

Protecting Client and Advisor Interests When Hard to Value Assets Are Part of a Portfolio

Fi360 Annual Conference

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Nashville



Speaker Bios

- John Hare
- Charles G. Humphrey, Esquire
- Dr. Susan Mangiero, AIFA, CFA, FRM
- Michelle Sullivan, CPA

John Hare

John Hare is Regional Managing Director for Fiduciary Plan Governance, LLC and is a founding partner of Flautt Hare Davis LLC Retirement Consultants in Brentwood, Tennessee. He has handled retirement plan assessment, implementation, administration and communication for over 23 years. He has significant experience working with 403(b) and 401(k) plans for both large and small organizations with particular emphasis in the healthcare, education and manufacturing markets.

Through his PRUDENT PROCESS™ discipline, John has focused on helping companies understand and improve their fiduciary responsibilities and procedures. He has worked extensively with organizations with multi-vendor plans. John has earned a BBA in Management Information Systems from Georgia Southern University, a Certificate of Financial Planning from Belmont University and is an Accredited Investment Fiduciary, AIF®. John and his wife Shawn live in Brentwood, Tennessee. They have seven children ranging from college age to 13 year old twins. John's interests include music, old cars and fly fishing. He is involved in his local church and community service activities. He spends most of his time supporting his children's interests in athletics, music and competitive Irish dance. He can be reached at jhare@fiduciaryplangovernance.com

Charles G. Humphrey, Esquire

Chuck Humphrey is Employee Benefits & ERISA Counsel of Fiduciary Plan Governance, LLC. He has concentrated his practice in the area of ERISA and employee-benefits law for over thirty-five years, assisting corporate and tax-exempt employers with their benefit-plan obligations and financial institutions with their retirement-plan product offerings.

He is an original member of the IRS Northeast Pension Liaison Committee; a vice chair of the American Bar Association (ABA) Subcommittee on Multiple Employer, Professional Employer Organizations, and Controlled and Affiliated Service Groups; and a member of the Fiduciary Responsibility/ Plan Investments Subcommittee of the ABA. He is also a member of the New England Employee Benefits Council, where he is on the planning committees for the NEEBC's two major annual events, the Benefits Fair and Trade Show and the Washington Update. He is a former member the IRS National Determination Letter Committee.

Mr. Humphrey speaks and writes frequently on topics related to employee-benefit plans. In May his new book, *A Guide to ERISA Fiduciary Responsibilities - For Advisors and Sponsors of 401(k), 403(b) and Profit Sharing Plans* will be published in May. He can be reached at chumphrey@fiduciaryplangovernance.com.

Dr. Susan Mangiero, AIFA, CFA, FRM

Dr. Susan Mangiero is a managing director with Fiduciary Leadership, LLC. Dr. Mangiero is a CFA charter holder, certified Financial Risk Manager and Accredited Investment Fiduciary Analyst. She has provided testimony and behind-the-scenes forensic analysis, calculation of damages and rebuttal report commentary for various investment governance, investment performance, fiduciary breach, prudence, risk and valuation matters. She has over 20 years of experience in capital markets, global treasury, asset-liability management, portfolio management, economic and investment analysis, derivatives, financial risk control and valuation. This includes work on trading desks for several global banks, in the areas of fixed income, foreign exchange, interest rate and currency swaps, futures and options.

She is a frequently invited speaker and has keynoted or led workshops for organizations such as the Stable Value Investment Association, Harvard Law School, Florida Public Pension Trustees Association, New York State Department of Insurance, Association of Public Pension Auditors, AICPA – Employee Benefits Section, National Association of Corporate Directors and Financial Executives International. She is a member of the 401(k) vendor RFP best practices committee for the Association of Financial Professionals. Susan can be reached at susanm@fiduciaryleadership.com or (203) 261-5519.

