ERISA STANDARDS FOR ALTERNATIVE INVESTMENTS

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Governmental Plans

- Governmental plans - maintained by the state or its agencies or instrumentalities
- Governmental plans subject to federal tax code on a modified basis
- Governmental plans exempt from ERISA
  - Disclosure and reporting requirements
  - Vesting
  - Funding
  - Fiduciary rules

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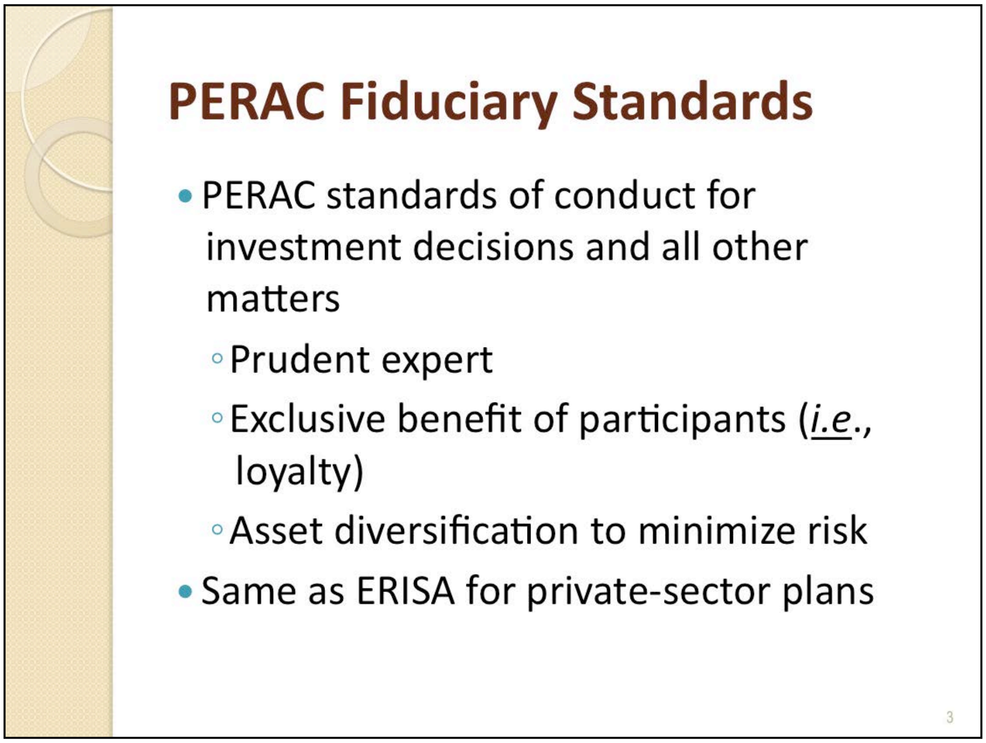
Since the PERAC plans are by definition plans maintained by Massachusetts or its agencies or instrumentalities, they come within the definition of a governmental plan under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974, otherwise known as "ERISA". Like all governmental plans, these public plans and their managers are exempt from ERISA's requirements and are subject to the requirements of the Code on a modified basis, meaning that Code requirements apply less strenuously than if they were private-sector plans. The ERISA exemption means that a governmental plan is excused from filing annual reports on Form 5500. Governmental plan status also results in exemption from ERISA's fiduciary rules about which we are hearing so much in the press these days, because of the Department of Labor's new conflicts of interest proposal. This proposal broadens the range of retirement advisers who would become subject to fiduciary standards and subjects transaction-based compensation earned by brokers and insurance agents, such as such as commissions, to significant restrictions. As we shall see, however, certain ERISA standards have a way of migrating to the field of governmental plans.



