FIDUCIARY DUTY ISSUES WITH ALTERNATIVE INVESTMENTS AND OUTSOURCING

Presented By:
Sharon M. Goodman, Slevin & Hart, Washington, DC
Andrew Irving, Arthur J. Gallagher & Co., Newark, NJ
Robert M. Projansky, Proskauer, New York, NY

2019 MIDWINTER MEETING
TOPICS

**Educating fiduciaries**
- Behind the Alternative Investment Label
- Common Structures For Alternative Investments
- Plan Asset Vs. Non Plan Asset Vehicles – Basic ERISA Rules
- Understanding Risk And Benchmarking
- Educating Clients Sufficiently To Invest In Alternatives

**Outsourced Investment Decision-Maker (OCIO)**
- What It Is
- Why Consider It
- Challenges – Including Selection and Monitoring
- Contracting
Alternative Investments
Behind the “Alternative Investments” Label

Categories of Alternative Investments:

- Private Equity/Private Credit
- Venture Capital
- Real Assets
- Hedge Funds

Common Traits of Alternatives

- Illiquidity: Fund level and underlying investments
- Cash flow unpredictability
- Different risk/return characteristics
- Flexible investment mandate with relatively less constraints = more complexity
- Leverage
- Difficult to value
- Higher fees
Behind the “Alternative Assets” Label

Each category includes multiple variations

<table>
<thead>
<tr>
<th>Hedge Funds</th>
<th>Private Equity</th>
<th>Private Debt</th>
<th>Real Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged Equity</td>
<td>Venture Capital</td>
<td>Direct Lending</td>
<td>Real Estate</td>
</tr>
<tr>
<td>Event-Driven</td>
<td>Growth Equity</td>
<td>Mezzanine</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>Global Macro/ CTA</td>
<td>Buyout</td>
<td>Opportunistic Credit/ Special Situations</td>
<td>Natural Resources</td>
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<tr>
<td>Relative Value</td>
<td>Distressed/ Operational Turnaround</td>
<td>Distressed Debt</td>
<td>Commodities</td>
</tr>
<tr>
<td>Multi-Strategy</td>
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<td>Specialty Finance</td>
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</tbody>
</table>

For illustrative purposes only; not an exhaustive list
Source: Gallagher Fiduciary Advisors
## Alternatives' Risk and Return Profiles

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Geometric Return</th>
<th>Standard Deviation</th>
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</thead>
<tbody>
<tr>
<td>US Equity</td>
<td>6.3%</td>
<td>16.0%</td>
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<tr>
<td>Intl Equity (DM + EM)</td>
<td>6.7%</td>
<td>18.3%</td>
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<tr>
<td>Core FI</td>
<td>2.7%</td>
<td>5.0%</td>
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<tr>
<td>High Yield</td>
<td>5.0%</td>
<td>9.9%</td>
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<tr>
<td>Marketable Alternatives</td>
<td>5.4%</td>
<td>8.0%</td>
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<tr>
<td>Private Equity</td>
<td>8.4%</td>
<td>22.0%</td>
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<tr>
<td>Private Debt</td>
<td>6.6%</td>
<td>6.0%</td>
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<tr>
<td>Commodities</td>
<td>3.8%</td>
<td>17.0%</td>
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<tr>
<td>Public Real Estate</td>
<td>6.5%</td>
<td>20.0%</td>
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<tr>
<td>Private Real Estate</td>
<td>5.7%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>7.1%</td>
<td>10.5%</td>
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</tbody>
</table>

Source: Gallagher 2018 Capital Markets Assumptions
## Alternatives and Diversification

