (but not REOCs)
 - Management Rights - Rights that create ability to influence the management of a venture capital investment
 - Right to a board seat, information and consultation

REOC / VCOC Exceptions

- **Two Main Components**
 - **50% Test** - are at least 50% of VCOC / REOC assets invested in qualifying investments?
 - 50% test is conducted by valuing VCOC / REOC assets at cost
 - Anti-abuse rule and a rule of convenience
 - 50% tests is conducted on the date of the fund's first long-term investment and any time during an annual valuation period (90-day period) thereafter
 - **Management Test** - are there sufficient management features in place for a purported qualifying investment to qualify as such?
 - VCOC must have contractual rights that run directly between the VCOC and OOC / REOC to substantially:
 - Participate in the management of the OOC / REOC; or
 - Influence the conduct of the management of the OOC / REOC; and
 - Actually exercise these rights with respect to one or more of its venture capital investments in the ordinary course of business each year
 - REOC must have rights to substantially participate directly in the management or development of the real estate investment
 - Rights may be exercised independent contractor
 - REOC must have ability to direct the activities of independent contractor

Operating Company Issues

- **Involvement of Subsidiaries in Ownership Structure**
 - **Applicable Rules**
 - **OOO Rule** - specifically contemplates majority owned subsidiaries
 - OOO "is an entity that is primarily engaged, directly or through majority owned subsidiaries" in the conduct of a sufficiently active business
 - Unclear whether majority is tested on vote or value
 - Regulations are unclear as to how majority ownership is tested in the case of successive tiers of ownership (e.g., OOO owns 70% of a subsidiary which, in turn, owns 70% of a lower tier subsidiary)

Operating Company Issues

- **Involvement of Subsidiaries in Ownership Structure**
 - **Applicable Rules Cont'd**
 - **VCOC / REOC Rule** - probably did not originally contemplate subsidiaries
 - VCOC exception does not apply to a VCOC that invests in another VCOC
 - Creates a fund of funds - top tier "VCOC" is not protected under regulation
 - Ignore interposition of "wholly owned" subsidiary between VCOC and its venture capital investments (Adv. Opn. 95-04A)
 - The first entity in the VCOC subsidiary chain that is not wholly-owned must be tested as an OOC or REOC
 - General adoption of DOL Adv. Opn. 95-04A in REOC contexts (non-controversial)

Applying the Regulation - Fund Structure

- **Designing Fund Structure**
 - Primarily an issue under the operating company exception
 - Multiple tiers of entities; parallel & feeder fund structures
 - Other non-ERISA considerations also drive the fund structure
 - Tax matters, foreign investors, etc.
 - Use of Holding Companies
 - Traditional Holding Companies
 - If holding company is not 100% owned 95-04A exception will not apply at holding company level
 - Umbrella Holding Companies (multiple chains of subsidiaries)
 - Not clear if holding company would qualify as OOC / venture capital investment
 - Consider looking to overall value of majority owned subsidiaries versus minority owned subsidiaries

Applying the Regulation - Fund Procedures

- **Fund Procedures**

- Primarily a drafting exercise relating to the fund's governing documents
 - These documents include:
 - The partnership agreement, LLC agreement or other agreement that establishes the fund as an entity
 - Side letter agreements relating to certain plans that wish to become investors in the fund
 - The offering memorandum that describes the fund, its investment strategy and the interests therein
 - The subscription agreements that enable plans to become holders of equity interests in the fund (i.e., investors in the fund)

Applying the Regulation - Fund Procedures

- **Partnership, LLC or Other Entity-Level Agreement**
 - Include provisions regarding
 - Compliance with exception to the plan assets regulation
 - Fund manager's level of compliance with the exception
 - Usually range from reasonable to best efforts standard
 - Fund manager's proof of compliance with the exception
 - Certifications or legal opinions often are required to prove compliance
 - Address frequency of providing this proof to BPIs (and similar investors)
 - Special procedures to use before VCOC/REOC exception applies
 - Limit or escrow overflow ERISA contributions (Adv. Opn. 95-04; Info Ltr. 9/23/98)
 - Continued operational compliance with the exception
 - Transfers of fund interests and associated approval and redemption rights
 - Procedures when there is a failure to comply with the exception (or other prohibited transaction requirement)
 - Means of disclosing the failure to the fund manager or BPI(s)
 - Period and efforts for correcting the failure
 - Withdrawal process when failure cannot be corrected

Applying the Regulation - Fund Procedures

- **Side Letters**
 - Include provisions to
 - Correct deficiencies in the partnership, LLC or other agreement establishing the fund as an entity
 - Usually involves adding procedures to address operational compliance with the exception(s) to the regulation
 - Delivery of opinions and other compliance certifications
 - Transfers of fund interests and associated approval and redemption rights
 - Procedures when there is a failure to comply with the exception (or other prohibited transaction requirement)
 - Often reserved for large plans / plans with large investments
 - Governmental plans often insist on being treated as traditional benefit investors in side letters
 - Rationale: similar laws justify similar treatment
 - Issue: potential creation of a new class of equity