A PERAC Board member's duty, as stated in 840 CMR Section 1.01, is as follows:

"A board member shall discharge all of his/her duties solely in the interest of members and their beneficiaries, and

(1) For the exclusive purpose of:

(a) providing benefits to members and their beneficiaries; and

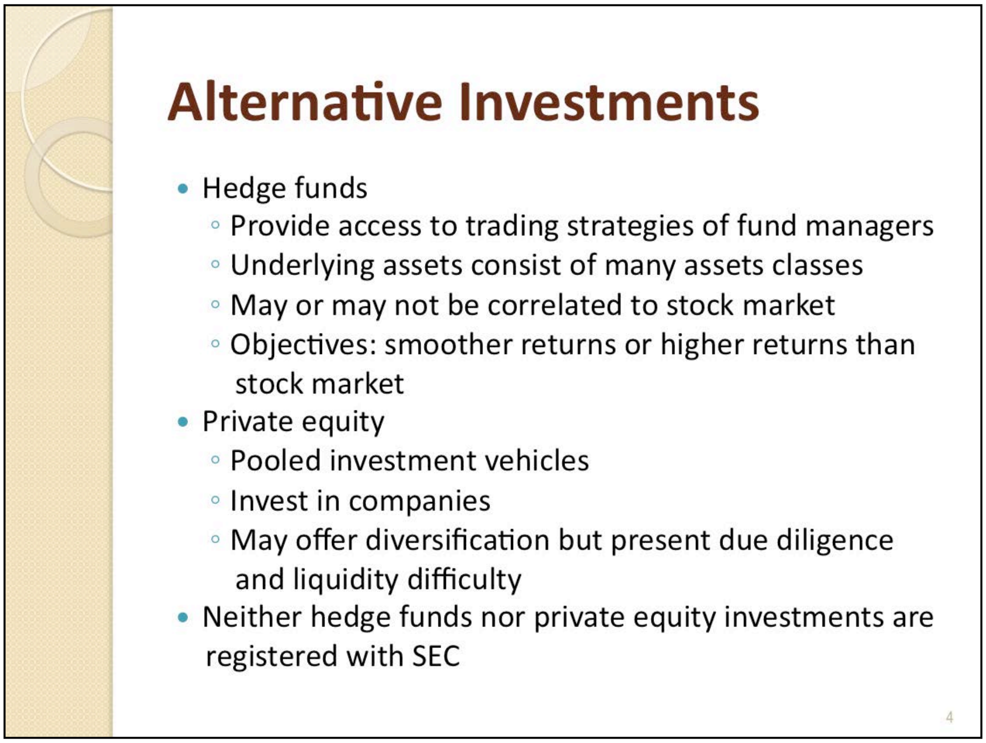
(b) defraying reasonable expenses of administering the system.

(2) With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.

(3) By diversifying the investments of the system so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

(4) In accordance with the Massachusetts General Laws, the rules and regulations promulgated by the Commission, and rules and regulations adopted by the Board and approved by the Commission."

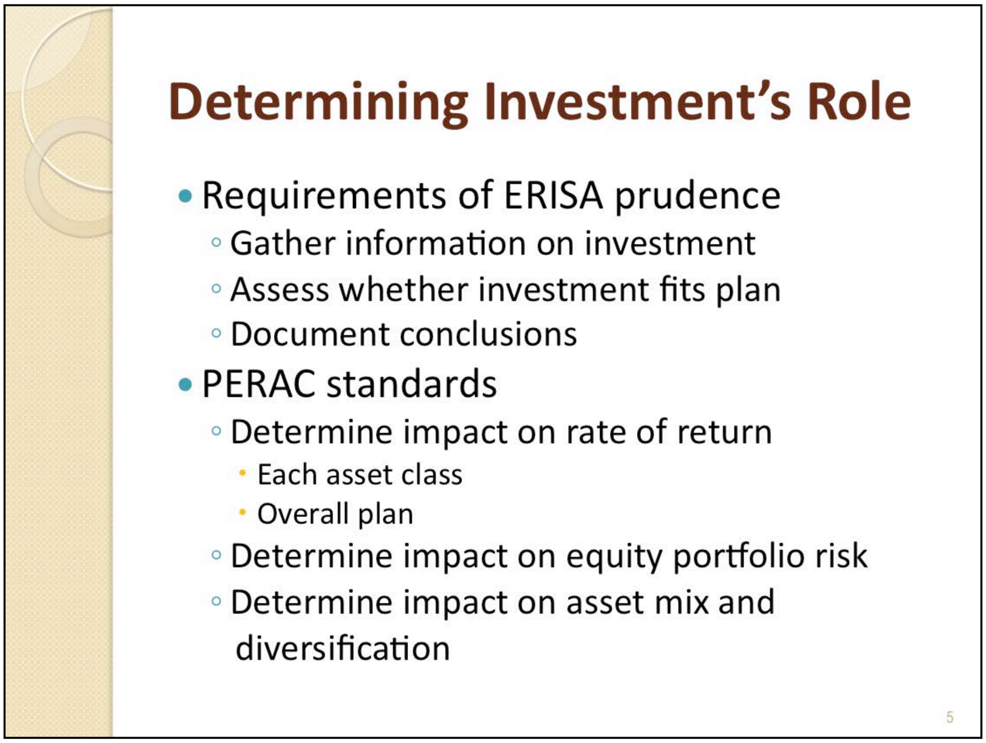
These standards, particularly those relating to prudence and loyalty, are nearly identical to those required by ERISA for private-employer plans. Therefore, adopting ERISA-compliant operational processes and procedures could be quite useful in overseeing investments, particularly alternative investments, which seem to be a current focus of SEC and DOL enforcement activity. I will now talk about how these standards should be applied, in particular with respect to the selection of alternative investments, such as private equity and hedge funds.



