

*Presenting a live 90-minute webinar with interactive Q&A*

## **ERISA Benefit Plan Investment Management Agreements: Selecting 3(38) Investment Managers, Structuring the IMA**

Documenting the Relationship to Minimize Risks for Plan Sponsors and Investment Advisers

---

WEDNESDAY, APRIL 15, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

---

Today's faculty features:

Mayoung Nham, Principal, **Slevin & Hart**, Washington, D.C.

S. John Ryan, Partner, **Seward & Kissel**, New York

---

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

## *Tips for Optimal Quality*

FOR LIVE EVENT ONLY

---

### Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press \*0 for assistance.

### Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

## *Continuing Education Credits*

FOR LIVE EVENT ONLY

---

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

# ERISA Benefit Plan Investment Management Arrangements

---

Presented by:

**Mayoung Nham, Esq.**

Principal

Slevin & Hart, P.C.

Washington, D.C.

(202) 797-8700

[mnham@slevinhart.com](mailto:mnham@slevinhart.com)

[www.slevinhart.com](http://www.slevinhart.com)

**S. John Ryan, Esq.**

Partner

Seward & Kissell LLP

New York, NY

(212) 574-1679

[ryans@sewkis.com](mailto:ryans@sewkis.com)

[www.sewkis.com](http://www.sewkis.com)

# Presentation Overview

---

- I. Trustees, Fiduciaries and Investment Managers
- II. Negotiating Investment Management Agreements
- III. ERISA Considerations When Investing in Private Funds
- IV. Questions

# **Part I**

## Trustees, Fiduciaries and Investment Managers

# Trustees

---

- One goal of ERISA was to delineate responsibility and liability for investing plan assets
- **ERISA Section 403** provides that all plan assets be held in trust and that the Trustees have exclusive authority and discretion to manage and control the plan's assets, except to the extent that
  - the plan provides that the Trustees are subject to the proper direction of a named fiduciary; or
  - authority to manage acquire or dispose of the plan assets is delegated to one or more investment managers
- **Discretionary Trustees** are trustees who retain investment discretion, these tend to be individuals, Taft/Hartley plan trustees, smaller plan trustees and trustees of bank collective investment trusts
- **Directed Trustees** are Trustees that follow the directions of Named Fiduciaries or Investment Managers, these tend to be banks and their function is to custody the plan's assets



# Named Fiduciaries

---

- Every plan must have a Named Fiduciary
- A Named Fiduciary is a fiduciary named in the plan or is identified as a fiduciary under a procedure specified in the plan document
- A Named Fiduciary can appoint Investment Managers to manage assets of the plan
- This power to appoint Investment Managers is not a “trustee responsibility” and can be properly delegated to another fiduciary

# Investment Managers

---

- Investment Managers have discretionary authority to invest plan assets
- Investment Managers MUST BE:
  - Registered with the SEC as investment advisers, including “relying advisers” but not “exempt reporting advisers”
  - Unable to register with the SEC, but registered with the State of their principle place of business
  - A bank or
  - An insurance company
- Investment Managers must acknowledge in writing that they are acting as fiduciaries to the plan

# Delegation Issues

---

- Named Fiduciary can delegate responsibility and liability for investing plan assets to an Investment Manager; this delegation can include the authority to appoint other Investment Managers
- The appointment of an Investment Manager is subject to the ERISA fiduciary standards: to act prudently and for the exclusive benefit of the plan's participants
  - Diversification and scope of the appointment - developing "Investment Guidelines"
  - Selection and due diligence of the Investment Manager
  - Fees and expenses of the investment
  - Ability to avoid prohibited transactions
- Monitoring the ongoing activity of the Investment and the Investment Manager
  - Performance
  - Proxy voting
  - Compliance
  - Reporting

# ESG Considerations

---

- Developing an ESG Policy
  - Plan Sponsors and participants have been pushing ESG
  - Defining ESG
- ESG vs SRI & ETI
  - Modern portfolio theory
  - ESG is distinguishable
- Plan Fiduciary Considerations
  - Investment horizon
  - ESG definition

