

**NATIONAL CLE CONFERENCE: EMPLOYEE BENEFITS**

**SELECTED ISSUES IN  
PRUDENCE AND INVESTMENT DUE DILIGENCE  
IN THE POST-CRASH ENVIRONMENT**

**January, 2010**

**Rory Judd Albert, Esq.  
Partner and Chair, Employee Benefits and Executive Compensation Group  
Proskauer Rose LLC  
New York, New York  
ralbert@proskauer.com**

**Andrew Irving, Esq.  
Managing Director and General Counsel  
Independent Fiduciary Services, Inc.  
Washington, D.C. and Newark, New Jersey  
AIrving@IndependentFiduciary.com**

The substantial declines in value of virtually all categories of investment assets, combined with the exposure of Bernard Madoff's Ponzi scheme, shook the confidence of investors in the rationality of the financial markets and the credibility of providers of investment products. This crisis of confidence fed the collapse of not only market prices but entire institutions as a "flight to quality" caused investment assets to flock to cash and U.S. government securities despite their history of relatively low absolute returns when compared to other asset classes, including stocks and bonds issued by blue chip corporations, the prices of which dropped at astonishing rates in response. Fundamental investment factors, like profitability and cash flow, were completely overwhelmed by selling pressure generated by capital calls and panic. And the benefits of diversification were lost as correlations among asset classes increased markedly. Everything (other than cash and government bonds) lost, and lost a lot.

Employee benefit plans did not escape the carnage, notwithstanding that Congress had protected them with ERISA's famously demanding fiduciary standards, "the highest known to the law." Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir.), cert. denied, 459 U.S. 1069

(1982). Aside from the duty to adhere to the plan's documents (unless doing so itself is not consistent with ERISA), the ERISA fiduciary must comply with three distinct though overlapping standards: loyalty, prudence and diversification. ERISA states the prudence standard succinctly:

[A] fiduciary shall discharge his duties . . . with the care, skill, prudence and diligence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .

This standard is primarily procedural, and focuses on the nature and quality of the fiduciary decision-maker's investigation into a particular investment and the evaluation of the information derived from that investigation. More than thirty years of litigation of claims alleging imprudent investing have not produced any definitive formulation or checklist of issues that an investing fiduciary should examine or a procedure for examining them. This is true if the fiduciary is a named fiduciary selecting and monitoring the activities of investment managers to whom fiduciary responsibility for particular investment decisions has been offloaded pursuant to ERISA § 402(c)(3). For example, obtaining advice from independent, qualified experts is evidence of prudence but is not dispositive. Chao v. Hall Holding Co., 285 F. 3d 415 (6<sup>th</sup> Cir. 2002); Donovan v. Mazzola, 716 F.2d 1226, 1234 (9<sup>th</sup> Cir. 1983). It is also true of the investment managers themselves, and of the fiduciary consultants whom plan trustees and investment committees engage to assist them in their manager selection and monitoring functions.

Federal court complaints on behalf of the ERISA-governed plans among the Madoff crime spree's victims allege that the managers and consultants who placed ERISA assets into Madoff's hands violated the ERISA standard of prudence.<sup>1</sup> The complaints list the depressingly familiar litany of "red flags," such as media reports questioning the plausibility of Madoff's reported returns in light of the strategy he purported to pursue, the absence of an independent custodian, the use of a tiny obscure accounting firm to "audit" Madoff's books, the lack of transparency in investment process and the proliferation of Madoff family members in key positions. Plaintiffs allege, in effect, the failure of due diligence on the part of ERISA fiduciaries

---

<sup>1</sup> See, e.g., Consolidated Amended Class Action and Derivative Complaint in In re: Beacon Associates Litigation, Docket 1:09-cv-0777 (SDNY) (Oct. 1, 2009); Complaint in Laborers' District Council of Western Pennsylvania Pension Fund, et al., v. Austin Capital Management, Ltd., 2:09-cv-02848 (E.D. Pa.) (June 25, 2009) (transferred to In re: Austin Capital Management Ltd. Securities & ERISA Litigation, 1:2009-md-2075 (SDNY)); Class Action Complaint in Morin, as Trustee of the Empire State Carpenters Pension Fund, etc., et al. v. J.P. Jeanneret Associates, Inc., et al., Docket 1:09-cv-00305 (SDNY) (Apr. 2, 2009);

who made the investment decisions that cost benefit plan investors millions of dollars. Judicial evaluation of whether ERISA fiduciaries who invested plan assets with Madoff violated ERISA's prudence standard in light of these facts – and others that may be developed as the cases are litigated – should add to the body of law on the subject of what constitutes procedural prudence under ERISA (unless, of course, the cases settle before judges get a chance to weigh in on the merits).