The growing popularity of so-called "alternative investments" is due to the perception that they have performed well and decreased plan exposure to market volatility, particularly in an environment where broad-based equity and bond markets are forecast to produce anemic returns. The level of interest has risen such that some plan fiduciaries may believe that they could be failing in their duties if they do not consider, and possibly include, hedge funds and/or private equity funds as investment options in their defined benefit pension plan portfolios. The 2013 PERAC annual report notes that a quarter of state pension funds may have been placed in these types of investments.

The term "hedge fund" refers to a diverse group of funds that invest in different types of assets, *e.g.*, long and/or short positions in exchange traded securities, exchange traded and off-exchange derivatives, currencies, commodities and different types of investment products. As such, these funds do not constitute an asset class but rather provide access to particular trading strategies. Some hedge funs seek to provide smoother returns than the stock market, while others take on complex risks in an effort to achieve higher returns than the stock market. A common thread among hedge funds is the use of high levels of leverage. Hedge funds are not registered with the SEC.

Private equity funds are pooled investment vehicles that invest in companies that do not have publicly traded equity. Those who manage these funds are frequently involved in managing the businesses they acquire. Private equity funds provide access to companies that cannot normally be purchased through traditional investment vehicles of the stock markets. Accordingly, they provide access to a separate asset class. Investment in these funds may provide plan sponsors with the opportunity to obtain valuable diversification within their plan's investment portfolios. However, diversification is only one factor to be taken into account and plans also need to consider whether the necessary due diligence can be executed. Private equity funds also lack liquidity which could interfere with a plan's ability to pay benefits. Like hedge funds, private equity is not registered with the SEC.



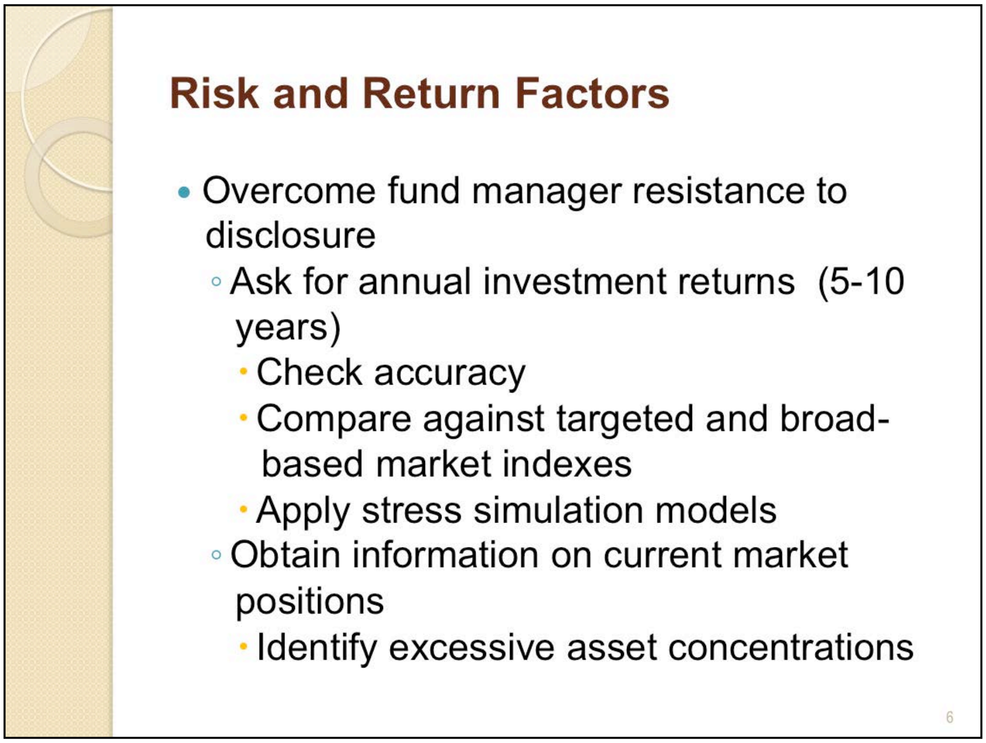
Role of Investment. To be ERISA-compliant from a fiduciary perspective, the process for selecting a prospective plan investment requires obtaining sufficient information about the investment to understand it and using this knowledge to determine the role it will play in the plan's investment portfolio. This role should be consistent with the plan's investment policy statement. This decision-making process should be documented in writing, including the reasoning behind a decision to make an investment.