Applying the Regulation - Fund Procedures

- **Offering Memorandum**
 - Include provisions regarding
 - Compliance with exception to the plan assets regulation
 - Brief statement on compliance in summary of terms section
 - Maintain consistency with partnership, LLC or other entity-level agreement
 - Risk factors for BPIs (and similar investors)
 - Compliance with exception or other prohibited transaction requirement can impact timing of the fund's investments
 - Transfer and withdrawal issues due to exception
 - Application of fiduciary / prohibited transaction rules (usually the "ERISA Considerations" section)
 - Extensive statement on compliance in ERISA considerations section
 - Maintain consistency with partnership, LLC or other entity-level agreement
 - Circular 230 language if necessary

Applying the Regulation - Fund Procedures

■ Subscription Agreement

- Include provisions that enable a clear description of each type of BPI and similar investor
 - Check-the-box nature of the document helps determine:
 - Extent to which BPI(s) or similar investor(s) hold interests in the fund
 - Useful in determining if insignificant equity participation exception is satisfied
 - Types of BPIs or similar investors to identify
 - Plans subject to Part IV of Title I of ERISA and Section 4975 of the Code
 - Plans subject Part IV of Title I of ERISA, but not Section 4975 of the Code
 - Plans subject to Section 4975 of the Code, but not Part IV of Title I of ERISA
 - Plans that are not subject to Part IV of Title I of ERISA or Section 4975 of the Code
 - Entities treated as BPI's by virtue of their underlying assets being plan assets

Fund Related Fees

- **Types of Fees Charged by Funds**
 - Management Fees
 - Based on a percentage of assets under management
 - Measured by calculating the net asset value of the fund
 - Fee generally ranges from 0.8% to 2.0% on an annual basis
 - Performance Fees
 - Based on increase in value of assets under management
 - Measured by calculating net asset value of the fund
 - Pre-conditions for charging fee often include "hurdle" and "high water mark" limitations
 - Expense Reimbursements
 - Organizational expenses / other operational expenses relating to the Fund are often passed through to the investors

Fund Related Fees - Form 5500 Schedule C

- Post-2008 Form 5500 Schedule C
 - Background
 - Revises the reporting of service provider compensation in conjunction with new regulations under ERISA 408(b)(2)
 - Relevant types of compensation
 - Direct compensation (e.g., compensation for plan's trustee)
 - Compensatory payments that are made by the plan
 - For services rendered to the plan or due to a person's position with the plan
 - Indirect compensation (e.g., brokerage commissions)
 - Compensatory payments that do not constitute direct compensation
 - In connection with services provided to, or a person's position with, the plan (payment based, on services provided to, or transaction(s) involving, the plan)
 - Eligible indirect compensation (e.g., mutual fund 12b-1 fees)
 - Indirect compensation provided to service providers solely pursuant to an investment vehicle or separately managed account
 - Service provider must furnish compensation info to plan

Fund Related Fees - Form 5500 Schedule C

- **Application in Alternative Investment Arena**
 - DOL guidance specifically addresses "investment funds"
 - Investment funds include
 - Funds that do not satisfy any exceptions in the plan assets regulation
 - Fees paid to fund manager from such a fund constitute indirect compensation
 - Funds that satisfy the insignificant equity participation exception in the plan assets regulation (i.e., under 25% funds)
 - Fees paid to fund manager from such a fund constitute indirect compensation
 - Investment funds exclude
 - Funds that satisfy operating company exception in the plan assets regulation (i.e., OOCs, VCOCs and REOCs)
 - Exclusion applies even if operating company is wholly-owned by a plan, such that the operating company's assets would be deemed as plan assets
 - Certain lower-tier funds in a fund of funds arrangement
 - No direct plan investment in lower-tier fund
 - Exclusion applies even if fund's assets are plan assets

Fund Related Fees - Form 5500 Schedule C

- **Reporting on the Schedule C**
 - Threshold Requirements
 - Large Pension Plan - 100 or more participants
 - Total service provider compensation exceeds \$5,000
 - Regular Reporting
 - In general, plan must report
 - Compensation amount
 - Identity of the service provider
 - Service codes of the service provider
 - Codes describe service provider's business and services rendered
 - Relationship of service provider to any known party in interest

Fund Related Fees - Form 5500 Schedule C

- **Reporting on the Schedule C - Cont'd**
 - Alternative Reporting - Eligible Indirect Compensation
 - Plan sponsor / administrator must report
 - Identity of the service provider
 - Plan sponsor must receive info from service provider describing:
 - The existence of indirect compensation
 - The services provided for the indirect compensation
 - A description of the indirect compensation received
 - Amount of the compensation
 - Estimate of the compensation
 - Formula for calculating the compensation
 - Identity of the parties paying and receiving the compensation
 - Alternative reporting can apply to certain investment funds
 - Funds that satisfy the insignificant equity participation exception in the plan assets regulation (i.e., under 25% funds)
 - Disclosures can be made in offering memorandum



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