<table>
<thead>
<tr>
<th>2018 CMA Correlation Table</th>
<th>Core Govt/Credit Blend (7-yr)</th>
<th>High Yield Bonds</th>
<th>U.S. Equity - All Cap</th>
<th>Intl Equity (DM ex-US + EM)</th>
<th>Marketable Alternatives</th>
<th>Commodities</th>
<th>Public Real Estate (REITs)</th>
<th>Private Real Estate</th>
<th>Private Equity</th>
<th>Private Debt</th>
<th>Infrastructure (Private, Core)</th>
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<tbody>
<tr>
<td>Core Govt/Credit Blend (7-yr)</td>
<td>1.00</td>
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<tr>
<td>High Yield Bonds</td>
<td>0.18</td>
<td>1.00</td>
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<tr>
<td>U.S. Equity - All Cap</td>
<td>-0.09</td>
<td>0.66</td>
<td>1.00</td>
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<td>Intl Equity (DM ex-US + EM)</td>
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<td>0.71</td>
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<td>Marketable Alternatives</td>
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<td>0.60</td>
<td>0.70</td>
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<tr>
<td>Commodities</td>
<td>0.06</td>
<td>0.39</td>
<td>0.36</td>
<td>0.53</td>
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<td>Public Real Estate (REITs)</td>
<td>0.16</td>
<td>0.59</td>
<td>0.60</td>
<td>0.56</td>
<td>0.28</td>
<td>0.23</td>
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<td>Private Real Estate</td>
<td>-0.08</td>
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<td>0.11</td>
<td>0.07</td>
<td>0.14</td>
<td>0.14</td>
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<tr>
<td>Private Equity</td>
<td>-0.02</td>
<td>0.74</td>
<td>0.86</td>
<td>0.90</td>
<td>0.70</td>
<td>0.47</td>
<td>0.67</td>
<td>0.15</td>
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<tr>
<td>Private Debt</td>
<td>-0.05</td>
<td>0.78</td>
<td>0.48</td>
<td>0.53</td>
<td>0.51</td>
<td>0.36</td>
<td>0.49</td>
<td>-0.06</td>
<td>0.61</td>
<td>1.00</td>
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<tr>
<td>Infrastructure (Private, Core)</td>
<td>0.79</td>
<td>0.43</td>
<td>0.09</td>
<td>0.19</td>
<td>0.14</td>
<td>0.10</td>
<td>0.27</td>
<td>-0.10</td>
<td>0.14</td>
<td>0.23</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: Gallagher 2018 Capital Markets Assumptions
Common Alternative Investment Structures

Limited Partnership Or Limited Liability Corporation

• Partnership or corporation created solely to purchase/hold investments
• Manager is general partner hired by Part./LLC and investors (ERISA funds and others) are limited partners/shareholders
• Part./LLC’s assets are the investments held
• Private structures, not regulated by SEC, etc.
• Usually limited to Accredited Investors and Qualified Eligible Person (defined terms)
Common Alternative Investment Structures

FUND OF FUNDS

• **Structure, not strategy**—used for any alternative asset
• Often also LP or LLC structure
• “Lead manager” controls LP/LLC investments
• ERISA Fund invests in LP or LLC
• Lead manager hires other managers (“sub-managers”) to invest portions of LP/LLC
• Allows ERISA fund to access many strategies in 1 vehicle
Common Alternative Investment Structures - Fund of Funds Structures

**Primary Fund**
- Investor (LP)
  - General Partner’s Investment Fund
    - Companies
      - A
      - B
      - C

**Co-Investment Fund**
- Investor (LP)
  - General Partner’s Investment Fund
    - Companies
      - X
      - Y
      - Z

**Secondary Fund**—Buy another investor’s interest in investment fund (often private equity) after investment fund fully or partially invested in private companies
Plan Asset Vs Non Plan Asset Vehicles – Who is Fiduciary for Investment?

Is Manager ERISA Fiduciary Controlling Plan Assets?

- **Section 3(42) Basics**: When ERISA plan invests in equity of any entity, both equity interest and proportionate interest in that entity’s assets treated as assets of ERISA plan, **unless exception applies**.
Plan Asset Vs Non Plan Asset Vehicles – Who is Fiduciary for Investment? (cont’d)

• Most Common Exceptions Under DOL Reg. 2510.3-101
  – Investment in publicly offered security
    – Plan buys Facebook stock
  – Investment issued by investment company registered under 1940 Act
    – Plan buys share of Vanguard mutual fund
Plan Asset Rules - Who is Fiduciary for Investment?