For example, you need to know a prospective investment's goals and its strategy. Does it intend to beat a broad-based market index, such as the S&P 500 or is it aiming for an absolute return, say 10%? If its objective is high returns, does it have a strategy to mitigate risk? How volatile is the investment and is the level of volatility consistent with the plan's projection of investment earnings? Many of PERAC's member plans have funding ratios ranging from 40% to 60%, raising the question whether the higher levels of risk and volatility of certain alternative investments makes sense for these plans.

In certain matters of a plan's investment policy, the PERAC regulations are more specific than ERISA. Thus, Section 19.02(3) of the PERAC rules require every plan to create a statement of investment objectives that includes the following criteria:

- a statement of the philosophy and methods by which a plan's investment objectives are to be achieved;
- the rate of return to be sought for each asset class and for the plan as a whole;
- the expected level of risk for the equity portion of the plan's investments;
- the expected asset mix of the plan's investment portfolio; and
- the expected level of diversification within each asset class.

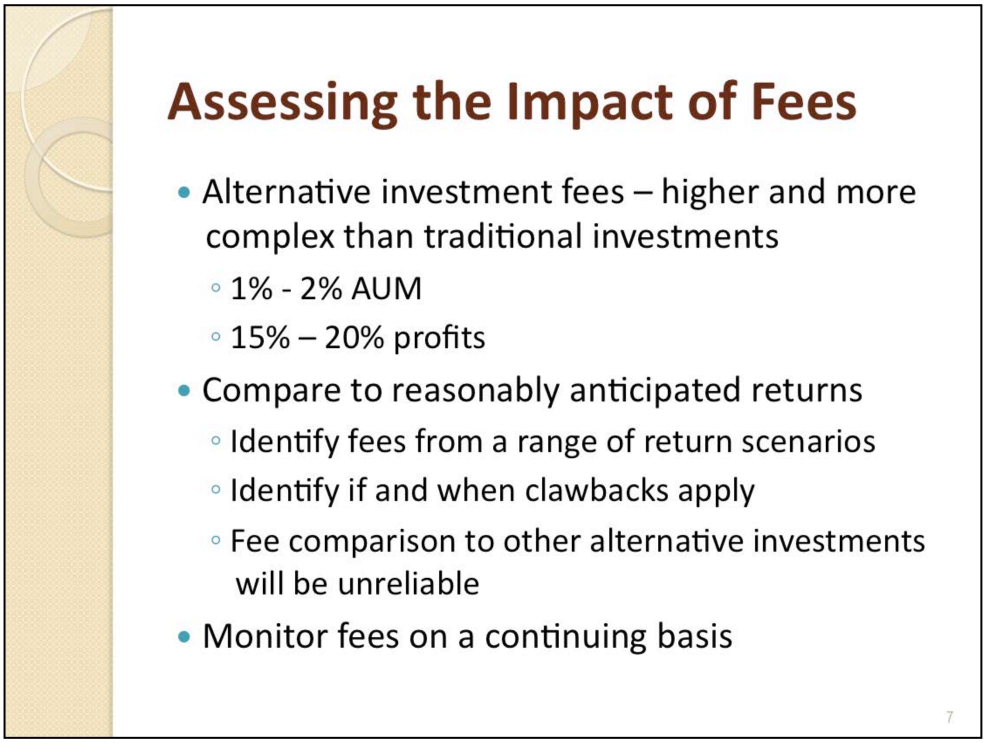
PERAC investment managers should refer these measures in their assessment of each