Michelle Sullivan, CPA

Ms. Sullivan is Director in the Accounting and Audit Department of Freed Maxick CPAs, P.C. and is responsible for leading the firm's Employee Benefit Plan Audit Group. Her area of specialty includes the audits of defined contribution, defined benefit and health and welfare plans for both private and public companies. Ms. Sullivan is responsible for the technical review of the employee benefit plan audits in accordance with both the Department Of Labor (DOL) and Public Company Accounting Oversight Board (PCAOB). She is responsible for the overall planning, organization, supervision, and completion of over 75 pension plan audits the firm performs.

Ms. Sullivan is a member of the AICPA and the Buffalo Chapter of the New York State Society of Certified Public Accountants. She graduated from University of Buffalo with a Bachelor of Science in business administration. She joined Freed Maxick (formerly Freed Maxick Sachs & Murphy, P.C.), in 1995 after having worked for a local CPA firm. She can be reached at michelle.sullivan@freedmaxick.com.

Ms. Sullivan has assisted clients in ERISA and IRS reviews and has consulted on employee benefit plan administration issues, including plan mergers, plan terminations, and corrective implementation for employee benefit plans. She has also assisted numerous entities in preparing and reviewing Forms 5500, 5330 and 990.

Overview

- Introduction to the Speakers
- Program Description
- Objectives
- Trends in Alternative Investing
- Risk and Return Considerations
- Regulators are Paying Attention
- Getting Started
- Lessons Learned

Program Description

Plan sponsor fiduciaries have additional responsibilities when portfolios include allocations to alternatives such as hedge funds, private equity, venture capital and real estate. Investment advisors who assist their clients with these investments must have a due diligence process in place that takes into account economic, legal, and operational considerations. Lock-ups, redemption rights, leverage, access to capital (in case an alternative fund needs to borrow money quickly), key person risk and compensation incentives, and valuation are all factors that may come into play.

This panel discussion will focus on what investments advisors need to know about these investments in order to protect themselves and their clients. Reliance on net asset values and recent court cases that have an impact on the value of these investments will be discussed and the ERISA compliance and reporting requirements that are raised by these investments.

