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The SEC Can Further the Goals of Dodd-Frank by Heeding Pension Funds' Calls to Bring More Sunshine to Private Equity Fees

By: Raymond M. Sarola

In the wake of the Securities and Exchange Commission's examinations of private equity firms and its finding of violations in over half of those exams – often with regard to the calculation and allocation of fees charged to investors – a group of public pension fund trustees recently wrote to the SEC to request improved disclosure of private equity fees. While the SEC often focuses on disclosure initiatives aimed at protecting retail investors, the Dodd-Frank Act confirmed the importance of protecting all investors when it required that hedge funds and private equity firms register with the SEC and provide public disclosure of the nature of their businesses. The combination of the SEC's presence exams of private equity firms and the disclosures currently required under Dodd-Frank has already resulted in improved fee disclosures in the industry. Heeding the pension funds' call for further disclosure would benefit investors and the marketplace as a whole.

Pension Fund Trustees Request SEC Action To Mandate Improved Private Equity Fee Disclosure

On July 21, 2015, Treasurers and trustees of thirteen of the nation's largest public pension funds wrote to SEC Chair Mary Jo White, asking for "increased disclosure transparency" over private equity fee structures that will "provide limited partners with a stronger negotiating position, ultimately resulting in more efficient investment options."[i] The pension funds' letter also observed that non-standardized fee disclosures impairs the ability of public pension funds, and their trustees, beneficiaries, and the public, from accurately understanding and comparing fees paid across funds.

The letter noted that U.S. public pension funds have approximately 9% of total assets in private equity, and that the asset class has outperformed more traditional investments over the last ten years. However, despite pension funds' growing familiarity with private equity, they have been unable to obtain sufficient disclosure of various types of fee arrangements that can cost pension funds millions of dollars a year. The South Carolina state pension fund even hired a separate firm to validate the fees and expenses charged by its private equity funds and was still unable to fully understand them over a year later.[ii]

The types of fees referenced in the pension funds' letter mirror those highlighted by the SEC as posing challenges for fair calculation and disclosure to investors.[iii] These include not only management fees but the allocation of fund expenses between the general and limited partners, and portfolio company fees – fees that private equity firms take from their controlled companies, often without clear disclosure to their limited partner investors. A particularly concerning example is that of accelerated monitoring fees, which are fees obtained by private equity firms as compensation for portfolio company monitoring that they would have done in the future had they not sold the portfolio company when they did.

It is worthwhile to note that the pension funds' letter to the SEC does not ask that private equity funds be prohibited from charging any of these fees. It seeks only sufficient, timely, and accurate disclosure of private equity compensation structures with their own limited partners, observing that fee transparency alone will improve investors' negotiating position with private equity managers. As one public pension trustee has explained, "You don't think to negotiate on fees that you're not aware you're being charged."[iv]

SEC Efforts To Improve Disclosure In Private Investment Vehicles After Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act included a requirement that hedge funds and private equity funds, both private investment vehicles that are open only to certain types of investors, register with the SEC and come into compliance with the Investment Advisers Act.[v] This marked the first time that these private asset managers were required to make any public disclosures (even of the fact of their existence), and demonstrated that the SEC's investor protection mission was not aimed exclusively at retail investors.

The SEC implemented Dodd-Frank's directive by requiring private investment advisors to file publicly with the SEC its Form ADV. This form contains a wide range of disclosure requirements, including the organizational structure, executives and other employees, types of clients, and assets under management of an advisor.

Notably, Item 5 of Form ADV Part 2 requires advisors to disclose their fee structure for advisory services. Specifically, they must disclose whether they deduct fees from client assets or bill separately, identify all the various types of fees charged (such as custodian fees, mutual fund expenses, or brokerage fees), describe how a client may obtain a refund of pre-paid fees if the advisory contract is terminated early, and state whether any fund executives receive other compensation for securities transactions.

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Item 6 of Form ADV Part 2 requires disclosure specifically of performance-based fees.[vi]

An SEC acting director recently observed that following the presence examinations and increased publicity regarding private equity fees, many private equity firms have updated their Form ADV disclosures in this regard. However, he cautioned that after-the-fact public disclosure of fee structures is not a substitute for timely and accurate disclosure to limited partners before a fund closes, where the investors retain an ability to negotiate alternative arrangements.[vii]

Increased regulation and mandated public disclosure by private investment funds was not universally supported, and many questioned whether it was a productive use of limited SEC resources to focus on an asset class that was closed to retail investors. In October 2013, Chair White spoke at a hedge fund conference in New York[viii] and responded at length to that view:

> *Now, I know questions have been raised about whether inclusion of private fund advisers in our examination program makes sense, given the often sophisticated nature of hedge fund investors. The question is legitimate and, as the head of a regulatory agency, I need to continuously assess whether our resources are being deployed in the most productive, cost-effective manner.*
>
> *That being said, the SEC has a mission of investor protection that runs across the investor landscape. It applies to all investors, and all investors in the U.S. markets deserve to know that there is a regulator on the block, looking around corners and concerned about their interests.*
>
> *We should also recognize that, while many hedge fund investors are considered to be "sophisticated" or "institutional," those terms apply to a wide swath of investor types. And the investment performance of institutional investors can affect the lives of people on the street. Institutional investors, for example, include pensions funding workers' benefits, college endowments and charities. These "sophisticated investors" can and do have a real impact on main street investors.*

Conclusion

In asking the SEC to require improved disclosure of private equity fees, the thirteen public pension fund trustees are seeking only to obtain, and be able to share in a useful format with the public, disclosure of the fees they are in fact being charged. This request is consistent with the Congressional intent of the Dodd-Frank Act and would build on the early success it has already enjoyed in bringing sunshine to alternative investment fee structures. As its Chair has explained, the SEC's mission includes the protection of all investors, from "mom and pops" to accredited investors, to our nation's largest institutional investors. Listening carefully to the pension funds' request to require disclosure of basic fee information would be consistent with that mission.

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ENDNOTES

[i] The letter is available at http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf and was submitted by the New York City Comptroller, New York State Comptroller, and Treasurers of the District of Columbia, Wyoming, Nebraska, California, South Carolina, Oregon, Rhode Island, Missouri, Virginia, Vermont, and North Carolina.

[ii] "Pension Funds Can Only Guess at Private Equity's Cost," The New York Times (May 3, 2015), available at http://www.nytimes.com/2015/05/03/business/pension-funds-can-only-guess-at-private-equitys-cost.html.

[iii] "Spreading Sunshine in Private Equity," Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, speech given at Private Equity International (PEI), Private Fund Compliance Forum 2014 (New York, May 6, 2014), available at http://www.sec.gov/news/speech/2014--spch05062014ab.html.

[iv] "Pension Funds Can Only Guess at Private Equity's Cost," The New York Times (May 3, 2015), available at http://www.nytimes.com/2015/05/03/business/pension-funds-can-only-guess-at-private-equitys-cost.html (quote from J.J. Jelinic of CalPERS).

[v] Hedge funds and private equity funds are largely restricted to "accredited investors" and "qualified purchasers." See e.g., Rule 501(a), Rule 506 of Regulation D.

[vi] Form ADV Part 2 is available at http://www.sec.gov/about/forms/formadv-part2.pdf.

[vii] "Private Equity: A Look Back and a Glimpse Ahead," Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations (New York, May 13, 2015), available at http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[viii] "Hedge Funds – A New Era of Transparency and Openness," Chair Mary Jo White, speech before the Managed Funds Association Outlook 2013 Conference (New York, Oct. 18, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539892574.

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Cyberliability Insurance: What Is It? Does My Plan Need It?

By: Joshua Geller

With the endless stream of news about cyber attacks and data breaches[1], it is easy to feel there is no way to successfully defend your plan's confidential information against "cyber threats." In an existential sense this feeling may be justified, but in reality there are a number of proactive steps you can take to protect your plan's sensitive information.[2]

Some plans look to Cyber Liability Insurance for help responding to a cyber attack. Like any insurance product, it is crucial to understand what risks you seek to insure against before buying a policy. This article will walk you through the decision-making factors and hopefully guide you towards a decision that works for your plan.