Under ERISA, plan fiduciaries have a duty to evaluate the market risk posed by a prospective investment. Therefore, even though hampered by the recalcitrance of alternative fund managers when it comes to transparency, plan fiduciaries should attempt to access the annualized returns of a prospective investment for the last 5-10 years, as well as current position-level information, *i.e*., the identity of the fund's underlying assets. Anecdotal evidence shows that, despite resistance, plan fiduciaries have been more successful in negotiating access to this information in recent years.

The accuracy of reported investment returns can now be checked through quantitative analysis techniques. Assuming this hurdle is cleared, fund performance metrics should be compared to a targeted index (*e.g*., the HFRI Index for hedge funds), as well as a broader market-based index, such as the S&P 500. This process can help plan fiduciaries forecast each fund's potential impact on plan assets and the exposure to risk that an investment in a particular fund would entail. In order to evaluate market risk, the DOL also recommends using stress simulation models for prospective investments showing their projected performance and impact on the plan's portfolio under various market conditions.

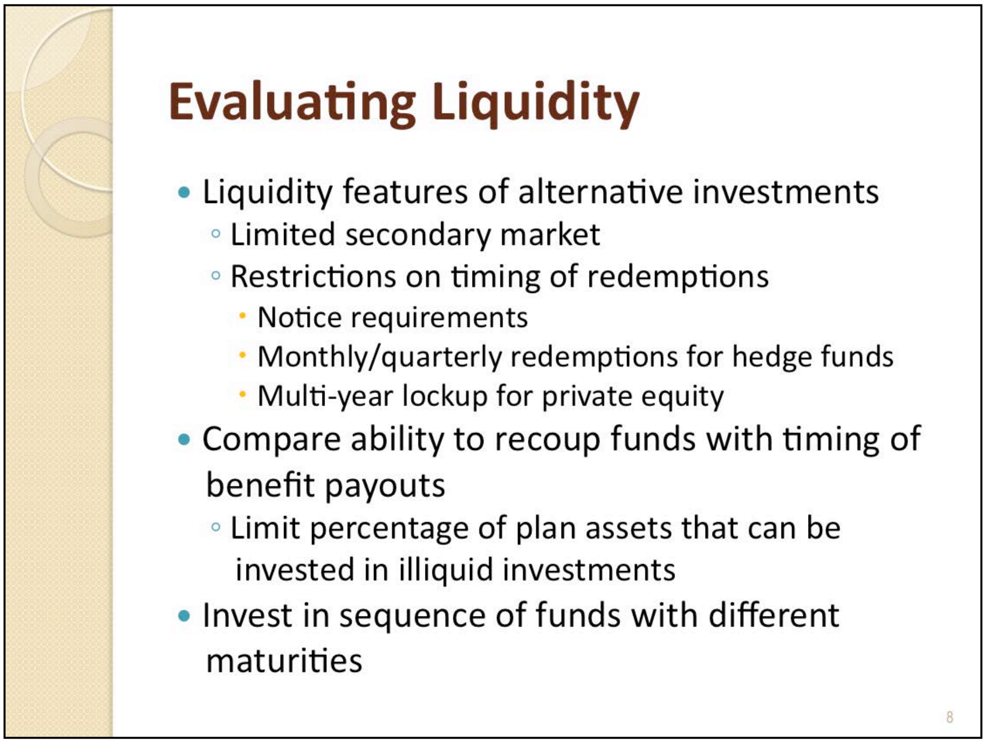
Position-level information enables a plan fiduciary to (i) identify individual positions that may present an unacceptable risk to the plan, (ii) identify excessive position concentrations across the plan's entire portfolio and (iii) determine the plan's overall market-sector exposures.



