A Road Less Travelled: Including Alternative Investments in a 401(k) Plan

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There has been a steadily increasing acceptance of alternative investments as part of a retirement plan's investment portfolio, including the presence of alternative investments on 401(k) plan investment platforms. These alternative investments may include "real estate investment trusts (REITs)," private equity funds, hedge funds, or pooled investment vehicles that frequently do not fall within the traditional asset classes of equity, fixed income, or cash equivalents or may not be registered investment securities. Their appeal lies in their unique asset classes and investment strategies which offer potentially higher returns, diversification, or downside risk protection. This article will discuss some of the issues raised by including such alternative investments on a 401(k) plan's investment menu.

As with any investment, the plan sponsor needs to understand and analyze the alternative investment to ensure that it is prudent and made solely in the interest of plan participants and beneficiaries, as required by ERISA. However, the analysis becomes more complicated, because fiduciaries also must resolve the question of whether the investment itself is deemed to be holding plan assets. If so, additional fiduciary considerations come into play, as discussed below.

Look-Through Rule

Under the Department of Labor's (DOL's) plan asset regulation, when a 401(k) plan invests in a share, interest, or unit of an entity, the plan's assets include the share, interest, or unit but generally do not, solely by reason of such investment, include any of the entity's underlying assets. However, where a plan acquires an alternative investment that is not a publicly offered security or a security issued by a company that is registered under the Investment Company Act of 1940, the plan's assets include not only the closely held equity interest, but also an undivided interest in each of the underlying assets of the alternative investment, unless one of the exceptions in the plan asset regulations is satisfied. This "look-through" rule has traditionally been of great concern to the managers of alternative investments, because if it applies, fund assets will be treated as plan assets subject to ERISA's fiduciary requirements.

The DOL's regulation limits the applicability of the look-through rule to investments in entities that do not produce or sell a product or service or where the entity's product or service relates to the investment of capital. Thus, entities whose underlying assets are *not* plan assets include: (i) a registered security that is widely held and freely transferable, (ii) an operating company engaged in the production or sale of a product or service other than the investment of capital, (iii) a venture capital operating company (VCOC) that actively manages venture capital investments in accordance with the regulation, and (iv) a real estate operating company (REOC) that actively manages and develops real estate in accordance with the regulation. In addition, statutory provisions provide that plan assets do *not* include the underlying assets of a mutual fund or a guaranteed benefit policy issued by an insurance company.

Finally, and importantly, an entity with respect to which "benefit plan investors" hold less than 25 percent of each class of equity interest in the entity will not be subject to the look-through rule. Ongoing monitoring of the 25 percent threshold is critical for many alternative investments so that they will not be deemed to hold plan assets. Fund documentation frequently incorporates this limit and procedures are maintained to track benefit plan investors. However, the managers of certain emerging funds are comfortable meeting ERISA responsibilities and are willing to take plan money in excess of the 25 percent limit. Advisors are available to counsel platform providers as to whether these funds are actually ERISA-compliant. Before making these funds available to participants, plan sponsors should assure themselves that this due diligence has been performed.

Consequences of Holding Plan Assets

If an alternative investment is deemed to hold "plan assets," the investment's managers will become fiduciaries subject to ERISA's duties of prudence and loyalty in their dealings with fund assets, as well as limitations on self-dealing and prohibited transactions. Failure to satisfy ERISA's standards would subject the fiduciary to personal liability for plan losses, the disgorgement of profits, and/or unwinding of the transaction, and additional statutory penalties imposed by the DOL of up to 20 percent. A willful fiduciary failure could potentially trigger criminal liability. Parallel rules under tax law enable the Internal Revenue Service (IRS) to assess an "excise tax" of up to 15 percent on certain prohibited transactions, which can increase to 100 percent if not timely corrected. Finally, ERISA voids, as a matter of public policy, certain exculpatory and risk shifting provisions, such as indemnification from plan assets, for losses that are attributable to fiduciary breaches. Therefore, indemnification provisions,

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standard of care provisions, and representations and warranties in the fund's advisory agreement and offering and disclosure documents must be carefully crafted.

Specific applications of these fiduciary duties include the duty of an ERISA fiduciary to act solely in the interest of plan participants. This means that every fund transaction must be structured so that it avoids any benefit at the plan's expense that flows to the fund itself, the fund managers, or their affiliates. Management incentive fees, in particular, are problematic and may result in a prohibited transaction unless structured to come within DOL exemptions.

The standard of care for fiduciary decisions is the prudence of a similarly situated investment manager. This standard must be applied in the evaluation of potential investment courses of action, taking into account how a proposed investment fits the needs of plan investors, including consideration of the potential for gain and the risk of loss. Further, the rationale for investment decisions must be thoroughly documented.

Plan sponsors should understand that alternative fund managers take the position that the duty to diversify is limited to the alternative investment's specific investment mandate. In other words, it is the ERISA plan's responsibility, not the private fund, to ensure overall portfolio diversity.

ERISA fiduciaries are bound to follow the terms of the plan document. Therefore, plan sponsors can expect alternative fund managers to seek a representation from the sponsor that their plan's investment in the fund will be ERISA compliant.

Alternative investment managers that "handle" plan assets (as would be the case if the manager has discretionary authority over underlying fund assets that are deemed plan assets) must maintain a fidelity bond equal to the lesser of 10 percent of the plan's investment or $500,000.

Conclusion

Employee benefit plan capital continues to flow into alternative investments, and it is important that such an alternative fund be carefully structured to either accept its status as holding plan assets or qualify for an applicable exemption, such as the 25 percent limit on benefit plan investors. Either way, plan fiduciaries need to identify and assess the implications for an ERISA plan of holding an alternative investment. For such an investment whose underlying assets constitute plan assets, it will be very difficult to conduct business unless one of the myriad of statutory and class exemptions from the prohibited transaction rules applies. Plan fiduciaries should assure themselves that the structure and proposed operation of any alternative investment with underlying assets that are plan assets will be in full compliance with applicable prohibited transaction exemptions. ❖

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