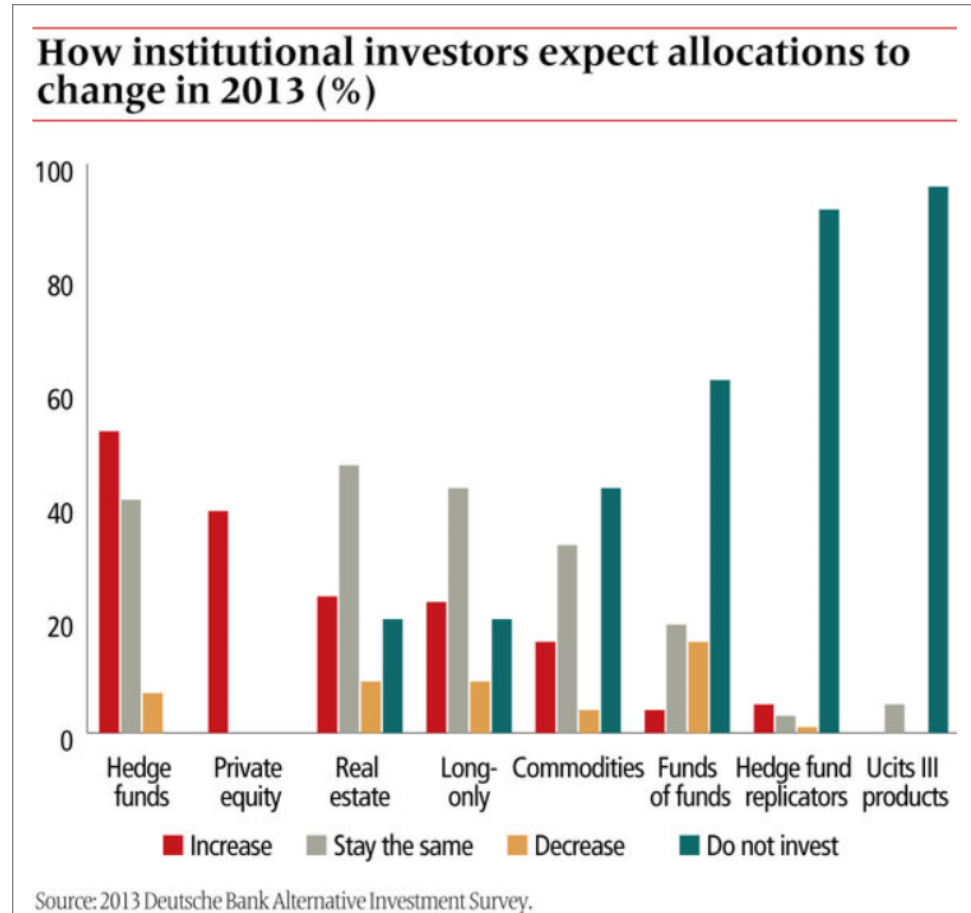
Learning Objectives

- How to manage risks associated with hard to value investments
- Due diligence necessary when investing in hard to value assets
- Governmental reporting requirements relating to these investments
- How performance metrics reflect the risk characteristics of hard to value investments and what information is not likely to be included in standard measures of investment return and risk
- Lessons that lessons can be learned from regulatory enforcement and litigation actions as related to hard to value investments

Headlines About Alternatives

- “SEC Looking at How Alternative Funds Value Investments,” *Wall Street Journal*, February 4, 2014
- “Enforcement Priorities in the Alternative Space” by Bruce Karpati, Chief, SEC Enforcement Division’s Asset Management Unit, U.S. Securities and Exchange Commission, December 18, 2012
- “Cash-strapped US pension funds ditch stocks for alternatives” by Sam Forgione, *Reuters*, August 16, 2012
- “Alternatives continue to win pension assets” by Emma Boyde, *Financial Times*, July 7, 2012
- “Pensions Find Riskier Funds Fail to Pay Off” by Julie Creswell, *New York Times*, April 1, 2012
- “More Pensions Turn to ‘Alternative’ Investments” by SHRM Online Staff, SHRM Website, September 1, 2011

Institutional Investors and Asset Allocation



Retail Investors and Asset Allocation

“Retail investors are embracing publicly registered [“liquid-alternative” mutual funds](#) and ETFs at an astonishing rate, according to a recent [survey conducted by Citigroup’s Prime Finance Unit](#). In the U.S., Citi projects that retail demand for liquid-alt funds will increase assets under management from \$259 billion in 2012 to \$779 billion by 2017 (a CAGR of 25 percent). The total global market for liquid-alt funds is expected to reach \$1.3 trillion by 2017, and more than 70 percent of this will be retail.”

<http://www.benefitspro.com/2013/10/17/global-liquid-alt-funds-13-trillion-by-2017>

Concept of “Hard to Value”

- “Hard to Value” concept can apply to traditional investments such as mutual funds
- Some hedge funds invested in actively traded stocks and bonds and are not considered “Hard to Value” funds
- With FASB and GASB accounting rules, “Hard to Value” typically relates to absence of active trading market and need for use of pricing model to determine value

Risk Factors to Consider

- Rights, Responsibilities and Liabilities of Manager(s) and Investors, Respectively
- Liquidity of Asset Portfolio
- Diversification of Client Base
- Rights to Redeem
- Cash Versus In-Kind Redemption, if Allowed
- Key Person Risk
- Valuation Procedures
- Independence of Board Members
- Fees and Expenses
- Transparency of Policies and Performance
- Access to Credit
- Use of Prime Broker
- Distribution Channels
- Rogue Trading Controls
- Reputable Auditor
- Anti-Money Laundering Policies
- Safeguards Against Insider Trading