Fees. Fees charged by alternative investments are generally higher and more complex than those of traditional investments. For example, most hedge funds have both 1% to 2% asset-based management fee and a performance-based fee equal to 15% to 20% of returns. The entire fee structure should be evaluated in relation to the services and results that they bring to the plan.

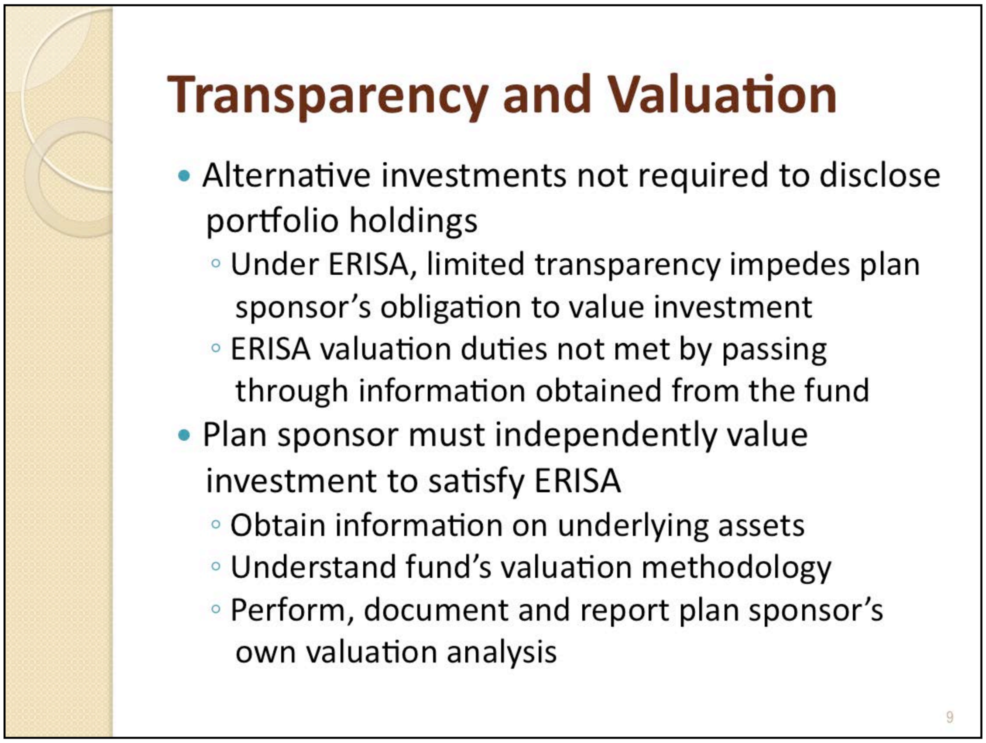
The performance fee part of this structure will make it difficult to compare alternative investment fees with fees assessed by other funds. For example, there may be clawbacks in which fees already paid are refunded if multi-year benchmarks are not met. Therefore, it is recommended that plan fiduciaries test the fee structure by examining the fees that would result from a range of different return scenarios.

Plan fiduciaries should also realize that their duties with respect to fees do not end once a decision to invest in a particular fund has been made. There is a continuing duty to monitor the investment and this would include looking for signs of undisclosed fees, as well as misallocated expenses. In 2014, the SEC enforcement division brought cases against private equity and hedge fund advisers that improperly took money for the advisers' expenses in addition to millions of dollars in management fees that the funds were already paying. The SEC has signaled that it is looking for more of these cases.