In California, the Attorney General defines a "data breach" as "any situation in which an individual or group steals sensitive, protected or confidential data."[3] This definition recognizes that the risk of a data breach does not stop at the edge of your network's firewall and is not limited to information held exclusively in electronic formats. Cybersecurity risk goes beyond a data breach, however. A broader concept is a "cyber attack": "the attempted or successful unauthorized access, use, disclosure, modification, or destruction of information or interference with system operations in an information system."[4] Cyber Liability Insurance can mitigate the two primary risks posed by a cyber attack: legal liability and operational impact.

The extent of your plan's legal exposure depends on what confidential information your system possesses and which data security laws apply (possibly HIPAA plus state or local statutes). If your plan maintains confidential information on members, staff, and investments, you could face claims from three separate classes of victim. Your plan may be susceptible to claims for violating data security laws as well as tort claims for breach of duty and breach of contract, for failing to secure sensitive information. Liability may also hinge on whether governmental immunity defenses would apply.

Beyond liability lies the question of damages. Even if your plan were somehow found liable for a data breach, would there be damages? This calculation would depend on what information was actually disclosed, whether the applicable law specifies a minimum damage award, and whether the disclosed data was used in a way that caused actual economic harm to anyone. Calculating damages from a data breach is an inexact science, but some courts have recognized that, given the nature of electronic data, the mere threat of exposure can justify a claim for damages.[5] In addition to economic damages, your plan might incur additional legal costs to defend resulting lawsuits.

Significant operational impacts may result from a cyber attack if irreplaceable data is stolen or rendered unusable, if users are locked out of the system, or information systems hardware is damaged. One type of attack, the launch of ransomware on your system, wouldn't entail any liability but could result in significant costs to regain access to your systems.[6] If your plan has implemented a disaster recovery program, many of the contingencies should already be addressed and budgeted. Reviewing your disaster recovery plan will help you see what actions and expenses might be necessary to restore operations.

In general terms, Cyber Liability Insurance provides coverage for responding to a cyber attack. In some respects, this works like a homeowner's liability policy: it can offset the financial and logistical impacts of a covered occurrence as well as provide support for repairing physical damage. A cyber liability policy can include coverage for all of the costs associated with responding to a data breach. These can range from immediate measures to secure information systems to mounting any legal defense and paying judgments or settlements. Depending on the circumstances, a response may also warrant notification of victims, repair or replacement of system resources, PR activities, timely compliance with legal requirements, and investigating the source of the incident.

Cybersecurity is a relatively new area of the law, and some of the costs associated with responding to a cyber attack remain uncertain. Despite this limitation, you can still identify and evaluate major risk factors and where they create potential costs for your plan. Start by asking the following questions:

1. Is your plan susceptible to a data breach?
2. Would your plan be liable for any damages arising out of a data breach?
3. Can your plan respond to a data breach?
4. What is the cost estimate to respond to a data breach, including potential damages resulting from a lawsuit in which your plan is found liable?
5. What is the cost of an annual premium and deductible for a cyber liability policy that covers your plan's risk factors?

Cyberliability Insurance: What Is It? Does My Plan Need It? *(continued)*

Is Your Plan Susceptible to a Cyber Attack?

The source of a data breach is not limited to hacking by an outside attacker infiltrating your network; data breaches can also result from employees' misplacing laptops containing sensitive information, falling prey to "spearfishing," and inadvertently launching malware across networks. Basically, any organization that employs human beings is susceptible to a data breach.

Plans that contract with outside vendors to provide services may further introduce risk of a data breach. If service contracts do not have indemnity clauses, requirements to adhere to data security best practices, or similar protections to limit liability, plans will be at risk for vicarious liability.

While the term "cyber liability insurance" suggests a primary concern with information security in the digital realm, your plan's data security concerns likely extend to information that exists in more tangible forms as well. A policy can be tailored to provide coverage for a breach involving any type or form of data.

Would Your Plan be Liable for Any Damages Arising Out of a Data Breach?

Your plan most likely possesses a variety of information that would be considered sensitive, protected or confidential, including personal identifying information of members and beneficiaries (e.g., Social Security Number, home address, bank account). If your plan administers any health benefits, it may also maintain personal medical information. Your plan probably also possesses confidential information of other third-parties obtained through RFP responses and investment agreements, and may also maintain confidential personnel records.

Unfortunately, even if your plan follows industry best practices for data security, it would be impossible and unrealistic to say that it is not susceptible to a data breach.[7] Fortunately, because of this presumed inevitability, merely suffering a data breach does not create risk of liability. If your plan adheres to best practices for data security and protecting confidential information, you should be in a strong position to defend claims for breach of duty or breach of contract by demonstrating that your plan has taken reasonable steps to safeguard confidential information. If you can show that your plan complies with all Federal and local data privacy statutes and regulations, you will also be on solid ground to defend statutory claims.[8] Further, many state's data privacy laws have "safe harbor" provisions that exclude claims where a data breach only concerns encrypted data.

Any affordable cyber liability policy will require that your plan put in place reasonable safeguards to protect sensitive information. Whether or not your plan carries cyber liability insurance, failure to conform to best practices will carve a direct path to liability following a cyber attack.

Can Your Plan Respond to a Data Breach?

Responding to a data breach involves multiple disciplines and might rely on resources outside your plan's normal chain of command (e.g., IT vendors, customer service representatives). Familiarize yourself with everyone's responsibilities and capabilities, then assess the resource impact of responding to a data breach. Review any service contracts that may be impacted. Responding to a cyber attack should be included in any disaster recovery plan. The following questions are examples of the information you would need in order to evaluate your response capabilities:

- Does your disaster recovery plan already account for additional or alternatively deployed IT resources?
- Can your IT staff defend an attack and investigate its source?
- Would you have an available backup system to restore system functions?
- Can your member services representatives handle suddenly increased call volume?
- Does your plan have media relations staff who can assist with PR?
- Does your plan have access to credit monitoring or similar services?

If your plan wouldn't have immediate access to any of the necessary resources to respond to a data breach, determine who and what else your plan would need. Those extra resources or services could conceivably be provided through a cyber liability policy.

What is the Cost Estimate to Respond to a Data Breach, Including Potential Damages Resulting From a Lawsuit in Which Your Plan is Found Liable?

As discussed above, there may be costs associated with the legal and operational impacts of a data breach. Presumably, most of the human resource costs for responding would be covered through

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normal salary expenses. If you have determined that your plan does not have access to all the resources it would need, estimate the amount of any anticipated extra expenses to address those shortcomings. (For example, what would be the cost of credit monitoring for victims?) With respect to damages (assuming liability), this amount will derive from the extent of exposure caused by the data breach.

What is the Cost of an Annual Premium and Deductible for Cyber Liability Insurance That Covers Your Plan's Risk Factors?

To get a quote for a cyber liability policy, consult with your plan's insurance broker. The questions a broker will use to compute a quote will likely include:

- What types and how much data is maintained by the system?
- What specific services would be required to respond to a data breach?
- Do any third-parties have access to the data?
- Is the plan compliant with applicable statutory data security requirements?
- Does the plan follow data security industry best practices?
- Does the plan website provide access to confidential information?
- What types of data breach events should be covered?

Because of the nature of these policies, a wide array of configurations is possible. If your plan is leaning towards carrying a policy, make sure that all of the stakeholders and representatives of impacted resources have a chance to weigh in, so you can ensure that the policy you design will actually serve everyone's needs in the event of a data breach. Discuss all conceivable scenarios and game them out to ensure that coverage would be broad enough to address the associated risk factors. Like any insurance policy, you don't want to wait until a triggering event to discover it doesn't cover what you thought it did.

Once you have a quote for a policy that addresses your plan's concerns, you should be in a good position to work through the cost-benefit analysis for whether you need insurance to help address the financial and human resources that will be required in response to a cyber attack. If you can calculate the estimated maximum cost exposure and compare that number against the annual premium and deductible of a cyber liability policy, you can assess the economic value of buying a policy. Understanding your plan's operational capabilities will also give you confidence in your decision. For some plans, opting to self-insure will be a no-brainer; for others, buying a cyber liability policy will seem equally obvious. Whatever the case, the best decision will be the one that is the result of open discussion and thoughtful consideration of the issues discussed above.