# Developing an ESG Policy

---

- Developing an ESG Policy
  - Aspirational or mandatory
  - Include ESG definition
  - General or Tailored to investment philosophy and strategy of the manager
- Incorporating ESG into a Plan's Allocation Process
  - Review current investment allocations in light of ESG factors
  - Formalize and memorialize the steps taken to reflect the ESG considerations incorporated into the allocation decision-making process
  - Review and understand information sources
    - Difficulty of obtaining consistent and accurate data points on investment managers or investment funds regarding ESG metrics since there is no standardized ESG approach
    - Diligence third party provides of ESG data and metrics
    - Review third party weightings

# Part II

## Negotiating Investment Management Agreements

# Issues For Negotiation Under Investment Contract

---

## *Indemnification*

- Investment documents should (try) to:
  - Require manager to indemnify Plan and Trustees
  - Often mutual/parallel indemnification by plan of manager and manager of plan
  - If so, make clear that ERISA plan - AND NOT TRUSTEES—liable for any indemnification
  - Beware of “signatory below shall indemnify.....”

# Issues For Negotiation Under Investment Contract

---

## *Fees*

- **Most Favored Nations (“MFN”) Treatment on Fees, Rights and Features**
  - All investors?
  - Similar sized investors?
  - Count affiliated investor plans?
- **Incentive Fees**
  - Warrant under DOL guidance?
  - Valuation of Portfolio and Potential Conflicts
- **Claw back If Incentive Fees**
  - *Avoid heads manager wins, tails fund loses*
  - How is high-water mark for payment of incentive fees set and reset?



# Issues For Negotiation Under Investment Contract

---

- **More Fees -- Unrelated Business Taxable Income**
  - Effort to avoid?
  - Protections if taxable income is earned?
  - Impact of tax on net return/incentive fee?
- **Key Man Provisions** - If strategy depends on superstar/few key people, what happens if they are unwilling or unable to continue to manage investment?

# Issues For Negotiation Under Investment Contract

---

## *Confidentiality*

- **When can manager release ERISA plan's information?**
  - What notice is required to plan?
  - Disclose to manager's potential clients?
  - When can plan prevent disclosure?
- **When can ERISA plan release information about investment?**
  - Any limits on what ERISA plan can disclose?
  - What notice is required to manager?
  - Disclose to plan's professionals to operate ERISA plan?
  - When can manager prevent disclosure?
  - Section 101(k) for multiemployer plans
- **Special issue - DOL, IRS audits**

# Issues For Negotiation Under Investment Contract

---

## *Reporting*

- Sufficient for ongoing monitoring by plan's investment consultant?
- Sufficient for ERISA plan's auditor to prepare financial statements?
- ERISA plan auditor needs financial statement of underlying investments  
“tiered” investment structure - example, in hedge fund.

## *Termination of Agreement*

- What is frequency/ liquidity?
- Timing of notice

# Issues For Negotiation Under Investment Contract

---

## *Bonding*

- ERISA Section 412 requires any person handling plan assets to be bonded
- ERISA fiduciary manager should have own bond

## *Proxies*

- Agreement should make clear who votes proxies (if any)

# ESG Issues For Negotiation Under Investment Contract

---

- Manager Considerations
- Articulated investment thesis as to: (i) what ESG factors are considered and (ii) why these ESG factors should lead to comparable returns over the investment horizon
- Tailoring the Plan's ESG Policy to the Investment Guidelines
  - Mandatory or Aspirational
  - Considering ESG risks and rewards with regard to the investment strategy
  - ESG factors are impacting share price
  - ESG is a consideration in the investment process, but not determinative
  - ESG considerations do not limit the universe of available investments
- Proxies
  - How will ESG factors impact proxy voting

# What Is A QPAM?

---

- “**Qualified Professional Asset Manager**” (“QPAM”) is investment professional that meets regulatory and asset minimums under Prohibited Transaction Exemption (PTE) 84-14
- PTE 84-14 is a class exemption - applies to transactions that meet the rules in PTE - no separate filing with DOL to meet exemption
- Under PTE 84-14, as amended, QPAM is entity meeting definition of investment manager that also has substantial assets
  - Bank with equity capital in excess of \$1,000,000
  - Insurance company with net worth in excess of \$1,000,000, or
  - Registered investment adviser with total client assets under management in excess of \$85,000,000 and with partners/shareholders equity in excess of \$1,000,000