In the meantime, however, investment professionals and regulators have begun to weigh in with their views on investment best practices, with a particular focus on hedge funds. Two committees sponsored by the President's Working Group on Financial Markets issued reports in January, 2009 which presented a robust set of guidelines with respect to decisions to invest in hedge funds, the management of hedge funds and the monitoring of hedge fund investments by the investors. Created in 1988 by Executive Order 12631, the Working Group consists of the Secretary of the Treasury and the Chairs of the Federal Reserve board of Governors, the Securities and Exchange Commission and the Commodity Futures Trading Commission. In 2007, the Working Group published its "Principles and Guidelines Regarding Private Pools of Capital," articulating "fundamental principles that will inform our approach to private pools of capital."<sup>2</sup> The 2007 document included the following key, and prescient, points:

- While private investment funds "bring significant benefits to the financial markets . . . [they] also present challenges for market participants and policymakers. . . . Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk."
- "Because 'private pools of capital' can involve complex, illiquid or opaque investments and investment strategies that are not fully disclosed, the risks associated with direct investment in these pools are most appropriately borne by investors with the sophistication to identify, analyze and bear these risks."
- "Market discipline by creditors, counterparties *and investors* is the most effective mechanism for limiting systemic risk from private pools of capital. . . ." (Emphasis supplied).
- Investors should not only perform due diligence to find out the facts about the particular investment vehicle, but also "carefully evaluate the strategies and risk

---

<sup>2</sup> The document is available online at [http://www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf). Interestingly, the Preamble stated, "The current regulatory structure, which is also based on these principles, is working well."

management capabilities of the private pool to ensure that the pool's risk profile is compatible with their own appetites for risk.”

Later in 2007, the Working Group brought together two committees to advance the work begun with the Principles document. The Investors' Committee (“IC”) consists of representatives of various categories of institutional investors, including pension funds (corporate, public sector and union), endowments, foundations, hedge “funds of funds,” and consultants. The Asset Managers' Committee (“AMC”), on the other hand, is comprised of hedge fund managers themselves. Each Committee's Mission Statement<sup>3</sup> called for the development of best practice guidelines. In the case of the IC, its guidelines would be aimed at investors, while the AMC guidelines would be directed at hedge fund managers. In both cases, the purpose of the guidelines was to:

foster efforts to enhance market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and complement regulatory efforts to enhance market integrity.

Each Committee issued its final report on best practices on January 15, 2009.<sup>4</sup>

What follows is a summary of the key points in the Committees' reports, presented from the perspective of ERISA-regulated plans as potential investors. We do not suggest that the best practices guidelines that the Committees produced are definitive, that the ERISA standard of prudence will necessarily evolve to require that they be followed or that fiduciaries who do not adhere to them will be deemed inherently imprudent. The Investment Committee itself acknowledged in its report that “no set of best practices provides a complete solution to the complexities of hedge funds. . . .” On the other hand, the Department of Labor, the governmental agency responsible for enforcing ERISA's standards, has a history of developing standards of fiduciary conduct that rely on concepts developed by investment professionals. For example, the Department's so-called “safe harbor” regulation interpreting the prudence rule<sup>5</sup> effectively embraces concepts of modern portfolio theory, and courts have concurred with that approach.<sup>6</sup>

---

<sup>3</sup> The IC Mission Statement is available online at <http://www.amaicmte.org/Investor.aspx>. The AMC Mission Statement is at <http://www.amaicmte.org/Asset.aspx>.

<sup>4</sup> The IC Report, entitled, “Principles and Best Practices for Hedge Fund Investors,” is available online at <http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf>. The AMC Report, “Best Practices for the Hedge Fund Industry,” is at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>.

<sup>5</sup> 29 C.F.R. §2550.404a-1(b).

<sup>6</sup> See, generally, ABA Section on Labor and Employment Law, *Employee Benefits Law* (2d Ed. 2000) at 671, and cases cited at *Id.*, *Cumulative Supplement – 2008* at 576.

In any event, recognition of evolving standards developed by the investment community can only help that sector of the community subject to ERISA adhere to ERISA's requirements.

### **Distinguishing Hedge Funds from Other Investment Vehicles**

The IC Report divided its analysis and recommendations into the two categories of decisions that investors must make: the decision to invest in hedge funds at all, and the management of the allocation to hedge funds after the decision to invest in the asset class is made. The AMC Report focused on the internal management of individual hedge funds themselves. Both reports defined hedge funds as pooled funds with distinctive structural (as opposed to strategic) characteristics:

- Offer a wide variety of investment strategies.
- Funds are not registered as investment companies subject to the Investment Company Act.
- Not marketed to the general public; offered privately to high net worth individuals and institutions.
- Restricted redemption rights.
- Fund manager fee includes substantial performance-based component in addition to asset-based fee.
- Investment objective involves liquid securities and other investment assets, with only limited investment in private assets.