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Additional Resources:

National Cyber Security Alliance – Stay Safe Online Business Portal: **https://www.staysafeonline.org/business-safe-online/.**

FCC Cyber Security Planning Guide
http://transition.fcc.gov/cyber/cyberplanner.pdf.

"Need for Cyberliability Insurance Continues to Grow," Brian L. Smith and Matthew E. Jackson, *Benefits Magazine*, May 2015. **https://www.ifebp.org/inforequest/ifebp/0166726.pdf.**

"Responding to Today's Data Breach Environment: What U.S. Directors Really Need to Know about Cyber Insurance," Paul A. Ferrillo and Christine Marciano, World Data Protection Report, Bloomberg BNA, January 2015. **http://databreachinsurancequote.com/wp-content/uploads/2015/01/CDRM_Bloomberg-BNA_World-Data-Protection-Report.pdf.**

ENDNOTES

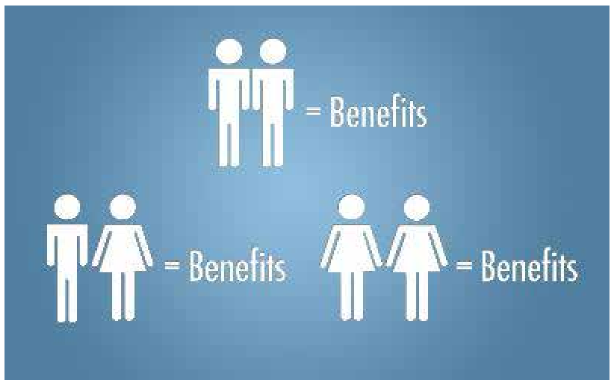
[1]I use the terms "cyber attack" and "data breach" interchangeably. Both refer to the unauthorized access and/or use of confidential data maintained in an electronic information system.
[2]The FCC's Cyber Security Planning Guide is an excellent resource that presents a full array of recommended security practices. It can be found at http://transition.fcc.gov/cyber/cyberplanner.pdf.
[3]California Attorney General Data Breach Report (October 2014), page 2. The complete report can be found at http://www.oag.ca.gov/sites/all/files/agweb/pdfs/privacy/2014data_breach_rpt.pdf?
[4]45 CFR 164.304 (2015).
[5]See, e.g., *In re Adobe Systems Inc. Privacy Litigation*, 66 F.Supp.3d 1197 (N.D. Cal. 2014) and *Remijas v. Neiman Marcus Group LLC,* 14-3122 (July 20, 2015).
[6]Ransomware typically results from an internal user inadvertently launching malicious software that takes over the system and locks out all users until a ransom is paid to the party that sent the malicious software. On the positive side, experts note that ransom payments usually work to restore access to the system. These hackers need to inspire trust in their victims in order to induce a payment that will restore system access. Otherwise, why pay the ransom if there's no guarantee of getting back into your system?
[7]It is a truism in the cybersecurity field that "there is no such thing as perfect security." See Mandiant 2014 Threat Report. https://dl.mandiant.com/EE/library/WP_M-Trends2014_140409.pdf.
[8]If your plan maintains information that is covered under HIPAA rules, electronic data security requirements can be found in 45 CFR 164.306. Compliance with these requirements will provide a defense against HIPAA claims.

Things to Consider After Obergefell and Before Eliminating Domestic Partner Benefits

By: Gary Lawson and Gus Fields

The Supreme Court's ***Obergefell v. Hodges*** decision established that states must issue marriage license to and grant divorces to two people of the same sex, and recognize lawful same-sex marriages from other states. Now, the changes that for a while only impacted private sector pension plans will affect government employee benefit plans as well.

Every employer provided employee benefit plan in the nation must now provide same-sex married couples the same benefits they offer heterosexual married employees. If available to other employees plans must offer full spousal benefits, including pension survivor annuity and survivor death benefits, along with spousal and–if relevant–family dependent health care coverage to all married employees. Employers and plans everywhere will also potentially have new tax reporting issues. In states with income taxes, further changes will be necessary since domestic partner benefits were generally not eligible for tax-exempt treatment under many state laws.



Before ***Obergefell*** some plans provided employee survivor, death, and health benefits for domestic partners as a way to put LGBT employees (and heterosexual couples reluctant to marry), on equal footing with their heterosexual married employees.

Can these plans eliminate those domestic partner benefits now that the Supreme Court has made marriage a nationwide option for members of the LGBT community? Yes, they can, but maybe they shouldn't just yet.

Some employers and plans have reported experiencing adverse selection on health care coverage because of offering domestic partner health care benefits; and eliminating these benefits certainly will reduce the administrative headache of getting proof of the relationship. At least one state, some smaller governmental units, and companies like Verizon and Delta Airlines have already eliminated providing future (or all) domestic partner benefits.

However, since eliminating such benefits may well force domestic partners to either get married or lose benefits, some employers have publically stated they will be keeping the domestic partner benefit option, at least for the time being. These employers may have other reasons to offer domestic partner benefits. For example, older heterosexual employees in a committed relationship can obtain benefits without being forced into a marriage that could jeopardize their social security. Additionally, some LGBT couples may still want to maintain their privacy and thus might prefer to access benefits via private communication with their human resource or employee benefits department without a public marriage.

As always, you need to approach changing employee benefits carefully. Those who decide to terminate domestic partner benefits may need to offer COBRA (or its state equivalent) for continuation of health care benefits. You should also probably at least allow a set period of time for employees to effect changes they wish, or may need to make, to retain very valuable benefits should you decide to eliminate domestic partner benefits.

While the LGBT community welcomes these post ***Obergefell*** changes, you need to consider carefully if continuing or eliminating domestic partner benefits will be the right choice. Carefully determine how and when you should change your employee pension/retirement, health, cafeteria and other employee benefit plans.

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When Trustees Have a *Duty* to Delegate Investment Management

By: Marc R. Lieberman, Mark E. Lasee, and Andrew L. McNichol

Most public retirement systems are governed by boards of trustees from diverse backgrounds. Despite the fact that many trustees have little to no investment acumen, legislation governing public retirement systems invariably vests these trustees with the ultimate responsibility for investing system assets. Historically, trustees were prohibited from delegating to third parties any of their authority to make investments, unless the terms of the trust specifically authorized such delegation.[1] The rationale for such a rule was that trustees were usually chosen for specific qualities, so it would be contrary to the legislative intent to allow others to exercise a trustee's fiduciary responsibilities.[2] Thus, in one famous case, a state supreme court held that a named trustee's delegation of investment authority to an alternate trustee was a breach of the named trustee's fiduciary duty, and remanded the case for a determination whether the trustee was personally liable for all losses incurred by the trust by the alternate trustee.[3] The court expressly rejected the trustee's argument that her lack of investment experience made it prudent for her to delegate her investment power to the alternate trustee, who had vastly more investment expertise; instead, the court reasoned that a trustee's delegation of investment authority for *any* reason, including an ostensibly good one, constituted a breach of trust.[4]

The rule that a trustee cannot delegate away his or her investment authority to make investment decisions may have made sense up to the middle of the 20th Century, when the range of investment choices was rather limited and within the understanding of most people appointed or elected to serve as trustees. Today, however, the complexity and multitude of investment options beg the question whether even the most knowledgeable and experienced trustee can competently make an informed decision to invest in many of these products. As a result, most states have adopted rules dramatically changing the law governing the delegation of a fiduciary's investment authority to allow delegation in appropriate circumstances.

This article will explain these changes, and make clear that there are few impediments with a trustee's prudent delegation of investment authority to more knowledgeable persons, *so long as* certain controls are in place. Indeed, as described more specifically below, a board's failure to delegate investment authority may constitute a breach of fiduciary duty, given the complexity and risks of today's highly-sophisticated securities markets.