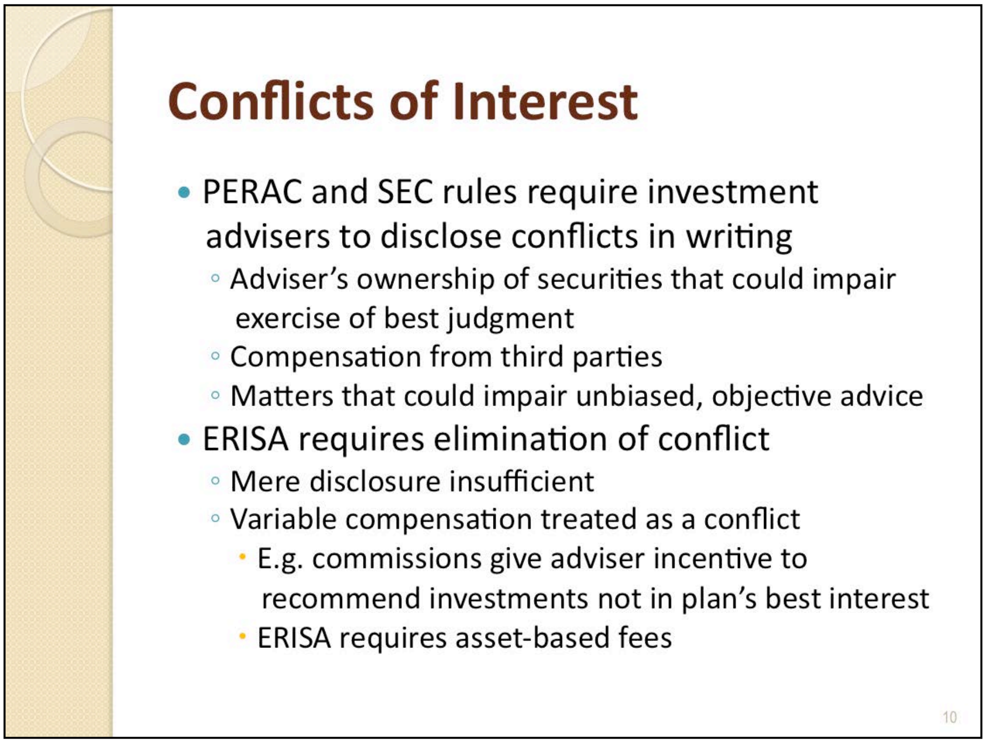
Liquidity. Alternative investments frequently do not have a secondary market that would allow the plan to sell them at will. Further, redemptions in these investments are often significantly limited. Private equity funds are of particular concern, because there is frequently a capital commitment of 3 to 5 years and the possibility that such an investment could be locked up for more than 10 years. Hedge funds typically allow redemptions only monthly or quarterly and required advanced written notice.

Under ERISA, plan fiduciaries need to consider the effect of fund illiquidity on the plan's overall investment strategy and how the relationship of plan assets to the timing of benefit payouts and other obligations may be affected. Arrangements should be made to match the overall liquidity of the investment portfolio with the need to pay out benefits. Larger plans may have the option of investing in a sequence of different alternative funds that mature at different dates. However, smaller plans will need to limit the percentage of plan assets that can be invested in illiquid investments.



Transparency and Fund Valuation. Unlike mutual funds, many alternative investments, such as hedge funds, need not reveal the holdings in their portfolios, and as previously noted, they are often reluctant to do so. Plan fiduciaries should press the managers of these funds to obtain this critical information. As I previously mentioned, PERAC's 2013 annual report warns that a large percentage of public pension funds have "disappeared" into alternative investments and worries about the resulting lack of transparency and public oversight.

A fund's transparency is particularly important when it comes to the methodology used to value the fund. Under ERISA, it is not sufficient to merely pass through information furnished by an investment fund manager. As stated by the DOL's Inspector General in a 2013 report, "While plan management may look to the service provider for the mechanics of the valuation, it must have sufficient information to evaluate and independently challenge the valuation." Under ERISA, plan sponsors must perform a fair value analysis of their plans' alternative investments and document how the value of an investment was determined. Likewise, managers of public plans should understand how the assets of alternative investments have been valued and whether the fund's internal valuation procedures appear to be appropriate.

