Alternatives in DC Plans

Background

Alternative assets are investments in hedge funds, private equity funds, private real estate funds, commodities or other asset classes besides public equities and bonds. While alternative assets have higher attendant fees and are generally less liquid than public equities or bonds, alternative assets have provided benefits to defined benefit plans who have invested in this asset class. These benefits include diversification and low correlation to traditional asset class performance, reducing volatility and potentially enhancing long-term risk-adjusted returns. Indeed, one of the reasons defined benefit plans have generally had better results than defined contribution plans is because of their use of alternative assets.

Alternatives are now starting to be incorporated into defined contribution (DC) plans. With their use in DC plans, issues have arisen with alternative investments. These issues include suitability for defined contribution plan participants, how to value these assets on a daily basis to accommodate daily liquidity, and the illiquid and long-term nature of these assets.

This paper gives a brief overview of the ERISA framework for alternative assets, and how an independent fiduciary could address some of the issues with having alternative assets in DC plans.

Legal Background of Alternatives in DC Plans

While there is no specific guidance in the Employee Retirement Income Security Act (ERISA) regarding the use of alternative asset classes, ERISA requirements with respect to investing defined contribution assets in hedge funds and private equity funds primarily derive from ERISA's "prudence rule" of ERISA Section 404(a). The "prudence rule" requires a plan fiduciary to carry out his/her duties with the care, skill, prudence and diligence of a knowledgeable person under similar circumstances, including the duty of investing plan assets. The plan fiduciary also has a duty to diversify plan assets and to follow the terms of the plan. To act prudently in selecting plan investments, a plan fiduciary must give appropriate consideration relative to the plan's portfolio regarding investment diversification, risks associated with the particular investment, investment liquidity and other investment return characteristics. If the fiduciary does not have the requisite expertise to make an informed decision regarding a particular investment option, in order to fulfill his/her duty of prudence, the fiduciary must consult with someone who is an expert in that area.

The Ludwig Letter issued by the DOL and its approach on the investment of derivatives at the time (1996) is an example of an earlier application of the principles of the "prudence rule" that has been compared to investing in alternatives. The principles of the Ludwig Letter are often cited in evaluating the appropriateness of hedge fund and private equity investments. These include the duty to evaluate legal risk, to assure proper documentation of the transaction or the contract that governs the transaction (e.g., reviewing the investment management contract), and to monitor the investment, with the frequency and degree of monitoring depending on the nature of the investment and the role the investment will take in the plans' portfolio.

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Issues with Alternative Investments in DC Plans

The issues with alternative investments in DC plans include suitability for defined contribution plan participants, the valuation of assets and the lack of liquidity of assets. The complexity, potential illiquidity, greater volatility and higher fees of alternative assets make alternative assets less suitable for DC plans. Prices for some less liquid alternatives are updated only periodically, which is an issue because of the need to determine appropriate daily valuation. The long-term nature of alternative assets also poses challenges for in a DC plan that allows daily participant cash flows.

Implementation Options

Given the issues presented by alternative assets, various implementation strategies have been adopted by DC plans. These include using mutual fund structures, using target date funds, not using the alternative assets sleeve for liquidity, and limiting the amount a DC plan participant can invest in alternative assets.

One way for alternative investments to be included in DC plans is to create mutual fund structures, which are registered under the Investment Company Act of 1940 and are referred to as "'40 Act" funds. Because these mutual funds for the most part offer daily valuation and liquidity, they can provide daily liquidity to meet participant activity. These liquid alternatives also offer transparency of their underlying holdings, and have a number of characteristics that provide greater regulatory safeguards, including mandatory independent fund governance, requirements for custody of assets and leverage restrictions. However, due to alternative assets' complexity, greater volatility and higher fees, alternative assets may be more appropriately included in defined contribution plans through multiasset funds such as target date funds and diversified core options, which reduces the potential for misuse by plan participants.

How an Independent Fiduciary Can Help

An independent fiduciary can help DC plans address the issues presented by alternative assets in a variety of ways. These include managing the disposition of illiquid assets, managing investment decisions regarding illiquid assets, and ensuring valuation models and methodologies, which can be used to facilitate liquidity, protect and are fair to DC plan participants. Addressing these issues requires an in-depth knowledge of ERISA, financial expertise and a deep understanding of DC investment products and services.

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Evercore Trust Experience

Evercore Trust Company, N.A. ("Evercore Trust") has served as an independent fiduciary in many situations to address the issues that arise from having alternative assets in DC plans. Evercore Trust has utilized its financial and legal expertise in each of these situations. Representative examples include:

<u>Major Private Equity Fund of Funds Manager (2014 – present)</u>

A major private equity fund of funds manager planned to offer a private equity product as a component as a target date fund for DC plans, but needed to ensure liquidity for non-routine redemptions. To address this issue, Evercore Trust serves as independent fiduciary on behalf of ERISA investors to formulate and monitor compliance with an objective "rules based" procedure and methodology for non-routine redemptions. Evercore Trust developed this procedure and methodology working closely with the client.

<u>Major Hedge Fund of Funds Manager (2015 – present)</u>

A major hedge fund of funds manager planned to offer a hedge fund of funds product as a component of a target date fund for DC plans, but needed to ensure daily valuation for the hedge fund of funds to facilitate daily liquidity. To address this issue, the hedge fund of funds manager internally developed a proprietary pricing model. Evercore Trust serves as independent fiduciary on behalf of ERISA investors to evaluate whether this internally developed pricing model is based on objective, "rules based" criteria that would be appropriate and prudent to utilize to calculate the daily net asset value of the fund of hedge funds product, and protective of the interests of plan investors that are subject to ERISA.

<u>Major Hedge Fund Manager (2011 – present)</u>

A major hedge fund manager undertook the restructuring of the hedge fund which it owned and managed. Investors in the hedge fund included the investment firm's defined contribution plan. Evercore Trust was hired by the hedge fund manager as the independent fiduciary on behalf of the defined contribution plan to make any and all determinations or decisions required to be made by the plan in its capacity as a shareholder of the hedge fund. These decisions included whether to either reinvest all or a portion of the proceeds from cash distributions from the sale of the hedge fund's securities and assets into a new hedge fund, or to receive such distributions in cash to be allocated to other investment options available under the plan pursuant to participant's individual directions.

Alternatives in DC Plans

Evercore Trust has also served as an independent fiduciary in many other situations involving alternative assets in retirement plans. Representative examples include:

Major Hedge Fund of Funds Manager (2012 – present)

Serve as independent fiduciary on behalf of ERISA investors to monitor subscriptions and redemptions from underlying hedge funds by funds of funds. Among other things, Evercore Trust monitors the manager's compliance with specified procedures and reviews research on the underlying managers in making its determinations.

Major High Yield Corporate Credit Manager (2015)

Served as independent fiduciary on behalf of ERISA investors to evaluate financial and other terms and determine whether to approve the transfer of a portfolio of direct loans between funds managed by the high yield corporate credit manager.