The Origin of The New Delegation Rules

In May 1990, the American Law Institute, one of the bodies responsible for codifying the common law into a uniform set of principles, published its Third Restatement of the Law of Trusts ("**Third Restatement**"). This Third Restatement expressly rejected the historical prohibition against the delegation of investment authority. Instead, the Third Restatement specifically authorizes such delegation so long as certain precautions were taken and controls were in place, and importantly, so long as the trust instrument allowed such delegation.[5]

It has taken many years for the Third Restatement's new delegation rules to be adopted by most jurisdictions, but by and large, the new delegation rules promulgated by the Third Restatement are now the law of the land.[6] As a result, it is critical for public pension lawyers, and the boards they represent, to be familiar with the rules governing a trustee's power to delegate investment authority, for today, a trustee's failure to delegate investment authority may constitute a breach of trust, as further noted below.

THIRD RESTATEMENT

The Third Restatement's New Delegation Rules

Section 80 of the Third Restatement sets forth the "new" rules governing a trustee's delegation of his/her authority:

> "A trustee has a duty personally to perform the responsibilities of the trusteeship *except as a prudent person of comparable skill might delegate those responsibilities to others.* In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter, in supervising or monitoring agents, the trustee has a duty to exercise fiduciary discretion and to act as a prudent person of comparable skill would act in similar circumstances." (Emphasis added).

Although the administration of a trust may not be delegated in full, the Third Restatement makes clear that a trustee may for many purposes delegate fiduciary authority to properly selected and supervised agents:

When Trustees Have a *Duty* to Delegate Investment Management *(continued)*

> "[D]elegation is not limited to the performance of ministerial acts. In appropriate circumstances *delegation may extend, for example, to the selection of trust investments or the management of specialized investment programs*, and to other activities of administration involving significant judgment."[7] (Emphasis added).

A delegation of fiduciary authority is proper when it "is reasonably intended to further sound administration of the trust."

Under the Third Restatement, there is no precise definition of acts that a trustee can properly delegate of the circumstances and conditions of proper delegation. A delegation of fiduciary authority is proper when it "is reasonably intended to further sound administration of the trust."[8] Conversely, according to the Third Restatement, it is proper to delegate performance of acts that it would be unreasonable to require the trustee personally to perform.[9] More than that is permitted, however, for the trustee has fiduciary discretion to delegate such functions as a prudent person would delegate under the circumstances.

The Third Restatement suggests that, in considering the circumstances and conditions a particular delegation of fiduciary authority is proper, the following factors, among others, might be of importance:

(i) The nature and degree of discretion involved;

(ii) The amount of funds or value and character of the property involved;

(iii) Efficiency, convenience, and cost considerations in light of the situs of the property or activities involved;

(iv) The relationship of the act involved to the professional skills or facilities possessed by the trustee; and

(v) The fairness and appropriateness of the responsibilities in question to the burdens and compensation of the trustee.[10]

The bottom line is that consideration should be given to "all factors that are relevant to analyzing whether the fact and manner of delegation can reasonably be expected to contribute to the sound, efficient administration of the trust."[11]

Factors Governing a Trustee's Delegation of Investment Authority

The Third Restatement makes clear that a "trustee is not required to perform all aspects of the trust's investment activities."[12] The Third Restatement also provides, however, that "a trustee cannot properly transfer the trust property to another as trustee and thereby abdicate responsibility."[13] The Third Restatement's overarching guidance with respect to delegating such authority is that "in deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising or monitoring agents, the trustee has a duty to exercise fiduciary discretion and to act as a prudent person of comparable skill would act in similar circumstances."[14] The Third Restatement intentionally provides little guidance on what types of investment authority can be delegated, reasoning that any specific guidance on the matter would be misleading and unhelpful:

> "The qualities and qualifications for which trustees are properly selected for fiduciary roles, and the scope and complexity of the investment programs of some trusts, are so diverse that prescriptions for prudent behavior in the delegations of investment functions cannot be expressed in simple and precise legal rules."[15]

Nevertheless, the Third Restatement does set forth some "bright line," general rules for the prudent delegation of investment authority:

> "With professional advice as needed, the trustee personally must at least define the trust's investment objectives. In addition, the trustee must personally either formulate or approve the trust's investment strategies and programs . . . [and] the trustee must exercise care, skill, and caution in determining what investment responsibilities to delegate. Then, fiduciary prudence must then be exercised as well in selecting an agent and establishing the terms of the delegation, all in a manner appropriate to the circumstances and conditions of the delegation and the competence of both agent and trustee."[16]

When Trustees Have a *Duty* to Delegate Investment Management *(continued)*

These rules are explained in more detail in Comment j of § 90 of the Third Restatement as follows:

> Many factors affect the nature and extent of prudent and therefore permissible delegation. These factors include the almost infinite variety that exists in trustees and trusteeships, as well as in investment objectives and techniques and in the types, circumstances, and goals of trusts. For example, it would be impractical for delegation decisions not to take account of the scale of a trust's operations and the nature of the trustee's operating structure. Corporate trustees necessarily act through their employees; between that situation and the individual who acts as a trustee or co-trustee, however, there are many variations of trusteeship, encompassing, for example, institutional governing bodies, law firms, and panels of individuals operating with the support of full-time staff.
>
> The trustee's authority to delegate is not confined to acts that might be described as "ministerial." Nor is delegation precluded because the act in question calls for the exercise of considerable judgment or discretion. The trustee's decisions with regard to delegation are themselves matters of fiduciary judgment and responsibility falling within the sound discretion of the trustee.

Thus, a trustee's delegation of investment authority will not be set aside unless found to be an abuse of discretion.[17] A trustee will not be found to have abused his/her discretion in delegating investment authority so long as the delegation was reasonable and adequately monitored.[18] The size of the trust estate and the burdens and complexity of both the assets to be managed and the strategies to be implemented are important considerations. Consequently, *"[a]ctive investment strategies, especially in low efficiency and privately traded markets such as real estate and venture capital, are likely to* ***require*** *the hiring of agents with special skills not possessed by many trustees, often not even by professionals or corporate fiduciaries."*[19]

Alternative Strategies *Require* Trustees to Delegate Investment Authority

One example of a circumstance where delegation of investment authority might be especially appropriate is in the venture capital realm. Illustration 23 of § 90 of the Third Restatement suggests that such investments might require delegation of investment authority to more expert professionals:

> Illustration 23:
>
> The trustees of a large trust, after consultation and study, have reasonably concluded that it would be desirable as part of an overall portfolio strategy to have a portion of the trust estate committed to a venture-capital investment program. They also have reasonable grounds for preferring to do this directly by holding company shares in the trust estate, rather than by purchasing shares of some suitable stock mutual funds or other venture-capital pools.… The trustees therefore wish to hire agents with specialized skills to manage the program. In this situation, substantial but prudent delegation is justifiable.

The Third Restatement notes that if a venture capital program of the type contemplated in Illustration 23 is to be pursued, "the trustees would have not only authority but a *duty* to delegate management activities in some reasonable fashion unless the trustees personally possess both the necessary expertise and the necessary time (even with the use of advisers) to manage the program themselves with the requisite degree of care, skill and caution."[20]

In sum, whereas historically, trustees were prohibited from delegating to others the right to make investment decisions for their trusts, the rule is quite the opposite today. When a trust's investments cannot be optimally managed by its trustees due to their complexity, the trustees have *duty* to retain competent professionals to manage the trust's investments to enable those investments to be successful.

Delegation Requires Prudent Manager Selection and Monitoring

While trustees wishing to implement an investment program involving complex strategies like derivatives, private equity, real estate or hedge funds may now be obligated to delegate authority to qualified professionals to facilitate the program,

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When Trustees Have a *Duty* to Delegate Investment Management *(continued)*

there are certain guidelines as to how such delegation is to be accomplished. Trustees are to "make a competent, careful evaluation of potential managers… and… monitor their performance of their duties."[21]

Conclusion

Trustees no longer have to go it alone in making investment decisions. If they reasonably believe they are not competent to select and manage an investment, they are obligated to delegate responsibility to a competent professional to manage the investment. Trustees must exercise due care in selecting investment management, and must also regularly monitor their manager's activities. But the days of trustees calling balls and strikes on the suitability of particular investments, especially "alternative investments," is largely over.