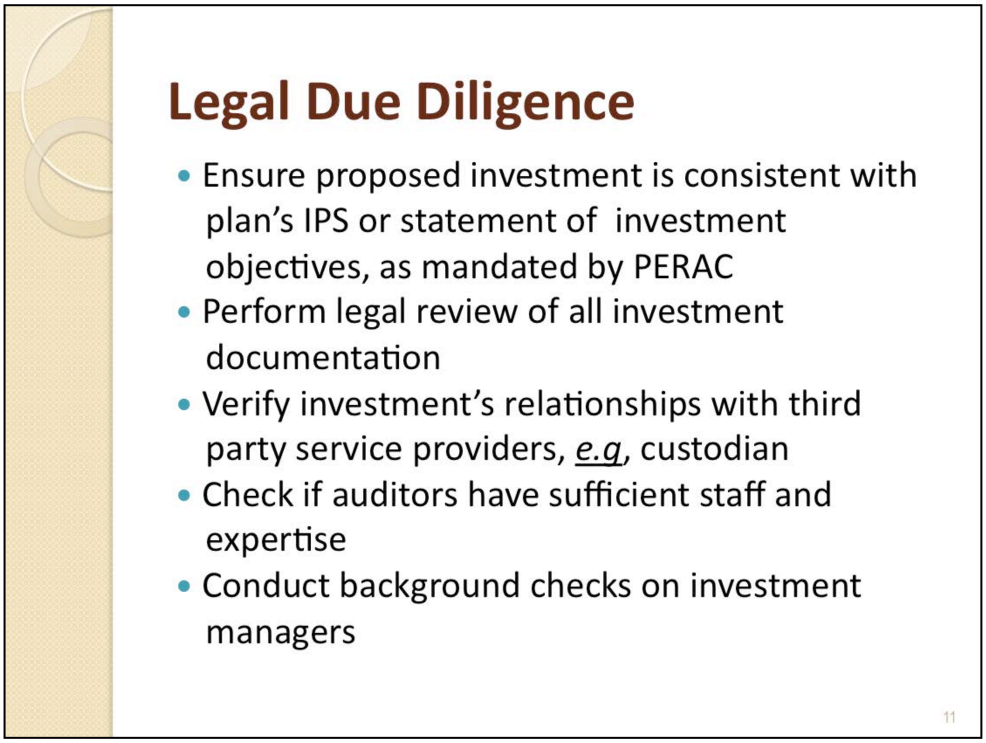


Under Section 17.04(7) of the PERAC's regulations, an investment adviser or consultant to a plan must make written disclosure to a the plan's board of any conflicts of interest that the adviser may have. This disclosure obligation includes:

· the adviser's ownership of securities which could impair his or her ability to render unbiased and objective advice (in other words, does the adviser engage in proprietary trading or investing?);
· all other matters that could impair the adviser's unbiased and objective advice;
· compensation arrangements under which the adviser is expected to receive payment or other benefits from third parties in connection with the adviser's plan services; and
· compensation arrangements under which the adviser will pay third parties, directly or indirectly, for their referring a plan to the adviser.

This is similar to requirements under the federal securities laws under which advisers must identify and then address the adviser's conflicts, either through mitigation or disclosure.

Although not strictly applicable to PERAC plans, you should know that ERISA takes a different approach to conflicts. Under ERISA, mere disclosure is not sufficient to resolve potential fiduciary violations. Accordingly, an adviser subject to ERISA fiduciary standards is prohibited from receiving variable compensation, such as commissions, that would give the adviser the financial incentive to recommend the commission-paying investment over another. To ensure impartiality, ERISA limits adviser pay to a flat or asset-based fee, *i.e.*, a fee equal to a percentage of all assets under the adviser's management. This is the standard required for private-sector plans, and public plan fiduciaries should be aware that it is an available tool for ensuring that they get the best possible investment recommendations from their investment advisers.



Plan fiduciaries should ensure that investment in an alternative fund is consistent with the plan's investment policy statement. The IPS is generally thought of as an ERISA document, but public plans would benefit by having one. PERAC mandates that each plan maintain a written policy governing certain issues, such as investment objectives. Due diligence includes investigation into whether an investment complies with these mandates.

Legal due diligence also requires review by counsel of all relevant documentation, including private placement memorandums, prospectuses, fund operating agreements and various side letters. Obtaining all of these documents can be a challenge.

One sees from SEC statements and anecdotal reports that there is a movement to independently verify the existence and viability of alternative investment fund relationships with key third-party service providers, such as administrators, custodians and auditors. You may recall that in the Madoff fraud, the auditing firm was too small and without the resources to detect asset misallocation. The effort to verify third-party providers aims to prevent a repeat. Examination of audited financial statements that have been competently prepared can also reveal possible conflicted transactions with related third parties.

Similarly, there has been a push to conduct background checks on managers of alternative funds.

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