Most Common Exception To Plan Asset Rules For Alternatives

- Investment by benefit plan investors not **significant (less than 25%)**
- 25% includes: employee benefit plans, whether or not ERISA; IRA and Keogh plans; any entity whose underlying assets include “plan assets” (e.g., insurance company separate accounts or collective investment vehicles).
  - 25% Excludes Governmental, Certain Church and Foreign Plans.
- **Many** alternatives avoid ERISA fiduciary status for manager by limiting benefit plan investors to **less than 25%**.
- If exception applies, **Trustees not delegated** fiduciary control to manager and remain **fiduciary** controlling those assets.
Non-Plan Asset Vehicles
Investment in Operating Company

Other Exceptions To Plan Asset Rules For Some Strategies

- Venture capital operating company (VCOC) -- entity with 50%+ of assets invested in “venture capital investments” in which it has “management rights”
- Real estate operating company (REOC) -- 50%+ of assets invested in qualifying real estate and directly engaged in real estate management or development activities
- Manager of operating company does not control assets of ERISA plans
- SO Trustees remain fiduciary in control of those plan assets
Special Delegation Issues in Fund of Funds

• **Named Fiduciary** = ERISA Section 402(a)(1) and (c): Only fiduciary with ability to appoint investment manager and delegate its ERISA fiduciary duty to another fiduciary
  - Must be identified in Plan Document (usually Trust Agreement)
  - “Lead manager” of hedge fund of funds
    - Lead manager may be willing to be named fiduciary to delegate ERISA fiduciary duty to sub-managers/sub-funds.
    - If not, lead manager is liable for sub-manager’s actions.
    - Does Trust Agreement allow that designation by Board?
Understanding Risk and Benchmarking

• Fiduciary Risk of Overall Suitability

• *Sulyma v. Intel Corporation* (N.D. Cal. Case No. 5:15-cv-04977): ERISA challenge to including alternatives in DC Plan investment options.

Understanding Risk and Benchmarking

Benchmarking – Issues with Performance Measurement

• Measuring and comparing performance is challenging in the alternatives space
  – Strategies tend to be complex and vary widely among managers
  – Many underlying investments, particularly in private market funds, are not publicly traded so timely and reliable valuation is difficult

• Existing benchmark options have flaws and do not meet the criteria for an ideal benchmark\(^1\); in particular, they are **NOT**:
  – Unambiguous and Transparent
  – Investable
  – Measurable: Valuing underlying assets are difficult and highly subjective
  – Appropriate
  – Pre-specified

\(^1\)Source: CFA Institute
Educating the Client On Legal Risks

FIRST (AND MAYBE LAST) QUESTION FOR CLIENT

Policy Decision For Client—Invest If Manager Not ERISA Fiduciary (Either By Law Or Contractual Standard - ERISA-like or ERISA-light)?

- If Not, Access To Alternatives May Be Limited
- Expanded Role For Counsel To:
  - Negotiate side letter
  - Monitor/review future side letters with other investors
  - Herd/Corral other providers to fulfill their roles
Educating the Client On Legal Risks (cont’d)

• Expanded Role For Consultant To Perform:
  – Modeling And Stress Testing
  – Role in Portfolio
  – Look-Through Analysis of True Risk Exposures
  – Return Expectation and Timing/J curve?
  – Lock-Ups and Cash Flows/Liquidity Premium

• Perform (and Document) Additional Due Diligence of Initial Review
  And After Investment
Educating the Client On Legal Risks

Other Differences From Public Investments

• Multiple plan providers require more detailed information:
  – Administrators—5500 filings
  – Auditor—Audits, hard to value assets
  – Dept. of Labor and IRS—Audits
  – Consultants—Performance reporting, risk measurement, cash flows for liquidity analysis

• Maybe expanded under future Form 5500s
Outsourcing Investments
Common Lingo

- Outsourced Chief Investment Officer
- Fiduciary Manager
- Delegated Consultant
- Discretionary Advisor
- Implemented Consultant