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ENDNOTES

[1] *See* Comment c, § 18 Restatement (Second) of Agency ("trustees cannot delegate to others the use of discretion in exercising their powers, unless the terms of the trust so provide"); Comment h, Restatement (Second) of Trusts § 171 ("A trustee cannot properly delegate to another power to select investments").
[2] *Cf.* § 171, Restatement (Second) of Trusts ("trustee, being in a fiduciary relation to the beneficiary, is under a duty *personally* to perform his duties as a fiduciary").
[3] See *Shriners Hospitals for Crippled Children v. Gerdiner*, 152 Ariz. 527, 529, 733 P.2d 1110, 1112 (1987).
[4] See *id.* at 529, 733 P.2d at 1112 ("A delegation of investment authority is unreasonable and therefore, May Jane's delegation is a breach of trust").
[5] See §§ 80, 90, 91 Restatement (Third) of Trusts.
[6] The Uniform Prudent Investor Act, which was promulgated by the Uniform Law Commission and is substantially similar to the Third Restatement, has been adopted in forty-one states and the District of Columbia. Seven additional states have adopted some form of the Uniform Prudent Investor Act. *Only two states*, Mississippi and Louisiana, have not adopted some form of the Uniform Prudent Investor Act, and boards in those states should tread more carefully when considering whether to delegate investment authority to third party managers. See https://www.fdic.gov/regulations/examinations/trustmanual/appendix_c/appendix_c.html#_toc497113667.
[7] See § 80, Comment e, Restatement (Third) of Trusts (emphasis added).
[8] *Id.*
[9] *Id.*
[10] See § 80, Comment e, Restatement (Third) of Trusts.
[11] *Id.*
[12] See § 80, Comment f, Restatement (Third) of Trusts.
[13] See § 80, Comment c, Restatement (Third) of Trusts.
[14] See § 80(2), Restatement (Third) of Trusts.
[15] See § 80, Comment f, Restatement (Third) of Trusts.
[16] *Id.*
[17] See § 80, Comment j, Restatement (Third) of Trusts.
[18] *Id.* (trustee must keep reasonably informed of investment advisor's activities).
[19] *Id.* (emphasis added).
[20] See *id.*
[21] See Restatement (Third) of Trusts, § 90, Comment j.

Annual Membership Dues

The NAPPA 2016 dues renewal period is from October 13, 2015 through January 31, 2016. You must be logged in to begin the renewal process. Payment may be made by check or credit card. If paying by check, you will receive an invoice in your email. Please forward the invoice to the appropriate person for payment processing.

Governmental members should verify whether they are the primary member or the associate member before making a payment selection. Each system has one primary member. If unsure, please call NAPPA at 573-616-1895.

Alternative Investment Fees and Expenses Under Increased Scrutiny

By: Susan Weiss and Yuliya A. Oryol

The Securities and Exchange Commission (SEC) is finally shining the spotlight on the business model of private equity and other alternative investment funds.[1] At issue are the fees and expenses of operating private market funds and the portfolio companies in which the funds invest. The amounts and nature of the fees and expenses that are passed on to the investors are generally at the discretion of the private asset manager/general partner (manager) and often not fully disclosed at the time investors make their capital commitment to the fund.

In his May 6, 2014 speech, appropriately entitled "Spreading the Sunshine in Private Equity," Andrew J. Bowden, then-director of the SEC Office of Compliance Inspections and Examinations Group (OCIE), outlined in detail the hidden fees and expenses that the managers charge the investors in their funds. According to Mr. Bowden, the SEC identified violations of law or material weaknesses in controls over 50% of the time with much of what was revealed being, "undetectable by even the most sophisticated investors."[2] According to Mr. Bowden, in some instances "investors' pockets are being picked."

We believe that these practices are not new, but rather recently revealed due to enhanced regulatory requirements and SEC review. The Dodd-Frank Wall Street Reform and the Consumer Protection Act have resulted in improved fee disclosures in the industry. The SEC registration requirements under the Investment Advisers Act of 1940 have forced managers to make public disclosures of the fees and expenses charged to the investors in their funds. In addition to the requirement for public filing of a Form ADV, the SEC presence exams have exposed the nature of the hidden fees and expenses. Through its 2012 Presence Exam Initiative, the SEC performed close to 400 presence exams for newly-registered managers by December 2014. This satisfied OCIE's goal of examining 25% of the new private fund registrants by the end of 2014.[3]

Despite the SEC's actions to date, many institutional investors still believe that not enough is being done to protect their interests and investments. In July 2015, several State Treasurers and Comptrollers sent a joint letter to the SEC Chair Mary Jo White urging the SEC to require managers to more fully disclose their fees and expenses.[4] In September 2015, the Institutional Limited Partners Association (ILPA) launched its *Fee Transparency Initiative,*[5] a broad-based effort that aims to establish more robust and consistent standards for fee and expense reporting and compliance disclosures among investors, managers and their advisors.

Below we have outlined some of the business practices that have been revealed. Armed with increased transparency and knowledge, institutional investors can now address these practices in their due diligence and contract negotiations prior to making the decision to invest.

Private Fund Fee and Expense Structure

Generally, alternative asset classes involve a more complex and expensive cost structure than public asset classes. Expenses incurred in operating a private fund are apportioned among the fund and its manager – at the reasonable discretion of the manager. As such, the investors in most cases do not know the amount of fees and expenses the fund will incur during its lifetime. The manager in most cases has the authority to determine what is reasonable in terms of timing and amount even when paying fees to its affiliates and related parties. Furthermore, the undisclosed fees and expenses result in a substantial weight on returns.[6] In addition, more than half of the fees charged to U.S. public plan investors are not properly disclosed by the managers.[7]

Fund expenses generally include (i) organizational expenses (typically capped at around 1% to 3% of the fund's capital commitment with any excess amount offset against management fees), (ii) management fees (typically around 2% of the fund's capital commitments), (iii) operating expenses of the fund (other than the manager's overhead such as rent and insurance), (iv) incentive fees or carried interest (typically around 20%), and (v) portfolio company operating expenses. Out of these categories, only management fees are easily segregated and disclosed. Although managers generally disclose information on all types of fees, these are often reported deep in annual financial statements and not reported directly to the investors on a quarterly basis. The lack of frequent, consistent and clear reporting has resulted in an uneven approach to fee disclosure and a misalignment of interests between the managers and the investors. Some areas that deserve special attention are discussed below.

Alternative Investment Fees and Expenses Under Increased Scrutiny *(continued)*

Shifting of Management Expenses to Fund or Portfolio Companies

Often various overhead costs and expenses of a fund's operations that one would expect to be paid by the manager are instead passed on to the investors. These expenses can cover the salary of certain management company personnel (including investment professionals), health benefits, day-to-day costs of operations, and costs of monitoring existing investments. SEC investigations have confirmed that hidden fees and expenses have included improper shifting of fund administration and overhead expenses from the manager payroll to the payroll of portfolio companies during and after the formation of the fund.[8]

For example, individuals presented to investors as employees, either in private placement memorandums (PPMs) or roadshow presentations during the fundraising stage, are later terminated and hired back as so-called "consultants" by the funds or portfolio companies directly. Senior advisors, industry advisors and "entrepreneurs in residence" appear to investors to be employees of the manager, but instead these individuals are hired as unaffiliated contractors with salaries outside the management fees.

The Dodd-Frank Wall Street Reform and the Consumer Protection Act have resulted in improved fee disclosures in the industry.

In addition, the funds are paying fees of third-party service providers, often affiliated or related to the manager. Unlike actual employees with the compensation expense borne by the manager, these individuals are either paid directly by the portfolio companies they advise or their compensation is expensed to the fund without an offsetting reduction in management fees. Investors need to examine the advisor and subadvisor fee differential in order to determine whether the subadvisor fees are negotiated at arm's length, an unlikely event where the subadvisor is an affiliate or commonly associated with the advisor. Investors should also examine whether the management fee bears a "reasonable relationship" if a third-party subadvisor is carrying out the brunt of the work. Several lawsuits have been filed accusing managers of breaching their fiduciary duties by excessively overcharging fees to investors for funds that are being overseen by third parties.[9]

Furthermore, the OCIE has reported that some managers bill their funds separately for various in-house services and back-office functions that have traditionally been included as administrative and operational services provided in exchange for the management fees, including registration, compliance, tax, legal, recordkeeping, audit, reporting, accounting, travel (including first class and charter flights), luxury hotels, meals and insurance without prior disclosure and consent of the investors in the fund. Most institutional investors would agree that consultants or operating partners hired by the manager to assist portfolio companies should not be an expense of the fund, but rather compensated by the portfolio companies. If paid by a portfolio company, the compensation should offset the management fee rather than have the fund pay such compensation directly, or indirectly bear the burden of that management expense.