Cited Benefits of Alternatives

- Diversification
- Yield Enhancing
- Flexibility
- Absolute Return Potential
- Add-On to Immunization Strategy
- Leverage

ERISA Fiduciary Responsibilities

- Act for the Exclusive Benefit of the Plan
- Be Prudent
- Diversify
- Follow the Plan Documents
- Carefully Select an Outside Service Provider
- Educate Investment Committee

U.S. Department of Labor and Alternatives

- Prudent Investment Process
- Plan Assets and Prohibited Transactions
- Qualified Professional Asset Manager Exemption
- Use of Derivatives
- Reporting of Values
- Fees Paid

Look-Through Rules

- ERISA imposed restrictions and prohibitions on those who manage plan assets directly or through plan asset look-through vehicles
- Plan investors must ask is the potential investment a “look-through vehicle” that exposes plan to prohibited transaction and other consequences?
- The question needs to be asked when the investment is not a publicly traded security or ‘40 Act Fund

What Are Not Look-Through Investments

- Equity interests in investment vehicle is less than 25%
- Venture capital operating companies
- Real estate operating companies

Consequences of Look-Through Status

- Fees paid by the fund to the manager may be prohibited transactions*
- Fund manager and others making discretionary decisions subject to the fiduciary standard
- Trustees may not be relieved of duty to manage assets
- Reporting requirements
- Payments to affiliated entities prohibited

*See DOL Advisory Opinions: 1986 – BDN Management Company and Batterymarch Management Company; and 1998 – Alliance Capital and 1999 – Lucas Management Company

Sophisticated Investor Concepts

- By restricting investors to sophisticated investors or qualified purchasers hedge funds/private equity funds do not have to register under section 3(c)(1) or 3(c)(7) of the “1940 Act”
- ERISA pension plan with > \$5 million in total assets, an ERISA plan with < \$ 5 million if decision made by ERISA plan fiduciary that is either a bank, savings & loan association, insurance company or RIA and a participant-directed ERISA plan where participants are “Accredited Investors”
- “Qualified Purchaser” includes any person acting for his own account or accounts of other qualified purchasers who in the aggregate owns and invests on a discretionary basis > \$25 million in investments

Defined Benefit Versus Defined Contribution Plan Investors

- Should they look at hard to value investments differently?
- If so, what are the differences in their concerns and interests?
- What about 40 Act hedge fund investments?

Getting Started

- Identify strategies to assess fit with plan needs, objectives and constraints
- Research different investment strategies
- Assess whether to invest directly or indirectly via fund of funds
- Meet with fund managers to review answers to RFI and/or due diligence questionnaire

Risk Management – Partial List

- Ask about how portfolio risk is controlled
- Query about operational due diligence procedures
- Ask about personnel background checks
- Identify if auditor, custodial agent and prime broker are independent
- Inquire about technology systems
- Ask about whether stress tests are conducted and how often
- Identify whether trading limits are properly monitored
- Ask whether general partners have their own money invested

Lessons Learned From Enforcement Actions, Litigation and New Regulations

- Excessive Leverage
- Undue Concentration in High-Risk Strategy and/or Securities
- Poor Reference Checks on Staff
- Failure to Oversee Key Traders and Back Office Staff
- Short Track Record
- Style Drift
- Inadequate Risk Management Systems
- No Independent Valuation Reviews
- Absence of Knowledgeable and Reputable Auditor
- Perverse Compensation that Rewards Too Much Risk-Taking
- No Diversification in Client Base
- Insufficient Access to Capital

Disclaimer

This presentation addresses information and developments in the broad and rapidly changing area of hard to value investing.

This presentation is not intended to offer legal, financial or accounting advice, but rather, to provide general information and sources only.

The presenters and their respective affiliated firms do not assume any liability with respect to the content of this presentation.

For legal, financial or accounting advice, individuals and their firms are urged to consult their attorney, banker, CPA or other appropriate professional advisor.