With its focus on investors, as opposed to hedge fund managers, the IC Report went on to identify other features of hedge funds that distinguish them from traditional investment products:

- They invest long or short, rather than long only.
- They are frequently leveraged.
- Fees are higher, and typically include both an asset-based and performance component.
- Regular use of futures and other derivatives.
- Fund managers typically co-invest.
- Performance target is absolute (e.g. LIBOR+) as opposed to relative outperformance of an index or peers.

## **The Fiduciary Decision to Invest in Hedge Funds**

Plans considering an allocation to hedge funds should confront fundamental issues arising out of hedge funds' distinctive characteristics:

- Can the plan's fiduciaries tolerate the uncertainty (as opposed to risk) that hedge fund investments often present?
- Do the plan's governing documents permit an allocation to hedge funds?
- Does the plan have the resources, internal and external, to evaluate potential hedge fund investments and monitor such investments when they are made?
- Is the plan willing to pay the fees associated with hedge fund management?
- Does the plan have liquidity needs that can be satisfied without relying on a hedge fund allocation in light of hedge funds' redemption and liquidity restrictions?

If the answers to those questions lead to the conclusion that an allocation of plan assets to hedge funds should be considered, an additional level of analysis is called for:

- Define the role hedge funds will play in the plan's overall portfolio of assets, and modify the plan's Investment Policy Statement and related documents to reflect the decision.
  - Will it complement the traditional stock and bond investments?
  - Will it be integrated with other investment vehicles within a particular asset class?
  - Will it substitute for/replace an allocation to traditional investments?
- Decide how many different hedge fund strategies should be considered, and the cost-effective basis for achieving diversification in light of the size of the expected allocation to hedge funds.
- Identify the combination of trustees/fund investment committee members, internal staff, external consultants and external managers who will be responsible for the selection and monitoring of particular hedge funds, and clearly define roles for each.

## **Due Diligence Elements in Hedge Fund Selection**

The IC Report presents a series of recommendations to “focus on how investors can apply appropriate due diligence standards to verify that hedge fund managers are following best practices and identify independent controls and processes to further safeguard their interests.”<sup>7</sup> Because the focus of a plan's due diligence should include evaluating whether a particular hedge

---

<sup>7</sup> IC Report at 17.

fund and fund manager follows best practices in fund management, the AMC Report provides a useful guide to identifying the hedge fund management practices that candidates for investment should follow.

The IC Report identifies the following key elements of due diligence that should precede an investment of plan assets in hedge funds. While many of these best practices require judgments on technical issues best made by an expert engaged for that purpose by the plan, the trustees/investment committee needs to be aware of these elements so it can monitor how well that expert is doing his or her job.

A key element of due diligence is the use of a due diligence questionnaire to probe “the material aspects of a hedge fund’s business and operations” including investment process, historic investment performance, personnel, risk management, third party service providers, legal structure and domicile, fees, legal terms, taxes and compliance policies.<sup>8</sup> The information derived from the questionnaire becomes the starting point for evaluating a particular hedge fund’s key characteristics.

### **Risk Management**

- The manager’s risk management programs
  - Risk management policies and procedures.
  - Independence of the manager’s risk management function and personnel from the portfolio management function and personnel, with risk managers’ compensation not directly tied to investment performance.
  - Components of risk associated with the hedge fund’s investment objectives and strategy, such, as market risks, credit risks, counterparty risks, interest rate risks and event risks.
  - How the fund uses leverage and the impact of leverage on the elements of risk present in the fund’s strategy and structure.
  - How risk is measured, the importance and limits of historical data and the basis and rigor of the stress tests.
  - Procedures for correcting breaches of risk limits and guidelines, including disclosures to investors.

---

<sup>8</sup> IC Report at 18 et seq.

- Compliance policies and procedures, including identification of the Chief Compliance Officer.
- Operational risks, and separation of operational and portfolio management functions.
- Prime brokerage, financing and other key counter-party relationships.
- Information technology and business recovery programs.
- Conflict of interest policies, including allocation of investment opportunities among the manager's products.

### **Legal and Regulatory Issues**

In the absence of a comprehensive regulatory regime, hedge funds' governing documents establish the rights, duties and liabilities of the investors and the fund managers. Evaluation of a particular fund's legal structure and documentation is an indispensable part of the due diligence process.