Misallocation of Management Fee Offsets

In some cases, managers have used management fee offsets as a way to pass operating expenses to the investors. Management fees are subject to reduction based on two principal events: (a) receipt by the investment manager and its affiliates of income from portfolio companies or proposed portfolio companies such as origination fees, deal structuring fees, monitoring/advisory fees,[10] break-up fees,[11] termination or divestment fees[12] and directors' fees[13] (collectively, transaction fees) and (b) payment by the fund of placement agent fees. Such fee income received by the manager, its affiliate or related party should be directly credited dollar-for-dollar to the fund. The SEC has exposed instances where such fees are not credited at all or credited pursuant to some pro rata formula, such as an 80/20 split to match the carried interest arrangement.

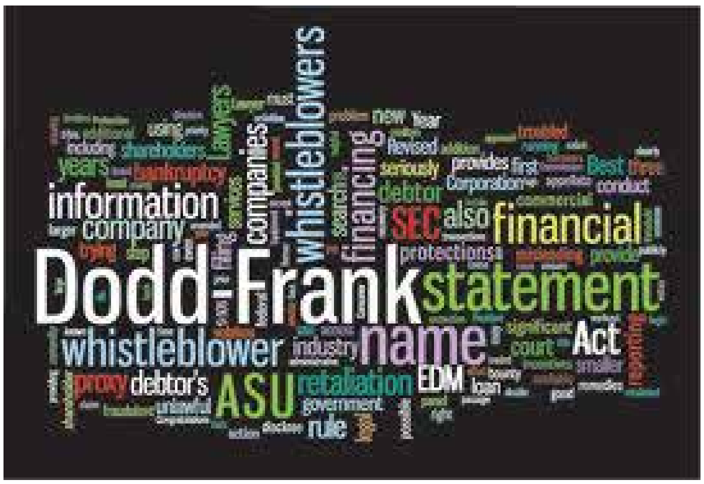
The SEC noted that managers often use their control over portfolio companies to require that the portfolio company defer <u>any</u> fee payments to be made to the manager (including monitoring fees) until after a final sale, in order to exempt the fees from being credited to the investors.[14] In fact, it is common practice for managers to charge monitoring fees to portfolio companies in exchange for board and other advisory services during the portfolio company's holding period. Some managers require the portfolio companies to enter into agreements to pay these fees for an indefinite term and upon a sale, IPO or

Alternative Investment Fees and Expenses Under Increased Scrutiny *(continued)*

other similar transaction, the manager can collect a potentially substantial fee to terminate those agreements. There is usually no disclosure of these practices when the fund agreements are signed, and the disclosure that exists when the acceleration is triggered is too late. Furthermore, it is important to ensure that the management fee offset accounts for any in-kind payments. If an in-kind payment is not marketable at the time of receipt, the value should offset the management fee as soon as the security becomes marketable or at the end of the life of the fund, whichever is first.

Excessive Organizational Expenses

Organizational expenses borne by the fund (as opposed to the manager) are generally capped by the fund's partnership agreement. These expenses include the costs of attorneys and accountants incurred in forming the fund and the manager of the fund (tax deductible and reflected as "organizational cost" on a fund's income statement). These expenses also include syndication costs of raising the fund, *e.g.* issuing the PPM, as well as travel and other expenses incurred by the fund's manager and external placement agents during the marketing of the fund.



Historically, the cap on organizational expenses was no more than 1%, but today it is typical to have a fixed dollar cap between 1% to 3% of the fund's target size. Caps should not exceed \$1 to \$2 million, even for the largest of funds, and especially for subsequent or "follow-on" series funds (but we regularly see caps in the range of \$2 to \$3.5 million). Organizational expenses borne by the fund should not include expenses associated with formation of the manager, its affiliates or related parties providing services to the fund, or the cost of registration or other regulatory compliance.

Remedial Measures

In today's market, especially with oversubscribed private funds, it seems unlikely that the manager will completely do away with its business model of passing the operating fees and expenses of the fund and the portfolio companies to the investors whenever possible. Besides simply walking away from funds that lack sufficient transparency, there are a number of possible strategies in addressing fees and expenses when negotiating fund terms that institutional investors may consider.

First, check for adequate alignment of interest in the fund's organizational documents. It is important during the due diligence stage to ask the managers detailed questions about how they allocate fees and expenses. If it is concluded that effective monitoring processes can capture relevant information, it will be important to insist on sufficient, timely and accurate disclosure and reporting. Ask the manager about the type of fees and expenses, including the amounts charged in any predecessor funds, to get a better picture of how the manager runs its business. In addition, verify that the fees and expenses are fully disclosed in the limited partnership agreement, investment management agreement or other fund documents.

Some institutional investors hire specialized consultants to recalculate and verify management fees, expenses and carried interest.[15] This approach gets the consultant involved ahead of time as part of the due diligence process. The consultant can, on a continuous basis, monitor, validate and reconcile services to ensure all future capital calls and distribution notices are in accordance with the limited partnership agreement.

Finally, consider negotiating a flat fee for fees and expenses of the portfolio companies, such as a range between 2% to 4% of the commitment size so that the amount is fair and predictable regardless of the amount of fees and expenses the manager may incur in the future.

Conclusion

Alternative investments serve a critical role in pension fund portfolios, contributing to asset diversification and typically higher returns necessary to secure the retirements of millions of teachers, firefighters, police officers and public servants. In this regard, private equity is the highest performing asset class for these funds, returning over 12%, net of fees, over a 10-year horizon.[16] The 2014 year-end returns reported by the ILPA U.S. Private Equity Index (excluding venture capital) showed

Alternative Investment Fees and Expenses Under Increased Scrutiny *(continued)*

returns of 11.2%, 15.8%, and 12.8%, for one-year, five-year and ten-year returns, respectively. And all of these figures are net of fees.[17] CalPERS' most recent Private Equity Annual Program Review shows that over a ten-year period, private equity exceeded the Asset Liability Management (ALM) return expectation of the asset class by 4.3%, and exceeded the Global Equity portfolio performance by 5.7%.[18]

A greater understanding of the fees and expenses charged by managers, as well as a consistent manner of disclosure, will ultimately lead to stronger partnerships between pension systems and the funds they invest in. It is imperative that the institutional investor community join the SEC in pushing for greater transparency and lower fees by managers.