# Rules to Meet QPAM Exemption

---

**QPAM transaction must meet following rules:**

- Assets of plan (and related plans) in transaction cannot exceed 20% of all assets managed by QPAM
- Terms of transaction must be at least as favorable to plan as terms available in arm's length transaction
- Counterparty (and its affiliates) cannot have power to appoint or terminate QPAM as manager of plan assets or to negotiate for plan over terms of QPAM's engagement

**The QPAM exemption only provides 406(a) relief**

**Part III**  
ERISA Considerations When  
Investing in Private Funds



# The Plan Asset Look-Through Rule

---

- In 1987, the Department of Labor issued the “Plan Asset Regulation” deeming the assets of an entity to be “plan assets” of each investing plan in situations where plans, through their investment in the entity, are essentially acquiring investment management services
- The Plan Asset Regulation provides that, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 the plan’s assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that—
  - the entity is an operating company, or
  - equity participation in the entity by benefit plan investors is not “significant”

# Significant Participation or the 25% Test

---

- Private Investment Funds typically rely on the significant participation exclusion to avoid an ERISA plan asset look-through
- 25% or more of the value of any class of equity interests in the entity is held by “benefit plan investors”
- Calculation is computed upon each acquisition or redemption of equity interests in the Fund
  - Benefit Plan Investors (BPIs): Section 3(42) of ERISA which modified the Plan Assets Regulation defines a BPI as:
    - An employee benefit plan subject to the fiduciary rules of Part 4 of ERISA
    - Any plan to which § 4975 of the Internal Revenue Code applies, and
    - Any entity whose underlying assets include plan assets by reason of a plan’s investment in such entity

# VCOCs and REOCs

---

- Private Equity and Real Estate Funds typically rely on the Venture Capital Operating Company (VCOC) and the Real Estate Operating Company (REOC), respectively, exclusions to avoid an ERISA plan asset look-through
- A VCOC is an entity that satisfies two specific tests: the investment test and the exercise test
  - The Investment Test, at least 50% of the fund’s long-term investments, valued at cost, must be invested in “venture capital investments” or “derivative investments”
  - The Exercise Test, also the fund must, in the ordinary course of its business actually devote substantial resources to the exercise of management rights for one or more of the operating companies in which it invested
- A REOC is an entity like a VCOC that satisfies an investment test and an exercise test, but which invests in real estate and devotes substantial resources to managing or development activities

# Investment Monitoring

---

- Should the Trustees hire an Independent Consultant who is an ERISA Section 3(21) fiduciary for performance reporting and monitoring of managers?
- Most plan do. Consultants can provide Trustees with:
  - Performance reporting
  - Risk measurement
  - Ongoing manager due diligence
  - Compliance monitoring
- Ongoing manager due diligence and compliance monitoring includes ongoing monitoring all of the items originally reviewed in the RFP and evaluating any changes.

# Tax Implications

---

- Side letters typically address the following tax issues:
  - Entity classification
  - AEOI compliance
  - Reportable transactions
  - Notification of tax reporting obligations
- If the Fund’s investment strategy utilizes leverage or otherwise generates UBTI it generally makes tax sense to invest in an offshore blocker, onshore blocker side letters typically also include:
  - Withholding notification and reporting representations
  - Partnership audit representations
  - UBTI representations

# Non-Plan Asset Funds

---

- A side letter for Private Investment Fund that intends to stay below its 25% threshold typically include:
  - A representation that the Fund is not now and will not be deemed to hold plan assets as defined in section 3(42) of ERISA
  - A representation that the Fund will mandatorily redeemed Benefit Plan Investors (BPIs) to keep the Fund below its 25% threshold
  - A representation that if the plan's investment is redeemed to maintain the Fund's non-plan asset status, the amount redeemed will not be more than the plan's pro-rata share among all the BPIs
  - A representation that should the Fund change its policy and elect to become a plan assets fund, the plan will receive prior notice with sufficient time to redeem its investment without penalty prior to the Fund being deemed to hold plan assets
  - Some accommodation regarding in-kind distributions should be reached