- Investment structure such as on-shore versus offshore fund
- Domicile
  - Regulatory regime
  - Stability of political and legal systems
  - Accounting standards
  - Taxation
- Governing documents
  - Articulation of a specific investment objective and guidelines versus "basket clauses" and other provisions granting broad freedoms to the manager.
  - Clarity of formulae for calculating manager's fees.
  - Redemption terms and the manager's power to suspend redemptions.
  - Payment of expenses from fund assets versus payments by manager.
  - Scope and limits of manager's liability.
  - Indemnification provisions.
  - Reporting and disclosure, including duty to disclose "side letters" with other investors.
  - ERISA issues, including status of the fund as a "plan asset" vehicle, manager's status as an ERISA "investment manager" and QPAM.

## **Valuation**

The IC Report introduces its discussion of valuation with this observation:

Valuation is ultimately at the core of any investment. It is the key to deciding whether to make the investment and to calculate returns from that investment over time. . . . The accuracy and appropriateness of valuation often has a profound impact on the ultimate portfolio returns reported to investors, as well as the fees paid to the manager. Therefore, it is critical that an investor understand the processes and controls related to deriving valuation, and that the investor evaluates and monitors these on an ongoing basis.

Due diligence steps to assess valuation issues should address the following:

- The manager’s written statement of valuation policies and procedures.
  - Consistency with GAAP, including Financial Accounting Standards Board Statement No. 157.
  - Oversight of the valuation process by a valuation committee of appropriate authority within the organization.
- Professionalism, credentials and independence from portfolio management function of valuation staff, including third-party pricing services and other vendors.
- Annual audit of financial statements by qualified, independent auditors, supplemented by independent midyear valuations.
- Delivery of NAV calculations by an independent fund administrator.

Additional insight into specific valuation issues a plan’s due diligence process should address can be derived from the AMC Report’s extensive discussion of valuation best practices for hedge funds.

## **Reporting and Disclosure**

While hedge funds have a reputation for providing investors with disclosures that are limited or opaque, or both, the AMC Report sets forth best practices that are surprisingly robust.<sup>9</sup> While hedge funds are exempt from most regulation, the AMC Report explicitly drew upon the disclosure regime applicable to public companies. The IC Report supports transparency because “hedge funds’ lack of transparency may lead to unexpected risk exposures” for investors.<sup>10</sup> Thus, due diligence should include obtaining and reviewing sample reports the fund proposes to provide investors.

---

<sup>9</sup> AMC Report at 1-11.

<sup>10</sup> IC Report at 55.

The IC Report calls for periodic (e.g. quarterly) reports disclosing specific data about the fund, such as portfolio concentrations, performance attribution, assets under management, portfolio statistics (such as turnover, long positions and short positions), gross and net exposure, and distribution of assets among the FAS 157 Level 1, 2 and 3 valuation categories. The goal of disclosure is to enable the investor to address key issues such as:

- Whether the manager is adhering to the investment style described in the fund’s offering materials.
- Whether the fund’s assets under management have either grown or shrunk significantly, and are still appropriate given the fund’s strategy and resources.
- Whether there have been material changes in personnel, operations, ownership or third-party relationships, such as changes in the fund’s auditor.
- Whether there has been exception outperformance or underperformance, either of which can signal fundamental problems like overconcentration or excess leverage, or deviation from the anticipated investment strategy.

Investors should also receive regular performance reports, after developing their own “comprehensive approach regarding the measurement of investment performance at the aggregate portfolio level, the investment strategy level, and the manager level.”<sup>11</sup> Performance reports should include the following elements:

- Performance measurement should be based on audited financial information.
- Where relevant, analyses of marginal contribution to risk and return.
- Total fund volatility and residual risk measures.
- The percentage of the portfolio in illiquid securities and in “side pocket” arrangements.

## **Fees**

Because compensation arrangements with plan service providers must comply with ERISA’s prudence and prohibited transaction exemptions, plans should seek to negotiate hedge fund fee arrangements and associated performance targets to avoid overpaying for investment services. Once an acceptable formula is arrived at, the IC Report advises that the fund’s governing instruments should accurately reflect all aspects of the fee structure, including:

---

<sup>11</sup> IC Report at 58.

- Requiring that fees be calculated on the basis of audited portfolio valuations. If a fee calculation period doesn't coincide with such a valuation, the interim valuation methodologies should be spelled out, and provision made for adjustments once audited financials are available.
- Performance fees should be based on value added, not percentage returns or capital invested, and net of fund expenses. The time period for measuring performance should reflect the volatility of returns and lock-up periods. "Generally, the more volatile the investment strategy, the longer the period included for calculating the performance fee."<sup>12</sup>
- Confirm the operation of "high-water mark" provisions.
- Categories of fund expenses to be paid from the fund's assets should be enumerated.
- Fee sharing arrangements, soft dollar arrangements and other sources of compensation or benefits the manager may receive by virtue of the fund's investments or operations.

---

<sup>12</sup> IC Report at 54.