OCIO assets reached $1.237 trillion at 6/30/2018, up from $907.3 billion at 6/30/2017*

Delegation of Authority

• Three possible arrangements
  – Non-discretionary – traditional investment advice only
  – Partial discretion/Hybrid – authority to implement client decisions, e.g., manage manager transitions, rebalance among asset classes and managers, draw cash for benefits
  – Full discretion – both investment manager/investment vehicle selection and replacement; full portfolio or selected asset classes
    – Client typically retains authority over risk budget and overall investment goals
<table>
<thead>
<tr>
<th>Non-Discretionary</th>
<th>Discretionary</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Help create IPS</td>
<td>Plus. . .</td>
</tr>
<tr>
<td>• Manager sourcing</td>
<td>• Portfolio construction</td>
</tr>
<tr>
<td>• Manager guidelines</td>
<td>• Manager selection/termination</td>
</tr>
<tr>
<td>• Portfolio monitoring</td>
<td>• Tactical asset allocation</td>
</tr>
<tr>
<td>• IPS/guideline compliance</td>
<td>• Rebalancing</td>
</tr>
<tr>
<td>• Liquidity analysis</td>
<td>• Manage cash flow</td>
</tr>
<tr>
<td>• Custodian reconciliation</td>
<td>• Legal review and negotiation</td>
</tr>
<tr>
<td>• Valuation review</td>
<td>• Execution of documents</td>
</tr>
<tr>
<td>• Reporting</td>
<td></td>
</tr>
</tbody>
</table>
Investment Manager/Named Fiduciary

- Investment manager
  - Relieves named fiduciary of responsibility for investment decisions
- Named fiduciary: many OCIOs will demand it
  - Concern that only a named fiduciary can hire a 3(38) manager
  - DOL Op. 82-30A: named fiduciary can delegate to others authority to hire a manager
- Can the OCIO be both?
  - “The term ‘investment manager’ means any fiduciary (other than a trustee nor named fiduciary. . . ) who . . .”
  - DOL Op. 77-69/70A: can serve in both capacities
- Unclear if same protection if appointment made by named fiduciary's designee.
Why Plans Consider Outsourcing

• Escalating investment complexity
  – Excess returns hard to come by – private investment popularity
  – Capital market, economic and geopolitical risks
  – Increased regulation of oversight responsibilities
• Lack of internal expertise in decision making
• “Legacy” status of frozen/closed DB plans
• Research capabilities
• Tactical allocation
• Facilitate decision-making
Challenges: Selection Process

- Identify candidates
- Written RFP
- Follow-up questions/phone interviews/site visit
- Semifinalists/finalists selected
- Obtain sample reports and asset allocation observations
- Interviews by client decision-makers
- Review regulatory and litigation history
- Reference check
- Internal memoranda documenting process
Challenges: Selection Criteria

- Organizational structure, stability and governance
- Staff stability and succession/key person risk
- Internal expertise/resources
  - Financial, legal, staff, research, investment
- Established portfolio construction/risk model – customization
- Track record
- Access to best in class products/managers and favorable fee arrangements
- Reporting/transparency
- Fees
Challenges: Monitoring

- Use external consultant?
- Test for consistency with IPS/guidelines
- Track changes in investment style within asset classes
- Benchmark performance by asset class and whole portfolio
  - Selected benchmarks: OCIO/independent
  - Check OCIO data against underlying managers’ data
- Compare performance to *similarly situated* peers
- “Deep Dives” into selected decisions
Other Challenges

- How much control is in-house fiduciary willing to cede
  - Veto powers undercut 3(38) and QPAM
  - Is advance notice of decisions advisable?
- Cost considerations
  - More or less
  - Avoiding 406(b) violations
Contracting

- Standard IMA terms
  - Insurance and indemnification particularly important
- Authority to negotiate/execute documents
- Responsibility for legacy private investments
- Cash movement (e.g., funding capital calls) authority or direction
- Reporting structure
- Investment guidelines (if desired)
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