# Non-Plan Asset Funds

---

- Side letter for Private Equity and Real Estate Funds that intend to qualify as VCOCs or REOCs typically include:
  - A “should” level opinion of council that the upon the Fund’s 1st investment it qualifies as a VCOC or REOC
  - A representation to provide an annual certificate regarding the Fund’s continuing status as a VCOC or REOC

# Hardwired Master-Feeder Funds

---

- After the PPA, this is a very common fund structure because an entity whose underlying assets include plan assets is deemed to hold plan assets “only to the extent” of the percentage of its equity interests held by BPIs
- “Hardwiring” requires that all of the investable assets of a feeder fund is invested in the master fund
  - The feeder fund may maintain a minimal amount of cash to pay expenses, but in many cases all expenses are paid by the master fund
  - Offering documents for the feeder funds often refer to them as mere conduits and will specifically state that the feeder fund is required to invest all their investable assets into the master fund
  - The feeder fund can accept BPIs over its 25% threshold, but the master fund stays below its 25% threshold, so that neither the master fund’ investment nor its investment manager are subject to ERISA
  - While the feeder fund is a plan asset look-through vehicle, its manager is not acting as an ERISA fiduciary when follows the investors’ direction to invests the assets from the feeder fund into the master fund
  - All managerial discretion is removed from the feeder fund so that there is nothing other than ministerial actions for the manager to undertake in connection with the management of the feeder fund



# ERISA Plan Asset Funds

---

- The person executing the side letter on behalf of the plan has the authority to appoint the Fund's manager as an "investment manager"
- Representations from the Fund and its manager that during any period when the Fund is deemed to hold "plan assets":
  - The Manager acknowledges that it is a fiduciary (as defined in Section 3(21)(A) of ERISA) with respect to the plan, and is not prohibited from acting as a fiduciary to an ERISA plan under Section 411 of ERISA
  - The Manager is registered as an investment adviser under the Investment Advisers Act of 1940. The manager will maintain its status as an "investment manager" (within the meaning of Section 3(38) of ERISA) for so long as the assets of the plan are invested in the Fund
  - The Manager shall conduct the affairs of the Fund in accordance with the fiduciary responsibilities imposed by ERISA Section 404, and shall not cause the Fund to engage in any non-exempt prohibited transaction as described in ERISA Section 406 or Section 4975 of the Code
  - The Manager meets the qualifications to be a "QPAM" as defined in Part VI of PTE 84-14
  - The Manager represent that any provisions in the formative documents of the Fund providing for exculpation or indemnification shall only be construed to provide for exculpation or indemnification of the Manager to the extent such exculpation or indemnification is permitted by ERISA.
  - The Fund shall maintain a fidelity bond in accordance with and in an amount not less than the amount required by Section 412 of ERISA
  - The Fund will provide the plan the fair market value of the assets held by the Fund as may be necessary to enable the Subscriber's investors to complete their annual returns/reports

# ERISA Plan Asset Funds

---

- Side letter Issues to Consider:
  - Soft Dollars: the Fund will only use soft dollar commissions in compliance with Section 28(e) of the U.S. Securities Exchange Act of 1934, as amended; EU managers are subject to MiFID II; certain strategies utilize single issuer swaps to trade in non-US jurisdictions. Consider requiring soft dollars only be spent to brokerage or research as defined by 28(e)
  - Valuation: for any securities held by the Fund for which market prices are unavailable, such securities will be valued either by an independent third party or by utilizing an objective pricing methodology. In the event an independent third party is used, the Manager agrees to provide the Subscriber with the name of such independent third party. In the event an objective pricing methodology is used, the Manager agrees to provide the Subscriber with a description of the methodology and the data necessary to establish the methodology's objectivity
  - Indica of Ownership
  - MFNs: size based; forward looking fee, liquidity and cherry picking
  - Managers that don't give side letters
  - Managers that don't give MFNs

# Part IV

Questions?