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ENDNOTES

[1]In referring to alternative investments, in addition to private equity, we also generally refer to venture, buyout, mezzanine/debt, infrastructure, real estate and hedge funds.
[2]Wylie A. Tollette, CalPERS' Chief Operating Investment Officer, told an investment committee in April 2015 that the fees CalPERS paid to private equity firms were "…not explicitly disclosed or accounted for. We can't track it today."
[3]See *Think Advisor* article January 7, 2015, *"SEC to Conduct 'Presence Exams' on Never-Examined Advisors."*
[4]See July 21, 2015 letter to SEC Mary Jo White, signed by State Treasurers and Comptrollers for District of Columbia, Wyoming, New York City, New York State, California, South Carolina, North Carolina, Nebraska, Virginia, Vermont, Rhode Island, Missouri and Oregon.
[5]See ILPA Press Release dated September 3, 2015. A proposed reporting template was made available for comment to ILPA members on September 30, 2015. Comments will be invited from the wider industry, including fund managers and investment advisers, beginning in mid-October. A final version reflecting input from a cross-section of practitioners will be released in early January 2016, along with additional recommendations on third-party compliance reviews and best practices regarding reporting and disclosures.
[6]For example, the average private equity buyout fund charges more than 7% in fees per year. See "Beware of Venturing into Private Equity," by Ludovic Phalippou, Journal of Economic Perspectives, 2009, 23(1): 147-66.
[7]See, CEM Benchmarking, a Toronto-based consulting firm specializing in pension fund performance analysis which estimates that the difference between what is reported and actually charged to investors has averaged at least 2% of total investments per year.
[8]See *In the Matter of Clean Energy Capital, LLC and Scott A. Brittenham, Respondents,* SEC Rel. No. 9551, 2014 WL 709469 (Feb. 25, 2014); See also *In the Matter of Lincolnshire Management, Inc., Respondent,* SEC Rel. No. 3927, 2014 WL 4678600 (September 22, 2014).
[9]See *Cox v ING Investments LLC, 47 F.Supp.3d 209 (U.S. District Court, D. Delaware),* 2014 WL 2567970 (June 6, 2014).
[10]Advisory fees, or monitoring fees, are paid to a fund's investment manager for providing ongoing consulting services to a portfolio company.
[11]Break-up fees are paid to the fund by a target portfolio company when the company wishes to terminate the purchase agreement between itself and the fund in order to accept a higher purchase price from another party. One hundred percent of such fees should offset the management fee until the fund is reimbursed completely for broken deal expenses charged to the fund (thereafter, an 80/20 split to match the carry may be appropriate). In June 2015, SEC charged Kohlberg Kravis Roberts & Co (KKR) with misallocating more than $17 million in broken deal expenses to its flagship PE Funds in breach of its fiduciary duty as an SEC-registered investment adviser. KKR agreed to pay $30 million to settle the charges. KKR did not adopt a broken deal allocation methodology prior to 2011 (more than 2 years after it registered with SEC as an investment adviser) and failed to disclose that broken deal fees would not be allocated to co-investment funds. *(2015 WL 3956127 (S.E.C. No – Action Letter) (June 29, 2015)).*
[12]Divestment fees are paid to the fund by a target portfolio company when an investment is exited.
[13]Directors' fees are paid by portfolio companies to their directors, including representatives of private equity funds serving on the board of directors of those companies.
[14]In *In the Matter of Lincolnshire Management, Inc., Respondent,* SEC Rel. No. 3927, 2014 WL 4678600 (September 22, 2014), the SEC brought fraud charges based on private fund manager's misallocation and lack of documentation of expenses between two affiliated companies.
[15]In 2013, the South Carolina Retirement System Investment Commission (SCRSIC) retained CEM Benchmarking Inc. to perform an independent review of South Carolina Retirement Systems' investment costs and performance. Also, See recently posted LACERA RFP for Consulting Services re: Private Equity Fund Investment Management Fees, Expenses, and Carried Interest Recalculation and Verification Services at http://www.lacera.com/Opportunities/RFP/private_equity_inv_svcs/index.html. RFP specifies that the services sought are for both retrospective and ongoing fees/expenses analyses.
[16]*See* PE Hub news article dated June 30, 2015, *Private Equity and Pensions: A Strong Partnership.*
[17]*Id.*
[18]*Id.*

The Trouble with *Tibble*: The Uncertain Scope of Trustees' Ongoing Duty to Monitor Investments

By: Ashley Dunning and Michael Toumanoff

The U.S. Supreme Court recently re-confirmed that ERISA trustees have an ongoing duty to monitor trust investment options in *Tibble v. Edison International,* 575 U.S. ___, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (May 18, 2015) (6-year statute of limitation did not preclude breach of ERISA defined contribution plan trustees' ongoing fiduciary duty to monitor and remove imprudent investment choices made available to beneficiaries occurring within six years of filing suit):

> Under trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset. … Rather, the trustee must systematically consider all the investments of the trust at regular intervals to insure that they are appropriate.

Tibble, *supra*, 135 S. Ct. at p. 1828 (internal quote marks omitted, citing A. Hess, G. Bogert, & G. Bogert, Law of Trusts and Trustees, § 684, pp. 145-148 (3d ed. 2009)), and concluding:

> In short, under trust law, a fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones.

Id. at pp. 1828-1829 (emphasis added).

With regard to whether or not this duty was active or passive, Tibble did not hold that the mere absence of a triggering event would absolve the trustees of their duty to take some affirmative steps to fulfill their ongoing duty to monitor, although the decision did indicate that the presence or absence of a trigger could have some bearing on the scope of the required review:

> The Ninth Circuit did not recognize that under trust law a fiduciary is required to conduct a regular review of its investment with the nature and timing of the review contingent on the circumstances.

Id. 135 S. Ct. at p. 1827-1828. Although confirming that trustees have an ongoing affirmative fiduciary duty to monitor trust investments, the Tibble court ultimately refused to provide any further specific details of the continuing duty to monitor "of some kind" that was required. Instead it simply remanded the case back to the Ninth Circuit to consider the respondents' specific claims noting, "We express no view on the scope of respondents' fiduciary duty in this case." *Id*. at p. 7. However, some further guidance can be derived from other sources.

Tibble did not make wholly new law. Under longstanding common law trust principles, trustees who invest trust funds have an ongoing duty to monitor those investments in order to comply with their fiduciary duties to exercise prudence and care. See Whitfield v Cohen, 682 F. Supp. 188, 196-197 (S.D.N.Y. 1988):

> …Cohen's common law and ERISA responsibilities did not end with the initial decision to invest Plan assets with Penvest. … Cohen had a duty to monitor Penvest's performance with reasonable diligence and to withdraw the investment if it became clear or should have become clear that the investment was no longer proper for the plan.

Similarly, in Public Service Company of Colorado v. Chase Manhattan Bank, 577 F. Supp. 92 (S.D.N.Y. 1983) the bank trustee of a pension trust was held liable for breach of fiduciary duty for its failure to adequately monitor and timely dispose of a large real estate investment loan that drastically declined in value after years of neglect by the owner that the bank negligently failed to discover, in part because it failed to obtain and review annual reports on the condition of the property that its own policies required. By the time that the bank belatedly discovered the deterioration of the development, it was too late to prevent the large loss to the trust.

The same failure of a trustee to follow its own policies to review and diversify trust assets resulted in removal and surcharge liability for the bank trustee in In re Estate of Rowe, 712 N.Y.S.2d 662 (3d Dept. 2001). The bank was trustee of a charitable lead trust funded entirely with shares of IBM stock, but had failed to take any steps to diversify the trust's investments despite its internal policies that required such diversification. The stock declined for five years until the suit successfully charging the bank with breach of trust for its failure to review and dispose of the inappropriately over-concentrated portfolio was filed.

Federal regulations governing ERISA trustees, although not binding on governmental plan trustees, may be considered as instructive because they apply the same generally applicable prudent investor principles to confirm an ongoing duty to monitor investments that continues beyond the due diligence supporting the initial decision to make the investment performed at the outset. See 29 Code of Federal Regulations ("CFR") § 2509.75-8 Questions and answers relating to fiduciary responsibility under the Employee Retirement Income Security Act of 1974, FR-17:

The Trouble with *Tibble*: The Uncertain Scope of Trustees' Ongoing Duty to Monitor Investments *(continued)*

> Q: What are the ongoing responsibilities of a fiduciary who has appointed trustees or other fiduciaries with respect to these appointments?
>
> A: At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.

Tibble, *supra*, 135 S. Ct. at p. 1828 also relied upon the general principles included in the duties of a prudent investor under § 90 of the Restatement (Third) of Trusts *comment b*, p. 295 (2007):

> The trustee's duties apply not only in making investments, but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved.

The same authority in the Introductory Note ("*Principles of Prudence*," *item 3*) to the Restatement (Third) of Trusts Chap. 17 (the "Prudent Investor Rule") §§ 90-92, at p. 291 (2007) emphasizes that the general standard of prudent investment extends to the monitoring of costs, as well as investment gains and losses:

> The duty to be cost conscious requires attention to such matters as the cumulation of fiduciary commissions with agent fees or the purchase and management charges associated with mutual funds and other pooled-investment vehicles.

Accordingly, principles of prudence include an ongoing fiduciary responsibility on trustees to monitor pension trust investments as a facet of the generally applicable duty to invest prudently. The specific details of how to fulfill that fiduciary responsibility are within the discretion of the trustees. However, we offer the following two general observations.

First, after Tibble it is now established that the duty to monitor is active and ongoing, and hence some process should be adopted and implemented that will ensure reasonable oversight on a periodic basis of the investments made on behalf of the trust that continues beyond the due diligence undertaken when the investment decision was originally made. Ordinarily, such a process will include some method to monitor compliance with the system's existing investment policies and the contractual terms (including diversification and leverage limits, as well as fees and expense allocation provisions) applicable to the particular investments. A process to trigger a more focused review in some circumstances is appropriate, but a process that forgoes any ongoing review whatsoever unless the trigger is met may not be sufficient.

The trustee's duties apply not only in making investments, but also in monitoring and reviewing investments.

Second, any such process must be reasonable, considering the resources available to support it. Although all systems require periodic reports from their investment managers and typically from their investment consultant as well, pension systems vary widely in the degree of staff administrative and budgetary support available to support trustee and staff review of those reports. Exclusive reliance upon self-reporting by investment managers themselves also suffers from the inherent weakness of the self-interest of the managers in concealing their own inadequacies. Unfortunately, those conflicts could only be expected to strengthen, not weaken, with the seriousness of a manager's non-compliance and so such a method would tend to lose reliability at the very time that it was most necessary. Accordingly, trustees may wish to explore the feasibility of a more disinterested approach, either internally, if that is administratively feasible, or through an outside vendor, if such can be done at a reasonable cost. Certainly the investment consultant that performed the initial due diligence to support the original investment may fairly be expected to have continued to monitor the performance of the investment that they had a hand in recommending and as to which the consultant presumably provides regular reports to the retirement system. An inquiry with regard to the consultant's ongoing attitude towards the manager or entity should not be met with hostility from the consultant. Some existing custodian and investment consultants are willing to provide some form of investment compliance monitoring for an additional fee. In addition, some vendors offering forensic fee and expense auditing services have begun to emerge, as trustees have begun to focus on such cost and expense allocation issues. Although not mandating any particular methodology, Tibble is a timely reminder that ignoring consideration of these ongoing obligations is no longer an option.

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The "Pay to Play" Saga Continues: Update on Two Important Decisions Issued Regarding SEC Rule

By: Suzanne M. Dugan

Public pension attorneys should be aware of two recent decisions regarding SEC Rule 206(4)-5, widely known as the "pay to play" rule.[1] The rule prohibits an investment adviser from receiving compensation for advisory services to a government entity for two years after the adviser or its covered associates makes a political contribution to a public official or candidate who is or would be in a position to influence the award of advisory business.

Dismissal of Lawsuit Challenging SEC Rule Affirmed On Appeal

In the first instance, the U.S. Court of Appeals for the D.C. Circuit dismissed the petition of the New York Republican State Committee and the Tennessee Republican Party seeking to invalidate the SEC Rule.[2] Plaintiffs brought suit in the district court, which dismissed the suit for lack of subject matter jurisdiction, concluding that courts of appeals have exclusive jurisdiction to hear challenges to rules promulgated under the Investment Advisers Act of 1940. The Court of Appeals affirmed the District Court's decision, and also held that such challenges must be brought within sixty days of promulgation of the rule. The petition was dismissed as time-barred as there were no grounds for an exception in this case. This decision is likely a lethal blow for constitutional challenges to Rule 206(4)-5, the SEC's powerful tool that is designed to "protect public pension plans and other government investors from the consequences of pay to play practices by deterring advisers' participation in such practices."[3]

SEC Grants First Ever Waiver To The Pay To Play Ban

Following on the heels of the August decision of the D.C. Circuit, on September 22, 2015 the SEC issued an order granting an exemption from Rule 206(4)-5 to Starwood Capital Group Management, LLC.[4] This action represents the first exemption given by the SEC to an investment adviser permitting receipt of compensation from a government entity client for investment advisory services provided to the government entity within the two-year period following a contribution by a covered associate to an official of the government entity. The brief order of SEC staff states that it received no requests for a hearing on a preliminary decision issued in August to waive the ban, and the Commission itself had not ordered a hearing. The order states merely that the matter had been considered and the proposed exemption was found to be appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Investment Advisers Act.

The SEC action ends an effort by Starwood Capital that took more than 18 months and 5 applications to the SEC. According to Starwood, their chief operating officer inadvertently tripped the wire when he made a "spontaneous" $1,000 contribution to an exploratory committee for then Illinois gubernatorial candidate Bruce Rauner. The donation was clawed back nine days later, but automatically disqualified Starwood from receiving compensation from the State Retirement Systems of Illinois for investments in Starwood funds. Starwood stated that the ban would deprive it of about $4 million in compensation, or 4,000 times the amount of the contribution.[5]

In contrast to the SEC's approach in the Starwood matter, in an earlier action in June 2014 the SEC settled its first enforcement action under the rule, with a private equity firm, TL Ventures, paying nearly $300,000 in disgorgement and fines.[6] TL Ventures obtained investments from the Pennsylvania State Employees' Retirement System in two of its private equity funds in 1999 and 2000. TL Ventures also obtained a $10 million investment from the City of Philadelphia Board of Pensions and Retirement in 2000. These private equity funds had lives of ten years with the possibility of extensions of up to two additional years, and the limited partners of these funds were generally restricted from withdrawing their capital during the lives of these funds. The political contributions that triggered the rule were made in 2011 by an associate of TL Ventures, in the amount of $2,500 to a candidate for Mayor of Philadelphia and $2,000 to the Governor of Pennsylvania.

Conclusion

The D.C. Circuit case will likely put to rest any remaining challenges to the SEC's pay to play rule. Public pension attorneys need to be familiar with the SEC Rule and should consider developing and implementing written policies designed to confirm compliance with the rule and avoid situations in which an investment adviser is prohibited from receiving compensation

The "Pay to Play" Saga Continues: Update on Two Important Decisions Issued Regarding SEC Rule *(continued)*

for advisory services for two years after the advisor or its covered associate makes a political contribution. Note that the rule specifically contemplates the provision of uncompensated services to give the government entity sufficient time to redeem or transfer its assets.

Moreover, the exemption from Rule 206(4)-5 granted to Starwood by the SEC should give comfort to those who were concerned, after the TL Ventures case, that draconian consequences could result from the SEC's enforcement. The Starwood case appears to reflect a measured and thoughtful approach by the SEC, and should calm fears that minor, inadvertent violations will have severe repercussions.

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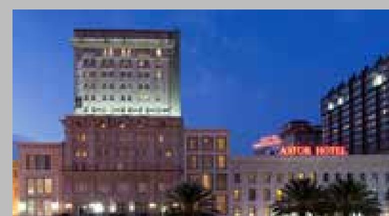
ENDNOTES

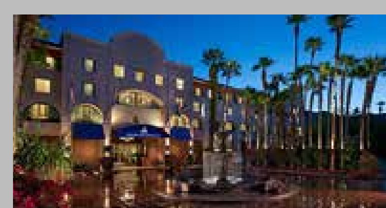
[1]17 C.F.R. § 275.206(4)-5.
[2]New York Republican State Comm. v. S.E.C., ---F.3d ---, D.C. Cir., August 25, 2015 (2015 WL 5010051).
[3]SEC Release No. IA-3043, at 25.
[4]https://www.sec.gov/rules/ia/2015/ia-4203.pdf.
[5]Ed Beeson, "Starwood Capital Gets Final OK For SEC Pay To Play Waiver", *Law 360*, September 23, 2015.
[6]https://www.sec.gov/litigation/admin/2014/ia-3859.pdf.

Mark Your Calendar

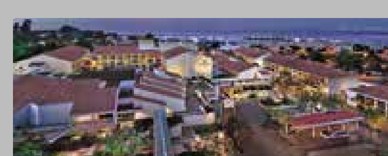
2016 Winter Seminar
Washington, DC (Omni Shoreham Hotel)
February 17 - February 19, 2016



2016 Legal Education Conference
New Orleans, LA (Astor Crowne Plaza)
June 21 - June 24, 2016
New Attorney Session on June 21st



2017 Winter Seminar
Tempe, AZ (Tempe Mission Palms Hotel)
February 22 - February 24, 2017



2017 Legal Education Conference
Monterey, CA (Portola Hotel)
June 27 - June 30, 2017
New Attorney Session on June 27th